

THE STATE OF WISCONSIN

101

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JOINT COMMITTEE ON FINANCE

March 19, 2002

Secretary Richard Chandler
Department of Revenue
2135 Rimrock Road
P.O. Box 8933
Madison, Wisconsin 53708-8941

Dear Secretary Chandler:

We are writing to inform you that the Joint Committee on Finance has reviewed the Department of Revenue lottery prize payout report, received February 28, 2002, pursuant to s. 565.02(7), Stats.

The report includes a slight modification to the weighted payout ratio for on-line games in 2002-03. The recommended 2002-03 increase, from 51.54% to 51.62%, is primarily the result of a plan to include a share of payouts relating to the Supercash on-line game for use on a new version of the lottery television game show.

No objections to this report have been raised. Accordingly, the report is approved.

Sincerely,

Handwritten signature of Brian Burke in black ink.

BRIAN BURKE
Senate Chair

Handwritten signature of John G. Gard in black ink.

JOHN G. GARD
Assembly Chair

BB:JG:dh

cc: Members, Joint Committee on Finance
Robert Lang, Legislative Fiscal Bureau
Vicky LaBelle, Department of Administration



Legislative Fiscal Bureau

One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

March 15, 2002

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Department of Revenue's Annual Lottery Prize Payout Report

Under s. 565.02(7) of the statutes, the Department of Revenue (DOR) is required to submit a lottery prize payout report to the Joint Committee on Finance, not later than March 1 of each year, that includes: (a) an estimate for that fiscal year and for the subsequent fiscal year of the gross revenues from the sale of lottery tickets; (b) the total amount paid as prizes and the prize payout ratio for each type of lottery game offered; and (c) an evaluation of the effect of prize payout ratios of lottery games on lottery sales, lottery operating costs and on maximizing the revenue available for the lottery and gaming tax credit. The report for this fiscal year was submitted to the Committee on February 28, 2002.

The report is subject to a 14-day passive review by the Committee. If, by March 20, the Co-chairs notify DOR that the Committee has scheduled a meeting for the purpose of reviewing the Department's proposed prize payouts, DOR may proceed with its plans for the prize payouts for the subsequent fiscal year only with Committee approval. If the Co-chairs do not notify the Department by March 20 that the Committee has scheduled a meeting to review the Department's proposed prize payouts, the Department's plans for the prize payouts for the subsequent fiscal year are considered approved by the Committee.

The report submitted by DOR addresses the requirements of s. 565.02(7). While the report states that no modifications of the currently approved lottery prize payout ratios are being proposed at this time, our analysis indicates that one modification would require the approval of the Committee. This is discussed below.

Lottery Sales Estimates

Under the 2001-03 biennial budget act (Act 16), lottery sales were projected to total \$403.6 million in 2001-02. In October, 2001, under an annual statutory process whereby the Department of Administration (DOA) and the Joint Committee on Finance certify the amount of lottery funds available for the lottery and gaming tax credit, the 2001-02 sales estimate was modified to \$412.0 million. Under the Department's prize payout report, the estimate for 2001-02 sales remains the same.

Under Act 16, lottery sales in 2002-03 were estimated at \$402.9 million. Under the March prize payout report, this estimate is reduced to \$400.4 million. This reduction totals nearly \$2.5 million and reflects: (a) lower sales estimates for scratch ticket sales (-\$4.8 million); and (b) higher pull-tab sales (\$0.9 million) and on-line sales (\$1.5 million). These minor modifications to the estimate made under Act 16 reflect the Department's latest sales projections.

This office will be reviewing sales estimates for 2002-03 in October, 2002, under the annual statutory process to certify the amount of lottery funds available for the lottery and gaming tax credit in 2002-03.

Payout Ratios

Changes in prize payout ratios for instant games were approved by the Joint Committee on Finance on June 22, 1994. At that time, the average payout ratio for instant scratch tickets was increased to no more than 63% (from 61.26%) and the average payout ratio for pull-tab instant games was increased to no more than 62.5% (from 60.38%). On-line game payouts were maintained at 51.54%, which was the weighted average for on-line game payouts at that time. On March 22, 2000, the Committee approved one further modification: the maximum payout ratio for pull-tab ticket sales by nonprofit organizations was increased from 62.5% to not more than 80%.

While the report states that no increase in payout ratios is being requested at this time, the report does reflect a slight modification to the weighted payout ratio for on-line games in 2002-03, to 51.62%. This represents an increase to the current on-line ratio of 51.54% approved by the Committee in 1994. The 2002-03 increase is primarily the result of a plan to include a share of payouts relating to the Supercash on-line game for use on a new version of the lottery television game show. This change, which is discussed in the report, would allow some Supercash players the opportunity to win additional prizes on the game show.

Summary

The report before the Committee conforms to the requirements of s. 565.02(7) and informs the Committee of modifications relating to a new version of the lottery television game show that

would include players of the Supercash on-line game. This change would have a slight effect on the prize payout ratio for on-line games. Approval of the report would allow the on-line payout ratio to increase from 51.54% to 51.62%. In the report, the Department estimates lottery sales of \$412.0 million in 2001-02 and \$400.4 million in 2002-03.

The Committee's response to the lottery's proposal must be provided to DOR no later than March 20, 2002.

BL/AZ/sas/bh

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JOINT COMMITTEE ON FINANCE

MEMORANDUM

To: Members
Joint Committee on Finance

From: Senator Brian Burke
Representative John Gard

Re: 14-Day Passive Review Approval

Date: March 1, 2002

Attached is a copy of a report from the Department of Revenue, received February 28, 2002, which contains information on lottery sales and prize payouts. The report, which recommends no changes to the prize payout ratio at this time, requires 14-day passive review and approval by the Joint Committee on Finance, pursuant to s. 565.02(7), Stats.

Please review the material and notify **Senator Burke** or **Representative Gard** no later than **Monday, March 18, 2002**, if you have any concerns about the report or if you would like the Committee to meet formally to discuss it.

Also, please contact us if you need further information.

Attachment

BB:JG:dh



State of Wisconsin • DEPARTMENT OF REVENUE

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Scott McCallum
Governor

Richard G. Chandler
Secretary of Revenue

February 28, 2002

The Honorable Brian Burke, Co-Chair
Member, Joint Committee on Finance
316 South Capitol
Madison, WI 53702

The Honorable John Gard, Co-Chair
Member, Joint Committee on Finance
315 North Capitol
Madison, WI 53702

Dear Senator Burke and Representative Gard:

Section 565.02(7), Wis. Stats., requires a report to the Joint Committee on Finance every March 1, containing the following information:

- A. An estimate, for the current and subsequent fiscal years, of gross revenues from the sales of lottery tickets;
- B. The total amount paid as prizes and the prize payout ratio for each type of lottery game offered, based on these sales estimates; and
- C. An evaluation of the effect of prize payout ratios of lottery games on lottery sales, on lottery operating costs and on maximizing the revenue available for lottery property tax relief.

The February 28, 2002 report, which is attached, does not recommend base changes to prize payouts. Please call me if I can answer any questions.

Sincerely,

Richard G. Chandler
Secretary of Revenue

Enclosure

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EXHIBITS

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A. HISTORY AND RECOMMENDATIONS

The maximum average payout percentage that the Lottery can offer is subject to approval by the Legislature's Joint Committee on Finance. Section 565.02(7), Wis. Stats., requires a report by the Lottery to the Joint Committee on Finance by March 1, 2002 containing the following information:

- A. An estimate, for fiscal years 2001-02 and 2002-03, of gross revenues from the sales of lottery tickets;
- B. The total amount paid as prizes and the prize payout ratio for each type of lottery game offered, based on these sales estimates; and
- C. An evaluation of the effect of prize payout ratios of lottery games on lottery sales, on lottery operating costs and on maximizing the revenue available for lottery property tax relief.

Statutory provisions require that at least 50% of Lottery gross sales be returned to players as prize payments [s. 25.75(3)(a), Wis. Stats.]. For fiscal year 2000-01, 58.05% of Lottery gross sales were returned to players as prize payments. The estimated prize payments for fiscal year 2001-02 are 57.91% of gross sales.

Following a Joint Committee on Finance hearing in May 1994, the average instant scratch ticket prize payout increased from about 61% to 63% and the average pulltab ticket prize payout increased from about 60% to 62%. Following review by the Joint Committee on Finance in 2000, the maximum pulltab ticket prize payout for non-profit retailers increased from about 62% to 80%. The Lottery has held the average instant scratch ticket prize payout at approximately 63% since 1995.

In the last three fiscal years, the average prize payout has risen slightly for the on-line/terminal generated games. On-line/terminal generated games are different from instant games in that it is difficult to predetermine the prize payout, due to the randomness of the selection of winners. For fiscal year 2000-01, the average prize payout across all on-line/terminal generated games was 50.91%. Actual prize payouts for individual on-line/terminal generated games ranged from 39.07% (Cash 4 Life) to 63.73% (Money Roll).

The Lottery is not planning any changes to the instant scratch and pulltab prize payout at this time. The Lottery does plan, however, to allow on-line/terminal generated game players the opportunity to participate in an updated version of the Lottery television game show. This change will involve moving some of the prize payout support of the television show from the instant scratch games to the Supercash! on-line/terminal generated game.

B. GROSS REVENUES FROM LOTTERY SALES (FY 1998-99 through FY 2002-03)

Table 1 shows sales by game type for the past three years and projected sales for the next two years. A decrease in on-line/terminal generated sales in FY 1999-00, primarily due to lower Powerball sales, was partially offset by an increase in instant scratch sales.

Compared to FY 1998-99, total sales decreased in FY 1999-00 by 5.02%. In FY 2000-01, instant ticket sales decreased by 1.03% and on-line sales decreased by 1.44% compared to sales in FY 1999-00. Total sales decreased in FY 2000-01 by 1.35%.

Total sales for FY 2001-02 are expected to exceed those of the previous fiscal year. On-line/terminal generated sales are expected to be higher due to very large Powerball and Megabucks jackpots early in the fiscal year. Although instant sales were slightly ahead of last year's pace earlier in the fiscal year, it is anticipated that sales will end up lower than last year's totals. (The instant sales were impacted significantly by the terrorist attacks in September. That negative impact appears to have dissipated at this point.)

Exhibits 1 through 4 are graphical representations of Lottery sales. A review of these exhibits shows that Lottery sales seem to have stabilized in the last three years.

Table 1
Ticket Sales by Fiscal Year and Game Type

Game Type	FY 1998-99 Sales Audited	FY 1999-00 Sales Audited	FY 2000-01 Sales Unaudited	FY 2001-02 Sales Projection	FY2002-03 Sales Projection
Instant Scratch	\$224,892,513	\$235,594,455	\$233,165,354	\$226,834,700	\$229,103,000
Pulltab	\$5,925,122	\$5,446,440	\$4,778,852	\$4,778,900	\$4,778,900
On-line/terminal generated	\$197,378,447	\$165,629,273	\$163,244,348	\$180,395,300	\$166,527,900
Total	\$428,196,082	\$406,670,168	\$401,188,554	\$412,008,900	\$400,409,800

C. TOTAL PRIZE PAYOUT RATIOS AND PRIZES PAID OR EXPECTED TO BE PAID (FY 1998-99 through FY 2002-03)

Table 2 shows the weighted actual average prize payout percentages by game type for the past three years and estimated prize payout percentages for the next two fiscal years. A weighted average is used to attribute more importance to games with higher sales, instead of giving all games equal consideration. The prize payout percentage is the average amount of the game's cost that is returned to players in the form of prizes. A game's prize structure is used to determine its prize payout percentage. Each individual game has a unique prize structure that represents the number, value and odds of winning each prize in that game.

Table 2
Weighted Average Prize Payout Percentages by Fiscal Year and by Game Type
 (percentages are rounded)

Game Type	FY 1998-99 Prize Payout	FY 1999-00 Prize Payout	FY 2000-01 Prize Payout	FY 2001-02 Prize Payout Projection	FY 2002-03 Prize Payout Projection
Instant Scratch	62.33%	62.84%	62.91%	62.90%	62.90%
Pulltab	61.76%	61.86%	62.60%*	62.96%*	62.96%*
On-line/terminal generated	47.05%	48.89%	50.91%	51.50%	51.62%
Total	55.28%	57.15%	58.05%	57.91%	58.21%

*Includes 80% prize payout game(s) for non-profit retailers. For-profit average is 61.96%

Table 3 shows actual prizes paid during the past three fiscal years and expected prizes to be paid in the next two fiscal years. Expected prizes to be paid in FY 2001-02 and FY 2002-03 are calculated by taking the sales projection for each game multiplied by the prize payout percentage for that *individual* game. Actual prizes paid, as a percentage of sales, may be less than the designed prize payout for several reasons, such as winners not claiming their prizes.

Table 3
Actual Prizes Paid or Expected to be Paid by Fiscal Year and by Game Type*

Game Type	FY 1998-99 Prizes Paid (Audited)	FY 1999-00 Prizes Paid (Audited)	FY 2000-01 Prizes Paid (Unaudited)	FY 2001-02 Projected Prizes	FY 2002-03 Projected Prizes
Instant Scratch	\$140,181,716	\$148,050,991	\$146,461,791	\$142,679,026	\$144,105,800
Pulltab	\$3,659,348	\$3,369,090	\$2,994,258	\$ 3,009,150	\$3,009,200
On-line/terminal generated	\$92,860,756	\$80,983,869	\$83,071,579	\$92,908,014	\$85,966,100
Total	\$236,701,820	\$232,403,950	\$232,527,628	\$238,596,190	\$233,081,100

*Prize amounts shown are based upon the accrual method. In certain situations (i.e. merchandise prizes), prizes are paid for up front (to the merchandise vendor). These up front costs may create a transitory situation where prize payout appears to be higher than it actually is. The accrual method reflects prizes as they are paid out to the players, and is consistent with generally accepted accounting principles (GAAP).

D. EVALUATION OF PRIZE PAYOUT RATIOS

On-Line/Terminal Generated Games and the Prize Payout Ratio

Actual on-line/terminal generated prize payout ratios currently average 50.91%. For on-line/terminal generated games offered, the payout ratios range between 47.04% and 63.73%. Table 4 lists the on-line/terminal generated games and associated designed prize payouts that are offered in Wisconsin. Actual prizes paid, as a percentage of sales, may be less than the designed prize payout for several reasons, such as winners not claiming their prizes. Prizes paid, as a percentage of sales, may also be more than the designed prize payout due to the random nature of on-line/terminal generated game drawings.

TABLE 4
Currently Offered On-Line/Terminal Generated Games and Corresponding Start Dates and Prize Payout Rates*

ON-LINE/TERMINAL GENERATED GAMES	START DATE	DESIGNED PAYOUT
POWERBALL	4/19/92	Approx. 50.00%
WISCONSIN'S VERY OWN MEGABUCKS	6/18/92	53.50%
SUPERCASH!	2/4/91	51.60%
DAILY PICK 4	9/15/97	Approx. 48.40%
DAILY PICK 3	9/21/92	48.20%
MONEY ROLL	9/8/00	52.00%

* Reflects anticipated rate based on game design

On-Line/Terminal Generated Market Trends and Prize Payout

Traditionally, prize payout for on-line/terminal generated games has been lower than for instant scratch games. The appeal of the on-line/terminal generated games has been primarily the chance to win a large jackpot prize or a better chance to win more significant prizes. However, as on-line/terminal generated games mature, it becomes more difficult to maintain player interest. Even though the Supercash!, Megabucks and Daily Pick 3 games each has a loyal player base, sales for these games have tended to erode over an extended period of time. The exception to this erosion in the short term has been Megabucks, which has benefited most recently by the record high \$20.3 million jackpot won in August of 2001. Currently, Megabucks sales are exceeding last fiscal year-to-date and exceeding sales at similar jackpot levels compared to last year.

2002 Prize Payout Report

On-line/terminal generated games require more effort and expense to change, so changes are not made as frequently to those type games. However, it is important to maintain product freshness by the rotation of games available or by making more subtle changes to the current game mix. Current strategy for the Wisconsin Lottery is to launch a new game approximately every 12 to 18 months to create new product news, and to continue to work with older games in the mix in an attempt to maintain player interest.

Many states have experienced a reduction in jackpot game sales at similar jackpot levels in recent years. Exhibit 5 shows the average Powerball sales per jackpot level for Wisconsin. Exhibit 6 shows the decline in average Wisconsin sales for various Powerball jackpot levels over seven and one-half years. Exhibit 7 shows the average Megabucks sales per jackpot level. In the last fiscal year Megabucks sales increased slightly to more than \$22.9 million and Powerball sales decreased to \$67 million. Powerball and Megabucks sales were boosted in August of 2001 by a near record \$295 million Powerball jackpot and a record \$20.3 million Megabucks jackpot.

As shown in Exhibits 5, 6 and 7 even if high jackpots occur in the future it will become increasingly difficult to obtain higher sales totals for jackpot games, as players continue to become "desensitized" to high jackpot levels. The Powerball Game Group, a sub-unit of the Multi-State Lottery Association continues to work on improving that product, and the Wisconsin Lottery is exploring options that would help maintain interest in the in-state Megabucks jackpot game. It is important to note that the segmentation study conducted in the year 2000 indicates that "players from each of the core player segments recognize the appeal of multi-million dollar prizes", and rolling jackpots.

The Lottery continues to implement a strategy that includes on-line/terminal generated games with smaller top prizes. The City Picks game, with a top prize of \$50,000 will replace Money Roll, a game with a top prize of \$500,000. The new game is expected to provide renewed interest in the product line and a considerable number of winners at significant prize levels. The Lottery should benefit both from greater sales for City Picks, and a lower overall prize payout, which in turn will result in an increase to the bottom line.

The primary elements of the current strategy are: 1) to launch games more frequently 2) to refresh or offer additional value on current games, and 3) to offer greater frequency of wins on games with a lower top prize to increase the number of prizes awarded. The focus will be on these three elements rather than significantly increasing prize payout. The Lottery will continue to develop this strategy in an effort to strengthen the overall game mix. As a further example, the Lottery plans to provide extra value by adding a Money Game Show entry opportunity for Supercash! players.

Opportunities to enhance the jackpot games will not be ignored. Powerball continues to be the best selling game the Lottery offers. The Power Play game feature was added to Powerball in March of 2001. Power Play offers players the opportunity to win higher secondary level prizes. From its introduction to the end of the second quarter of fiscal year 2002, Power Play has added over \$3 million to sales. The Powerball Game Group continues to discuss enhancements to the game. To date, discussions for improvements to Powerball have not included increasing the prize payout.

The replacement of up to 375 instant ticket retailer terminals with equipment capable of producing on-line tickets has begun and will continue through the current fiscal year. Addition of these enhanced function terminals will add to player convenience and could have a positive impact on sales.

Instant Scratch Games Market Trends and the Prize Payout Ratio

Since 1998-99, fiscal year sales of instant scratch tickets have been no lower than \$224 million. It is anticipated that total instant scratch sales will decrease slightly in FY 2001-02, from fiscal year 2000-01; going from \$233.2 million to \$226.8 million in the current year, and then increasing to \$229.1 million in 2002-03. Sales have remained relatively stable without a prize payout increase since calendar year 1995. It may be advantageous to increase prize payout at some point, but the Lottery plans to pursue other strategies in order to maintain instant game sales. These strategies include introducing new play formats, improving the Retailer Performance Program so retailers can better benefit from their own marketing efforts and having the field and telemarketing staffs work with retailers to improve the marketing of games at retail outlets.

Beginning with the introduction of higher price point tickets in 1994, Lottery instant game strategy has been to offer more in prize payout as a player risks more in the purchase price of a ticket. Thus, higher price point tickets normally offer higher top prizes, better overall odds of winning and higher prize payout. Sales of \$1 instant scratch tickets have declined over the years and sales of higher price point scratch tickets have increased. This sales shift reflects a trend to introduce more higher price point tickets, resulting in higher sales in these price categories. The Wisconsin Lottery strategy has been to mirror an industry strategy to offer a wider variety of higher price point tickets. Sales of \$5 instant scratch tickets have remained relatively stable. Exhibit 8 depicts these trends.

In the last fiscal year, the Lottery introduced instant scratch tickets at the \$3 and \$10 price points with positive results. As more higher price point tickets are offered, it becomes more difficult to balance the prize payout between the lower and higher prize payout tickets, in order to offer products that will appeal to potential players. Previous segmentation studies have revealed that players desire to win more frequently. The Lottery has employed a strategy to offer some games with more winners, but without increasing overall prize payout, it is difficult to offer games that provide frequent winning experiences as well as reasonable opportunities to win significant prizes.

To date, the Lottery's Money Game TV Show has been supported solely by the instant scratch games. Players have had the opportunity to appear on the TV show by playing certain scratch tickets. These \$1 scratch tickets have been of higher prize payout, in order to support the TV show. Over time, this type of ticket has lost much of its appeal with the players. It was determined that a new game design would be developed in order to refresh the game.

The format will be changed to allow both instant and on-line/terminal generated players the opportunity to appear on the show. Instead of many instant games supporting the show, one scratch game will be designated as the game show ticket. In addition, an on-line/terminal generated element will be added to the play. Players will also have the opportunity to appear on the television show by purchasing a Supercash! ticket. This will allow the Lottery to refresh an old but still productive Supercash! game. The overall prize payout for the TV game show will be reduced somewhat. The current estimated

prize payout per show is approximately \$93,000. In the newly formatted game, the prize payout will be reduced to approximately \$83,000 per show. The revamp of the television show will not greatly impact on total prize payout, but it will provide freshness to both product lines.

Pulltab Games Market Trends and the Prize Payout Ratio

Sales of pulltab tickets have continued to decline since the inception of the Lottery. The number of for-profit retailers selling pulltab tickets has declined over time. However, the number of nonprofit retailers selling the product has been relatively stable for more than five years. Pulltab tickets contributed less than \$4.7 million to Lottery sales in the most recent fiscal year; however, the Lottery recognizes an opportunity to increase sales in this product line. The Lottery continues the process of placing marketing emphasis on pulltab tickets, including implementing administrative rule changes to help support nonprofit organizations (NPOs) in their efforts to sell pulltab tickets.

This product provides a fund raising opportunity for non-profit organizations in Wisconsin. Following Joint Finance Committee approval two years ago, the Lottery raised the prize payout for several pulltab games to 80%. Non-profit retailers can purchase either these higher payout games or games that pay out approximately 62% of sales in prizes. Thus, those who may be concerned about a lower profit margin with the 80% payout tickets can continue to order and sell 62% payout tickets. The Lottery continues to investigate ways to assist NPOs in their fund raising efforts using pulltab tickets.

Continuing to maintain the same level of pulltab sales to for-profit retailers will be difficult in light of a recent court decision allowing the sale of "collectible" pulltab style tickets that adhere to s100.16(2), Wis. Stats. These tickets pay for-profit retailers a commission that is over three times what the Lottery can offer. It is anticipated that, barring any statutory change, pulltab sales to for-profit retailers will significantly decrease. In addition, this ruling, which in effect allows businesses to run their own lottery, could significantly impact total Lottery sales in the long run. The Lottery is exploring ways to address this concern.

Table 5 summarizes financial differences at retail between "collectible" style tickets and Wisconsin Lottery tickets.

TABLE 5
"Collectible" tickets vs. Wisconsin Lottery tickets (For-Profit Retailers)

	Collectible pulltab tickets	Wisconsin Lottery/pulltab tickets
Prize payout	68.75% of gross sales	61.96% of gross sales
Retailer Commission	21.53% of gross sales	6.25% of gross sales
For-profit retailer cost	9.72 % of gross sales	31.79% of gross sales

Since collectible style pulltab tickets do not contribute to property tax relief, they can offer a higher prize payout to players. In addition, the commission to for-profit retailers is more than three times that paid by the Wisconsin Lottery. Finally, the cost to for-profit retailers is significantly less for collectible tickets.

Those businesses providing collectible style tickets to retailers also offer ticket vending machines. These machines are placed in retail locations on a "no cash to purchase basis." The retailer pays for, and eventually owns, the machine though sales of a stipulated amount of collectible tickets. Pulltab vending machines are widely, and successfully used by state lotteries in Iowa, Missouri and Kentucky – states that have significantly higher pulltab sales than those in Wisconsin.

Assuming the collectible style pulltab ticket eventually captures the Wisconsin Lottery's for-profit pulltab retailer market share, approximately \$2,150,505 of gross Lottery sales will be lost. Those businesses now offering collectible pulltab tickets are contemplating offering scratch tickets. If this comes to pass, the Lottery's more than \$200 million per year scratch ticket sales could be in serious jeopardy.

Overview of Lottery Activity and Impact on Sales and Operating Costs

The Wisconsin Lottery continues to operate at efficient levels relative to other jurisdictions. The Lottery's operating expenses are approximately 8% of total revenues. Exhibit 9 demonstrates that the Wisconsin Lottery is 13th best of 38 United States lotteries when expenses are compared to total revenues. Primarily high population urbanized states fare better than Wisconsin when compared this way. Among neighboring lottery states, only Illinois, another state with high population, has a better operating efficiency when viewed in this manner.

The Lottery has made major efforts to strengthen its relationship with retailers through field marketing and telemarketing staffs as well as its Retailer Performance Program. Retailer response has been positive. Additional field staff have helped stabilize the retailer base which had been in decline for years. Field marketing staff have been critical in the placement of Lottery products at retail locations, and have helped in successfully introducing higher price point tickets to retailers. The stabilization of Lottery sales in recent years is in part due to the efforts of the field and telemarketing staffs.

Improvement of the game mix is an ongoing initiative for all product categories. New price point levels have been added to the instant scratch games and results are positive. For example, retailers have been supportive of higher price point tickets that offer the opportunity to increase their profits with fewer transactions. In addition, variety in game themes and prize payouts has been added to instant pulltab products. The Lottery continues to work on reversing the sales trend in this product category.

In March, the Lottery will replace the on-line/terminal generated Money Roll game with City Picks, featuring a theme with Wisconsin emphasis. Older products will be refreshed. Supercash! will be used as an entry vehicle for the updated TV show, adding value to the game. The Lottery is considering the use of Megabucks as a tie-in to a Lottery anniversary event. Future changes to the Powerball game would be accomplished in conjunction with the Powerball Game Group. Placement of upgraded on-line terminals should result in greater player convenience and positively impact sales.

Completion of a second segmentation study in 2000 improved the Lottery's understanding of the marketplace. Another study will be completed in 2002. Information obtained in these studies affords the Lottery a better view of player attitudes and preferences. The studies have helped document specific changes in the market over

time. Information obtained in the segmentation studies is used for determining product design and marketing direction.

The primary focus of the Lottery continues to be property tax relief for the citizens of Wisconsin. This is accomplished through the sale of Lottery products. However, the Wisconsin Lottery continues to be recognized among lotteries in the United States, as the most "restricted" in operation.

Advertising is a major example of these restrictions. The current advertising budget of \$4.6 million has remained constant since 1990. Due to inflation, the "real" dollars available for Lottery advertising decline each year. When adjusted on the basis of the Consumer Price Index, a \$4.6 million budget in 1990 would be a \$6 million budget today. Over this time, media expenses have increased at a greater rate than average inflation costs, leaving even fewer comparable dollars in the Lottery advertising budget. The Wisconsin Lottery has the lowest per capita advertising spending of lotteries in the Midwest.

Other examples of restricted activities are new technologies and enhancements being introduced into the lottery industry. Advances such as Keno, video lottery machines and instant ticket vending machines are just a few of the examples of options that are utilized by other state lotteries but are either prohibited or are not allowed funding in the State of Wisconsin.

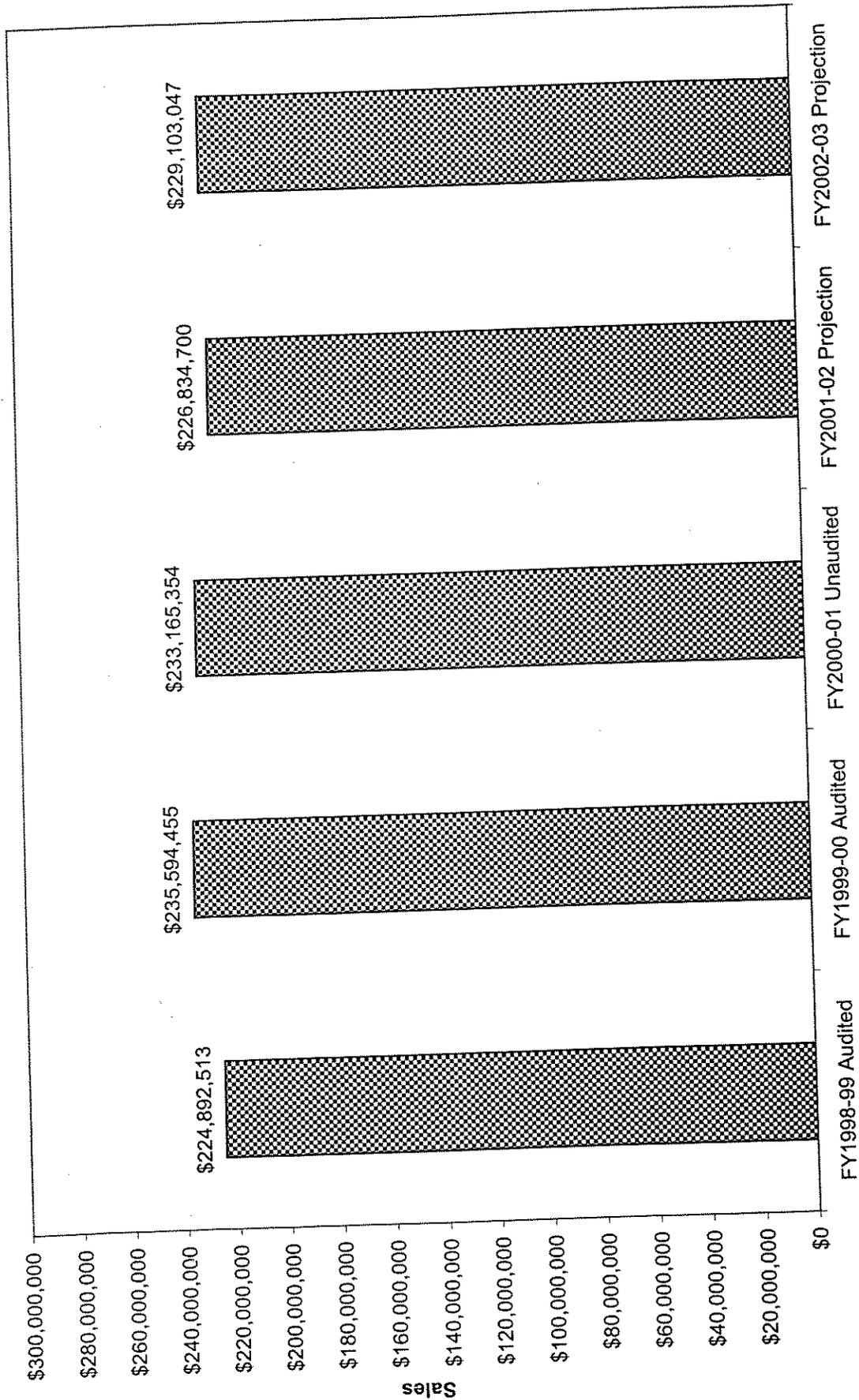
Combined with these restrictions is the level of competition coming from Native American gaming outlets scattered throughout the state. The State of Wisconsin, on a per capita basis, has more Native American-owned casinos than any other state in the nation. Over time this proliferation of gaming outlets, as well as their non-restricted ability to advertise their presence in our state, could realistically undermine the chance for improved sales of Lottery products.

Based on the aforementioned items, significant increases in Lottery revenue are not likely. At the current level of support for Lottery initiatives, sales will probably continue to be flat or declining over time.

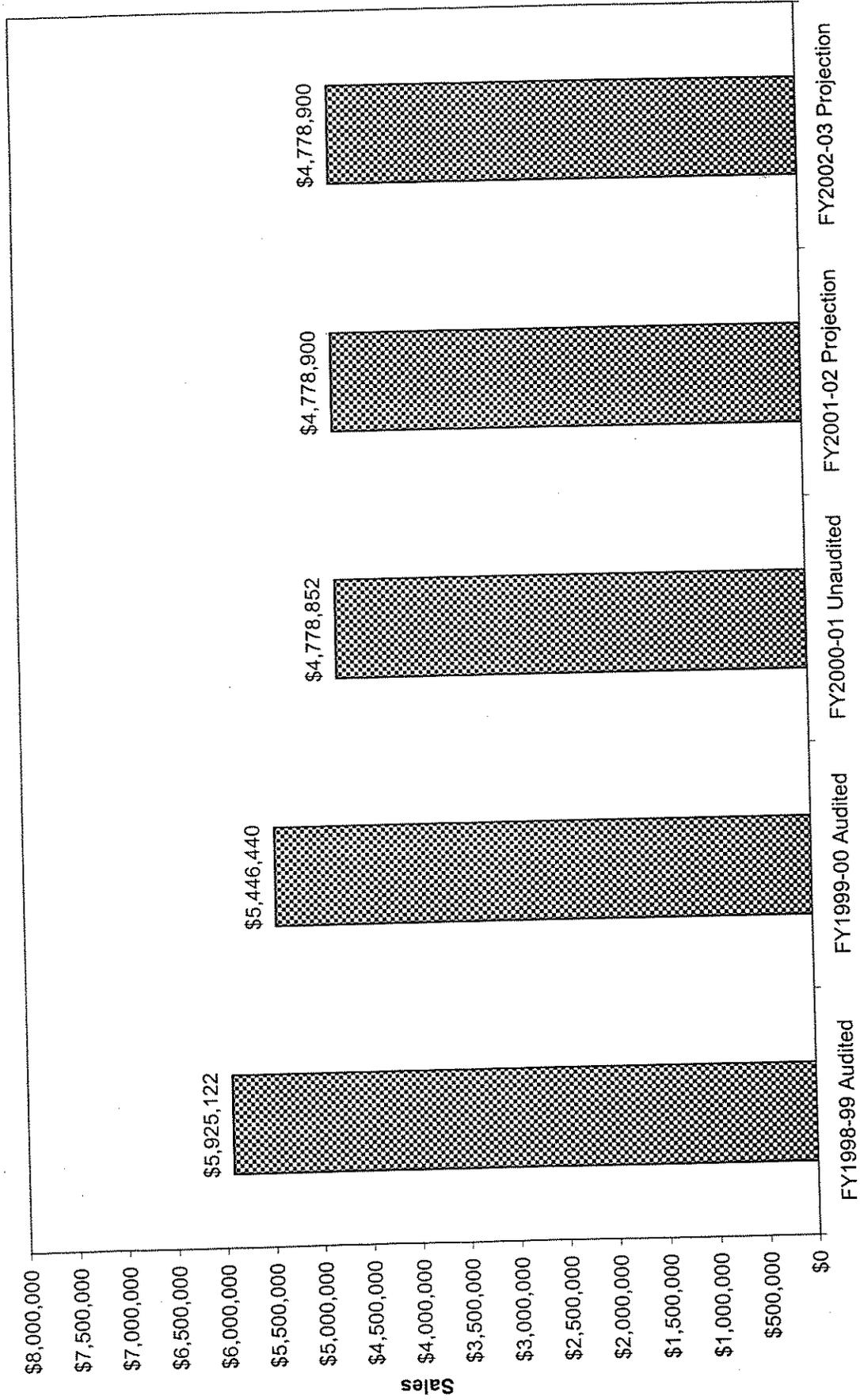
Summary

The Lottery does not recommend changes to the base prize payout for any of the three product lines at this time. One specific exception is made in the case of the Supercash! game, which will be used to help support the new version of the Lottery television show. The maximum impact of that change has been noted in tables 2 and 3 above. Other avenues will be pursued to address player preferences and to maintain a healthy game mix. Efforts will continue to maximize funds available for property tax relief.

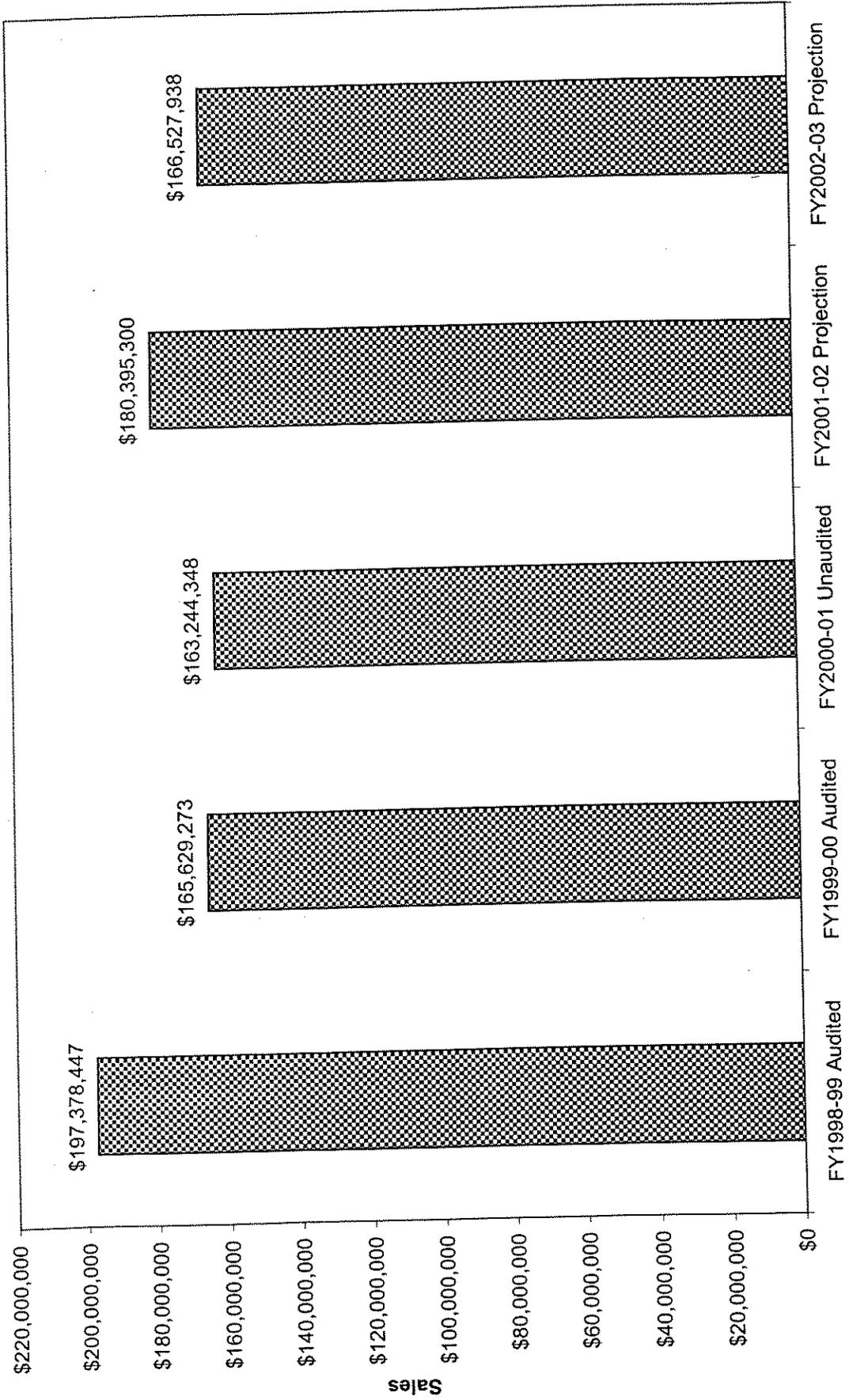
Total Instant Scratch Ticket Sales



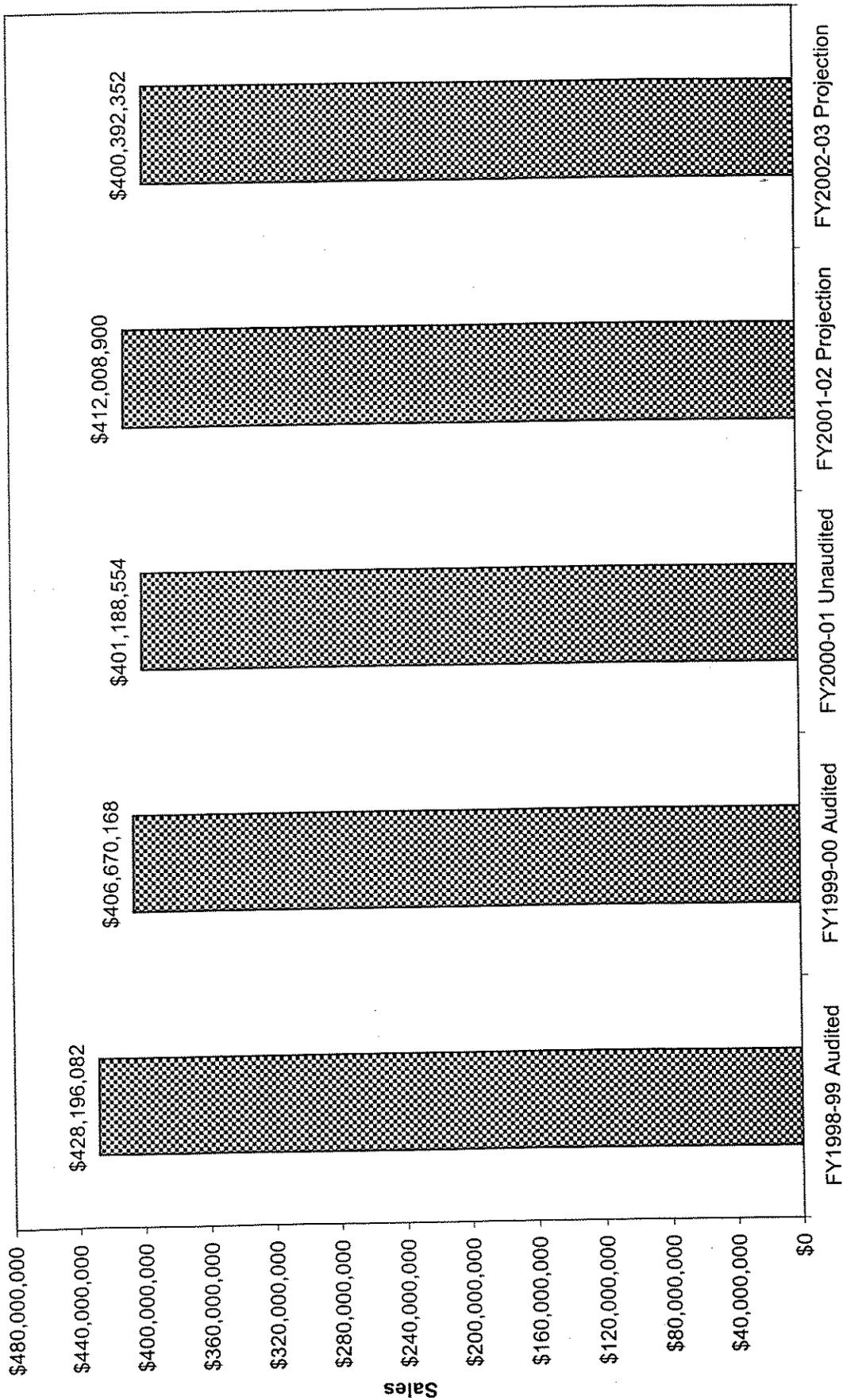
Total Pulltab Ticket Sales



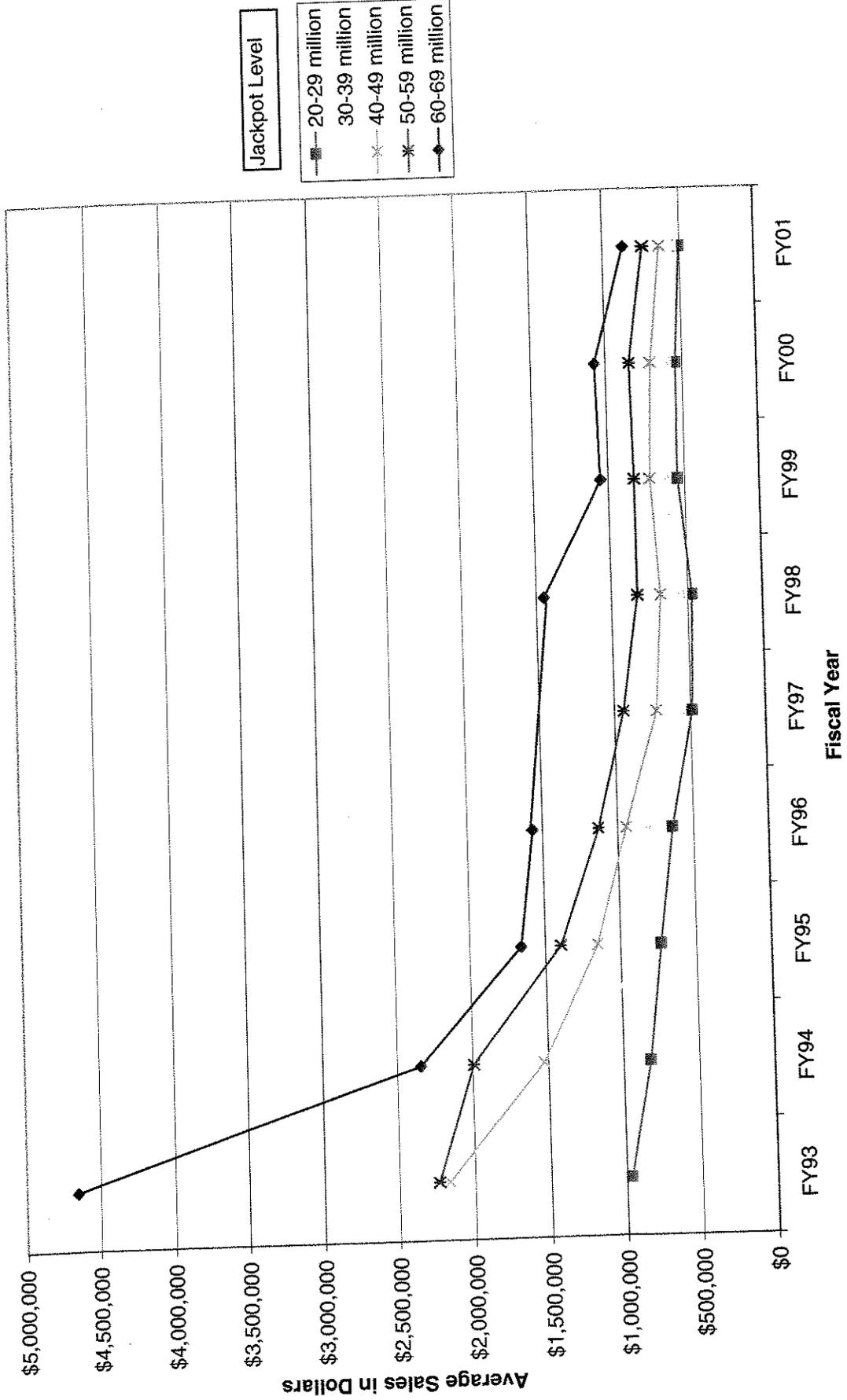
Total Terminal Generated Sales



Total Lottery Sales



Sales Over Time For Various Powerball Jackpot Levels



Instant Scratch Ticket Sales By Price Point 4 Week Moving Averages

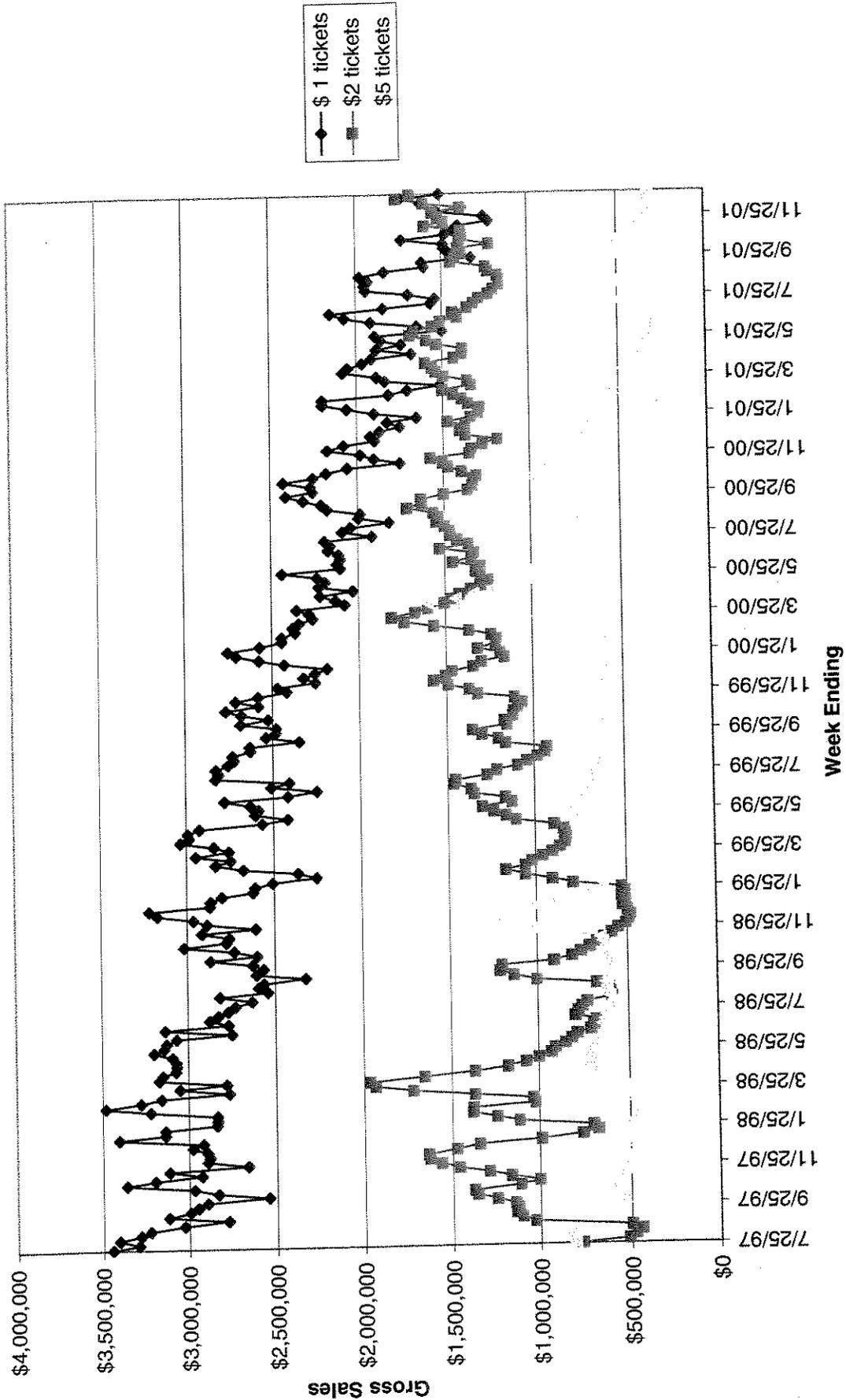
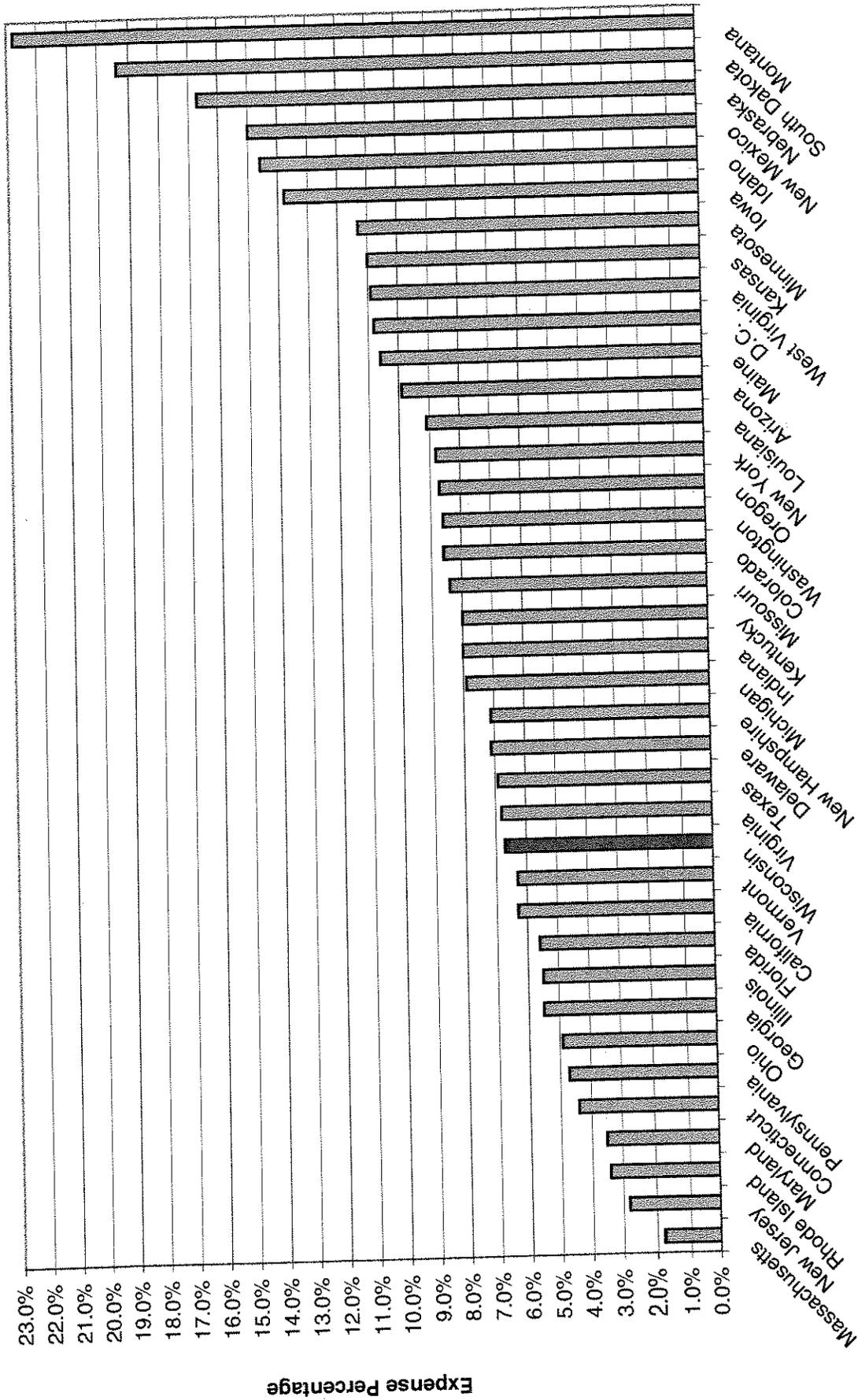


Exhibit 9 Expenses As A Percentage Of Total Revenue By State



STATE OF WISCONSIN

SENATE CHAIR
BRIAN BURKE

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ASSEMBLY CHAIR
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JOINT COMMITTEE ON FINANCE

March 20, 2002

DHFS Secretary Dubé
1 West Wilson Street, Room 650
Madison, WI 53707

Dear Secretary Dubé

It is the understanding of the Joint Committee on Finance that the state expects to receive approximately \$19.3 million from the federal government to support a variety of bioterrorism preparedness activities. It is possible that these federal funds could be used to support some of the activities for which the Governor had proposed additional GPR funding as part of the 2001-03 budget reform bill (SS AB 1).

During its deliberations on the Governor's bill, the Committee reduced or eliminated GPR funding for several of these items and included provisions that would direct DHFS to include, in the plan DHFS is required to submit to the U.S. Department of Health and Human Services (DHHS), proposals to fund several items with these federal funds, to the extent that these items would be eligible for funding under the federal program, including:

- Up to \$3,600,000 for: (a) communications equipment; (b) safety or protective equipment for law enforcement officers, fire fighters, emergency medical technicians, first responders or local emergency response team members who respond to emergencies; (c) training related to investigation or prevention of, or response to, acts of terrorism that pose a threat to the environment; (d) information systems, software or computer equipment for investigating acts of terrorism that pose a threat to the environment; (e) training for specific special events where heightened security exists; (f) hazardous materials response teams; and (g) and volunteer emergency entities that are short-staffed or in need of additional training;
- 2.5 positions to perform surveillance of, and respond to, communicable and infectious diseases and biological and chemical potential threats to the state;

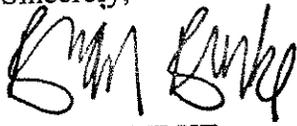
- Funding to support the development and implementation of the statewide trauma system; and

- 1.0 position for the state laboratory of hygiene and all bioterrorism related laboratory expenses.

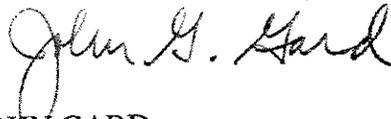
In addition, the Committee included a provision in the budget reform bill that would direct DHFS to submit its plan for the use of the federal bioterrorism funds to the Committee for review and approval before DHFS submits the plan to DHHS.

Although the budget reform bill may not be signed into law before the April 15, 2002 (the deadline for submittal of the plan to DHHS), the Committee requests that DHFS comply with the intent expressed in these budget amendments.

Sincerely,



BRIAN BURKE
Senate Chair



JOHN GARD
Assembly Chair

BB:JG:dh

cc: Members, Joint Committee on Finance
Secretary George Lightbourn, DOA

STATE OF WISCONSIN

SENATE CHAIR
FRANK J. BURKE



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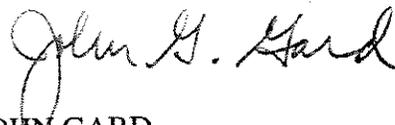
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BRIAN BURKE
Senate Chair



JOHN GARD
Assembly Chair

BB:JG:dh

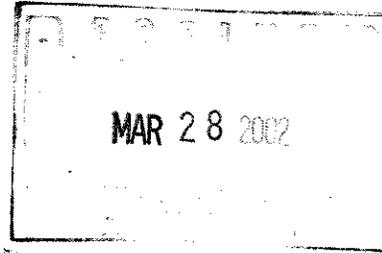
cc: Members, Joint Committee on Finance
Secretary George Lightbourn, DOA



State of Wisconsin Investment Board

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March 20, 2002

Honorable Brian Burke, Co-Chair
Joint Committee on Finance
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Honorable John Gard, Co-Chair
Joint Committee on Finance
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Mr. Donald Schneider, Senate Chief Clerk
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Mr. John Scocos, Assembly Chief Clerk
PO Box 8952
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Members of the Legislature:

Pursuant to ss. 25.17(14g) and (14m), Stats., I have attached a copy of the annual report to the Legislature regarding our goals, long-term strategies and performance. As we have done in previous years, we have combined the two reports to make it easier to understand the relationship between strategies and performance. In addition, in this report we further address several items raised by Legislative Audit Bureau (LAB) in its November 2001 Performance Audit.

- Reflecting a continued downturn in both national and global markets, total assets under management fell from \$67.0 billion at the end of 2000 to \$64.6 billion as of December 31, 2001.
- The -2.3% annual investment return for the WRS Fixed Trust Fund for 2001 exceeded the -4.5% return for the investment benchmark. The Fixed Fund continued to outperform its investment benchmark and the 8% long-term actuarial target on a five-year and ten-year basis.
- The -8.3% return for the WRS Variable Fund surpassed a -12.9% return for its benchmark and a -11.9% return for the S&P 500. The Fund, which is invested in domestic and international stocks, is also ahead of its five-year and ten-year benchmarks.
- In a difficult year for equities, the Small Company Stock portfolio earned a 32.1% return.
- The State Investment Fund (SIF) continued to outperform its one-, five- and ten-year benchmarks and earned 4.2% in 2001. SIF's return for 2001 ranked ranked 1st out of 234

government funds in the iMoneyNet Government Fund Index and 25th out of 1,148 money market funds in the iMoneyNet All Taxable Money Market Index (top 3%).

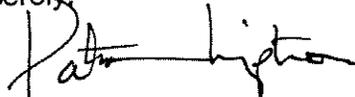
- During fiscal year 2001, SWIB made nearly \$1 billion in new investments in Wisconsin companies. Over the last four years, new investments in Wisconsin totaled nearly \$4.4 billion, exceeding SWIB's goal to invest between \$2.2 billion and \$3.9 billion in the state by 2004. Wisconsin investments are subject to the same due diligence and fiduciary responsibility that apply to all other investments.

SWIB has taken several steps to address issues concerning the role of the Opportunity E portfolio and other alternative investment portfolios that carry a higher degree of risk for the prospect of greater returns. Those changes are explained in detail in the report.

We have also more clearly defined the roles of the Trustees as governing fiduciaries and staff as managing fiduciaries. To provide a higher level of assurance that staff and Trustees are in compliance with state ethics standards, we have asked the LAB to review financial reports filed by staff and Trustees with the State Ethics Board more frequently.

We appreciate the support we have received from the Legislature as it has helped us to meet our fiduciary responsibilities to the participants of the funds we manage. If you have any questions about the enclosed report or need further information, please contact me.

Sincerely,



Patricia Lipton
Executive Director

cc: Members, Joint Committee on Finance
Members, Joint Committee on Audit

Robert Lang, Legislative Fiscal Bureau
Janice Mueller, Legislative Audit Bureau

State of Wisconsin Investment Board

Investment Goals, Strategies and Performance



March 2002

State of Wisconsin Investment Board
Investment Goals, Strategies and Performance

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Executive Summary

- Reflecting continued downturns in national and global markets, **total assets managed by SWIB** fell from \$67.0 billion at the end of 2000 to \$64.6 billion as of December 31, 2001 – a decrease of \$2.4 billion. At the end of 2001, SWIB managed \$58.5 billion in the Wisconsin Retirement System (WRS), \$5.4 billion in the State Investment Fund (SIF) and \$0.7 billion in smaller funds.
- The –2.3% annual investment return for the **WRS Fixed Fund** for 2001 exceeded the –4.5% return for the investment benchmark. The Fixed Fund continued to outperform its investment benchmark and the 8% actuarial target on a five-year and ten-year basis.
- The Fixed Fund's one-year return ranked first among public pension funds that the Legislative Audit Bureau had surveyed in 2000 for its performance evaluation of SWIB. Data also indicate that the **Fixed Fund** placed in the top quartile for the one- and ten-year periods when compared to other public pension funds with assets over \$1 billion. In addition, the **Fixed Fund** exceeded most of the funds in this peer group for the three-year and five-year returns as well, ranking in the second quartile. These returns are not reported on a risk-adjusted basis.
- The –8.3% return for the **WRS Variable Fund** surpassed a –12.9% return for its benchmark and a –11.9% return for the S&P 500. The Fund, which is invested in domestic and international stocks, is also ahead of its five-year and ten-year benchmarks.
- In a difficult year for equities, the **Small Company Stock portfolio** earned a **32.1%** return.
- As a result of the Wisconsin Supreme Court finding the 1999 benefits improvement law constitutional, the phase out of the **transaction amortization account (TAA)** and phase in of the **market recognition account (MRA)** began retroactive to 2000.
- The 4.2% gain for the **State Investment Fund (SIF)** exceeded a 3.5% return for its benchmark. SIF also continued to exceed its benchmark for the five-year and ten-year periods. SIF's return for 2001 ranked 1st out of 234 government funds in the iMoneyNet Government Fund Index and 25th out of 1,148 money market funds in the iMoneyNet All Taxable Money Market Index (top 3%).
- During fiscal year 2001, SWIB made nearly \$1 billion in **new investments in Wisconsin companies**. Over the last four years, new investments in Wisconsin totaled nearly \$4.4 billion, far exceeding SWIB's goal to invest between \$2.2 billion and \$3.9 billion in the state by 2004. Wisconsin investments are subject to the same due diligence and fiduciary responsibility that apply to all other investments.
- SWIB's **total cost to manage the Fixed Fund** (17 cents per \$100 managed) was less than the typical costs for funds of similar size and asset mix (19.2 cents per \$100 managed).
- As a result of the **increased budget authority** granted in 1999, SWIB was able to

continue providing a more competitive compensation package. This has assisted in recruiting for vacant positions and retaining existing staff but has not completely stopped the exodus of experienced investment staff leaving for higher paying positions.

- SWIB implemented several **strategic changes in 2001** that were designed to delineate more clearly the fiduciary roles of the Board of Trustees and the staff; streamline and improve internal operations; and enhance the long-term performance of the trust funds while maintaining an appropriate level of risk. Building on the changes made in 2001, the Board of Trustees agreed to several **strategic changes for 2002**. The strategic changes for both 2001 and 2002 are detailed on pages 7 and 8.

State of Wisconsin Investment Board

Investment Goals, Strategies and Performance

The statutes require the State of Wisconsin Investment Board (SWIB) to submit an annual report to the Legislature regarding the Board's investment goals and long-term strategies, noting any changes from the previous year, and an annual report on the Board's investment performance. As in previous years, we have combined the two reports to make it easier to understand the relationship between our goals, strategies and performance. As recommended by the Legislative Audit Bureau, this report further addresses several matters raised in the November 2001 performance evaluation of SWIB.

During 2001, we spent considerable time strategically planning how SWIB can best meet its fiduciary responsibilities in the years to come. Working with outside consultants, we took a number of steps to review our strategies, revise investment guidelines and strengthen internal operations, with specific attention paid to the structure and oversight of alternative investments. In addition, we reviewed how assets are allocated and the potential impact that 1999 Wisconsin Act 11 will have on financing the Wisconsin Retirement System (WRS).

Assets Under Management

SWIB is responsible for managing the assets of the WRS, which is composed of the Fixed Fund and the Variable Fund, the State Investment Fund (SIF) and several smaller trust funds. Our mission is to ensure that funds, for which we are responsible and that the State holds in trust, are prudently managed. This is accomplished by earning optimal investment returns consistent with the purpose and risk profile of each trust. As of December 31, 2001, assets under management totaled \$64.6 billion. As a result of market downturns that began in 2000 and continued in 2001, total assets decreased by \$2.4 billion over the prior 12 months. Appendix A illustrates the growth in assets under management since 1992.

Funds Managed by SWIB December 31, 2001		
Fund	\$ in Millions	% of Total
Wisconsin Retirement System (WRS)	\$58,516	91%
<i>Fixed Trust Fund</i>	52,175	81%
<i>Variable Trust Fund</i>	6,340	10%
State Investment Fund (SIF)*	5,413	8%
Other Funds	709	1%
State Life Insurance Fund	70	
Local Property Insurance Fund	28	
Historical Society Endowment Fund	11	
Patients Compensation Fund	588	
Tuition Trust Fund (EdVest)	12	
TOTAL	\$64,639	100%
*Excludes WRS Trust Funds cash balances.		

Wisconsin Retirement System (WRS)

With assets of nearly \$52.2 billion, the **Fixed** (or balanced) **Fund** is the largest trust under SWIB's management. It comprises 81% of all SWIB assets under management and 89% of all WRS assets. All 478,4000 current or former state and local government employees have at least half, if not all, of their pension accounts invested in this Fund. The Fixed Fund invests in several diversified asset classes, including stocks, bonds, business loans, real estate and other holdings. Within each asset class, investments are further diversified by portfolio. Diversification helps to stabilize the effects of market changes.

The remaining WRS assets are in the **Variable Fund**, which by statute is an equity fund. As of December 31, 2001, those assets were valued at \$6.3 billion and comprised nearly 11% of all WRS assets. As of December 31, 2001, 111,557 WRS participants, or over 20%, were in the Variable Fund. This number grew substantially in 2001 due to the reopening of this fund.

Prior to 1980, employees could opt to place half of their pension fund contributions in the Variable Fund where all assets are invested in the stock markets with the exception of 1%-2% that may be invested in cash at any one time. Participants who chose the Variable Fund option accepted a greater degree of risk with the potential of greater long-term returns. The Legislature, however, closed the Variable Fund to new entrants in 1980, partly because of the negative stock market returns that had occurred in the 1970s. Participants who were in the Variable Fund prior to it being closed in 1980 were allowed to remain in the fund. Until the enactment of 1999 WI Act 11, the Variable Fund remained closed to new participants. The new law, however, allows active employees, beginning January 1, 2001, to again elect to direct 50% of their future WRS contributions to the Variable Fund.

Until the mid-1980s, approximately 30% of the Fixed Fund's assets were invested in stocks, thus making it considerably less volatile than the Variable Fund. That portion grew significantly in the 1980s, and today the Fixed Fund is invested nearly 60% in stocks. The Fixed Fund, however, has a mechanism that smoothes gains and losses from one year to the next. The smoothing mechanism helps to prevent significant differences from one year to the next in annuity dividends for retirees and contribution rates paid by or on behalf of active employees.

The stocks in the Variable Fund are largely the same as those in the Fixed Fund. Like the Fixed Fund, these investments are diversified. What makes the Variable Fund riskier than the Fixed Fund is that, unlike the Fixed Fund that includes other types of assets, it is a total stock fund and does not have a smoothing mechanism. Instead, the gains or losses are recognized in the year after they occur.

Until the enactment of 1999 WI Act 11, the smoothing mechanism for the Fixed Fund was called the transaction amortization account (TAA). The TAA represented the market value gains and losses experienced by the Fixed Fund but not yet recognized and applied to account balances. Twenty percent of the TAA was recognized each year and applied to employer, employee and annuitant reserve accounts. The TAA mushroomed in the 1990s due to the significant market returns until it reached nearly \$14 billion in early 2000.

As a part of 1999 WI Act 11, the Legislature directed that a significant portion of the TAA be used to fund benefit improvements and that the balance be distributed over five years. At the same time, the Legislature created a market recognition account (MRA), which applies the gains or losses to the actuarial benchmark and spreads the difference over five years to the reserve accounts. With the MRA, gains and losses will be recognized more quickly than they would have under the TAA, which in effect went on in perpetuity. As a result, however, there may be greater fluctuation in annuity dividends and contribution rates than previously.

Investment Goals

Because of their varying structures, investment goals differ for the Fixed Fund and the Variable Fund. The basic investment objective for the Fixed Fund is to achieve an 8.0% annual average rate of return over the long-term. An 8.0% return is the minimum investment requirement set by the WRS actuary to accumulate the funds needed to pay projected benefits over time. Projected to be 3.5% more than the annual wage growth, an 8% return is an estimate of what is needed to ensure that a person who retires will receive a benefit that will stay constant in real terms. The WRS actuary does not set an investment goal for the Variable Fund. Instead, that fund is expected to meet or exceed market indices.

All WRS stakeholders benefit to the extent that investment returns exceed the basic investment objectives. First, higher returns reduce the contributions public employers (taxpayers) and employees must pay into the WRS to pay for future benefits. Secondly, they allow for improved benefit payments after retirement. This includes both the initial payment and the annual dividend that annuitants receive. Investment returns ultimately provide over 85% of the cost of retirement benefits WRS members receive. Exceptional investment returns enabled the Employee Trust Funds Board to reduce the contribution rates annually from 1996 through 2001.

A goal for both funds is to exceed an investment rate of return or "benchmark" established by SWIB's Board of Trustees with the assistance of a benchmark consultant. The benchmark for the Fixed Fund is a weighted blend of benchmarks that measure the performance of the broader markets for stocks, bonds and other assets. Except for Alternative Investment Portfolios, each individual portfolio within the Fixed Fund has a separate benchmark that compares its performance to that achieved by a market index or pool of assets. For example, the large company stock portfolio is compared to the S&P 500. The Alternative Investment Portfolios have a flat 15% net of fees benchmark.

The benchmark for the Variable Fund is a weighted blend of the Russell 3000 broad U.S. Stock Market Index and the Morgan Stanley Capital International Index of Non-U.S. Developed Stock Markets.

Finally, the investment results of both trust funds and their portfolios are compared to those of other managed funds and portfolios.

Investment Strategies

The Board of Trustees annually establishes strategies to meet the goals for each fund. The Board also establishes Investment Guidelines for each portfolio to carry out the approved strategies. Each portfolio manager is expected to invest the assets under his or her control in accordance with the Guidelines for the specific portfolio. **Strategies adopted for 2001** included changes that:

- Closed the equity portfolios dedicated to **emerging markets** and moved the assets into developed international equity portfolios. SWIB continues to make equity investments in emerging markets on an opportunistic basis from the existing international portfolios.
- Decreased the target that the **Variable Fund invests in international stocks** from 25% to 20% and correspondingly increased the portion allocated to domestic stocks from 75% to 80%. SWIB took this action to reduce risk in the fund for those already participating in the Variable Fund as well as the high number of new enrollees following enactment of Act 11.
- Closed an under-performing, externally managed global fixed income portfolio and moved those assets to passive management.
- Decreased the funds under management with two other fixed income external managers and brought the funds in-house for active management.
- Transferred assets from an internal fixed income portfolio to a newly created high yield bond index fund.
- **Refined certain fiduciary responsibilities of the Board of Trustees and the staff** and expanded the responsibilities of the staff Risk and Investment Committee.
- Revised and updated the **Investment Guidelines** to reflect strategic changes made by the Board.

Building on the changes made in 2001, the Board of Trustees has agreed to several **strategic changes for 2002**. SWIB will:

- Implement the recommendations of the outside consultant that was retained in late 2001 to review real estate and all alternative investment portfolios (including the Opportunity E portfolio that the Legislative Audit Bureau reviewed in its November 2001 report). These recommendations are discussed in more detail on pages 22 and 23.
- As a part of these recommendations, combine the Private Equity and Opportunity E portfolios under the direction of the manager for the Private Equity portfolio.

- Transfer the National Private Debt Portfolio from the Private Placements group to Fixed Income to reflect the similarity in their markets.
- Expand the guidelines for the Wisconsin Private Debt Portfolio to allow investing up to 15% of the portfolio in neighboring states.
- Establish two new, internally managed public equities portfolios. The first is a broad, diversified mix of stocks not currently covered by the large or mid cap portfolios. It will use quantitative techniques and be funded by transferring assets from external passive funds. The second is an all-capitalization, domestic equity, health care sector portfolio. This portfolio will be funded partly by transferring assets from the Small Cap Equity Portfolio and partly from external equity funds.
- Transfer some assets from the internally managed International Equity Portfolio and the Small Cap Equity Portfolio to the external BGI small cap and International enhanced passive funds.