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☞ Details: Audit Report 04-13, An Evaluation: State of Wisconsin Investment Board

(FORM UPDATED: 08/11/2010)

WISCONSIN STATE LEGISLATURE ...
PUBLIC HEARING - COMMITTEE RECORDS

2005-06
(session year)

Joint
(Assembly, Senate or Joint)

Committee on Audit...

COMMITTEE NOTICES ...

- Committee Reports ... **CR**
- Executive Sessions ... **ES**
- Public Hearings ... **PH**

INFORMATION COLLECTED BY COMMITTEE FOR AND AGAINST PROPOSAL

- Appointments ... **Appt** (w/Record of Comm. Proceedings)
- Clearinghouse Rules ... **CRule** (w/Record of Comm. Proceedings)
- Hearing Records ... bills and resolutions (w/Record of Comm. Proceedings)
  (**ab** = Assembly Bill) (**ar** = Assembly Resolution) (**ajr** = Assembly Joint Resolution)
  (**sb** = Senate Bill) (**sr** = Senate Resolution) (**sjr** = Senate Joint Resolution)
- Miscellaneous ... **Misc**

* Contents organized for archiving by: Stefanie Rose (LRB) (September 2012)

Record of Committee Proceedings

Joint Legislative Audit Committee

Audit Report 04-13,
An Evaluation: State of Wisconsin Investment Board.

March 2, 2005 **PUBLIC HEARING HELD**

Present: (10) Senators Roessler, Cowles, S. Fitzgerald, Miller and Lassa; Representatives Jeskewitz, Kaufert, Kerkman, Travis and Cullen.
Absent: (0) None.

Appearances For
- None.

Appearances Against
- None.

Appearances for Information Only
- Janice Mueller, Madison — State Auditor, Legislative Audit Bureau
- Diann Allsen, Madison — Legislative Audit Bureau
- David Mills, Madison — Executive Director, State of Wisconsin Investment Board

Registrations For
- Judy Frillici, Marshall — Wisconsin Retired Educators' Association
- Marshall Frillici, Marshall — Wisconsin Retired Educators' Association

Registrations Against
- None.

Karen Asbjornson
Karen Asbjornson
Committee Clerk


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State of Wisconsin \ LEGISLATIVE AUDIT BUREAU

JANICE MUELLER
STATE AUDITOR

22 E. MIFFLIN ST., STE. 500
MADISON, WISCONSIN 53703
(608) 266-2818
FAX (608) 267-0410
Leg.Audit.Info@legis.state.wi.us

DATE: November 18, 2004

TO: Karen Asbjornson and Pamela Matthews
Aides to the Joint Legislative Audit Committee

FROM: Diann Allsen
Financial Audit Director

SUBJECT: Report 04-13: An Evaluation of the State of Wisconsin Investment Board

As required by s. 25.17 (51m), Wis. Stats., we have completed our third biennial evaluation of the State of Wisconsin Investment Board, which manages a total of $69.1 billion in assets. Our evaluation includes a review of the Investment Board's performance in managing Wisconsin Retirement System assets, as well as an analysis of the reasons for significant increases in external investment costs. We also reviewed the Investment Board's compensation plan that was revised in 2000.

Overall, the retirement funds—the Fixed Retirement Trust and the Variable Retirement Trust—outperformed their benchmarks for 2003, and the Fixed Fund's 2003 performance ranked high among ten public pension funds surveyed. Domestic equities contributed to the Investment Board's performance success, while some of the fixed-income and private equity portfolios did not meet their benchmarks.

The Investment Board's costs to manage investments have increased $87.4 million in 1999 to $156.7 million in 2003, or by 79.3 percent. Most of the increase is related to increased costs paid to external investment managers and advisors. We analyzed some of the higher cost areas of external management fees, including fees for private equity and real estate investments, and quantitative funds. While we do not suggest that the Investment Board discontinue these higher cost investments, we do recommend that it regularly evaluate and, in its annual report to the Legislature, report on the cost and added value provided by these investments in comparison to other investment options.

Compensation costs for Investment Board staff totaled $13.2 million and represented 8.4 percent of the Investment Board's total costs during 2003. Expenditures for staff compensation increased $5.0 million over 1999 levels, in large part, because of changes to the Investment Board's compensation plan, including changes to its bonus program. In 1999, the Investment Board requested changes to its compensation plan because of difficulties it was experiencing in recruiting and retaining qualified investment staff. In our review of the compensation plan, we concluded that it awarded the largest bonuses to the most meritorious performers and the 2000 revisions appeared to have helped the Investment Board better recruit and retain qualified investment staff. The Executive Director and the Board of Trustees are currently considering changes to simplify its complex bonus program. We recommend that the Investment Board report to the Joint Legislative Audit Committee on any changes it makes to the bonus program as the result of this process.

In a future considerations section, we suggest that current limits on the Investment Board's internal budget and on use of external investment managers may not be resulting in the most cost-effective management of the Investment Board's assets. The Investment Board recently began a project, which it plans to complete in the spring of 2005, to analyze the optimal mix of investment approaches and to identify related statutory changes that may be needed to achieve that mix. As a result, the Legislature may wish to consider the results of the Investment Board's project as it deliberates any changes to the statutory limits. We also recommend that the Investment Board provide more comprehensive and descriptive information of investment management costs in quarterly reports to the Legislature.

Finally, we include several other recommendations pertaining to the Investment Board's contracting procedures, use of performance recognition payments, and practice of paying additional retirement contributions for more staff than statutes authorize.

The Investment Board has been very responsive to our recommendations and has included in its audit response detailed steps and timetables it plans to take in response to each of the audit recommendations. Consequently, we do not believe that the co-chairs need to send a compliance letter to the Investment Board.

We expect to release the report on Monday, November 22nd, at 9:00 a.m. If you have any questions, please contact us.

DA/bm

Enclosure


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WISCONSIN STATE LEGISLATURE
Joint Audit Committee
Committee Co-Chairs:
State Senator Carol Roessler
State Representative Suzanne Jeskewitz

For Immediate Release
For More Information Contact:
Senator Carol Roessler
Representative Suzanne Jeskewitz

November 22, 2004

(608) 266-5300
(608) 266-3796

Investment Board Audit Released Today

(Madison) Senator Carol Roessler (R-Oshkosh) and Representative Suzanne Jeskewitz (R-Menomonee Falls) announced today that the nonpartisan Legislative Audit Bureau completed its biennial management audit of the State of Wisconsin Investment Board. As of December 31, 2003, the Investment Board managed a total of $69.1 billion in investments that included assets of the Wisconsin Retirement System, the State Investment Fund, and five other state insurance and trust funds.

Two Wisconsin Retirement System funds—the Fixed Retirement Trust and the Variable Retirement Trust—account for more than 90 percent of all assets under the Investment Board's management and fund retirement benefits for more than 500,000 current and former state and local government employees. Despite negative returns from 2000 to 2002, both retirement funds exceeded investment performance benchmarks in 2003.

Joint Legislative Audit Committee Co-chairs Roessler and Jeskewitz said they intend to carefully review the audit's findings in the weeks ahead, but were pleased with the Investment Board's detailed response to the audit recommendations. The co-chairs will work closely with Investment Board staff to ensure that the Legislative Audit Bureau's recommendations are implemented. The co-chairs anticipate that the Joint Legislative Audit Committee will hold a public hearing on the audit report in early 2005.

###

SENATOR ROESSLER
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REPRESENTATIVE JESKEWITZ
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WISCONSIN STATE LEGISLATURE

Joint Audit Committee

Committee Co-Chairs:
State Senator Carol Roessler
State Representative Suzanne Jeskewitz

February 23, 2005

Senator Glen Grothman and
Representative Daniel Vrakas, Co-chairpersons
Joint Survey Committee on Retirement Systems
State Capitol
Madison, Wisconsin 53702

Dear Senator Grothman and Representative Vrakas:

The Joint Legislative Audit Committee will hold a public hearing on Legislative Audit Bureau report 04-13, *An Evaluation: State of Wisconsin Investment Board*, on Wednesday, March 2, 2005, at approximately 11:00 a.m. in Room 412 East of the State Capitol.

As this report presents information that may be of interest to the Joint Survey Committee on Retirement Systems, we invite you to be present to hear the testimony offered in response to the audit findings and recommendations. We also extend this invitation to any member of the survey committee.

Should you wish to attend and/or testify at the hearing, we would invite you to sit with the members of the Joint Legislative Audit Committee on the dais. Please contact Ms. Karen Asbjornson in the office of Senator Carol Roessler at 266-5300 to confirm your participation. We hope to see on you on March 2nd.

Sincerely,

Carol Roessler

Senator Carol A. Roessler, Co-chair
Joint Legislative Audit Committee

Suzanne Jeskewitz

Representative Suzanne Jeskewitz, Co-chair
Joint Legislative Audit Committee

Enclosure

cc: Senator Cathy Stepp
Senator Robert Wirch
Representative Mary Hubler

Ms. Janice Mueller
State Auditor

WISCONSIN STATE LEGISLATURE
Joint Audit Committee
Committee Co-Chairs:
State Senator Carol Roessler
State Representative Suzanne Jeskewitz

February 23, 2005

Mr. David Mills, Executive Director
State of Wisconsin Investment Board
121 East Wilson Street
Madison, Wisconsin 53702

Dear Mr. Mills:

The Joint Legislative Audit Committee will hold a public hearing on Legislative Audit Bureau report 04-13, *An Evaluation: State of Wisconsin Investment Board*, on Wednesday, March 2, 2005, at approximately 11:00 a.m. in Room 412 East of the State Capitol.

As this report relates to the activities of your agency, we ask that you, and appropriate members of your staff, be present at the hearing to offer testimony in response to the audit findings and to address questions from committee members. Before you begin testifying at the hearing, please plan to provide each committee member with a written copy of your testimony.

Please contact Ms. Karen Asbjornson in the office of Senator Carol Roessler at 266-5300 to confirm your participation at the hearing. Thank you for your cooperation and we look forward to seeing on you on March 2nd.

Sincerely,

Carol Roessler

Senator Carol A. Roessler, Co-chair
Joint Legislative Audit Committee

Suzanne Jeskewitz

Representative Suzanne Jeskewitz, Co-chair
Joint Legislative Audit Committee

Enclosure

cc: Ms. Janice Mueller
State Auditor

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WISCONSIN STATE LEGISLATURE
Joint Audit Committee
Committee Co-Chairs:
State Senator Carol Roessler
State Representative Suzanne Jeskewitz

February 23, 2005

Mr. James Senty, Chairperson
State of Wisconsin Investment Board
President, Midwest Bottle Gas
P.O. Box 429
La Crosse, Wisconsin 54602-0429

Dear Mr. Senty:

The Joint Legislative Audit Committee will hold a public hearing on Legislative Audit Bureau report 04-13, *An Evaluation: State of Wisconsin Investment Board*, on Wednesday, March 2, 2005, at approximately 11:00 a.m. in Room 412 East of the State Capitol.

As this report relates to the activities of the Investment Board, we ask that you be present at the hearing to offer testimony in response to the audit findings and to address questions from committee members. Before you begin testifying at the hearing, please plan to provide each committee member with a written copy of your testimony.

Please contact Ms. Karen Asbjornson in the office of Senator Carol Roessler at (608) 266-5300 to confirm your participation at the hearing. Thank you for your cooperation and we look forward to seeing on you on March 2nd.

Sincerely,

Carol Roessler

Senator Carol A. Roessler, Co-chair
Joint Legislative Audit Committee

Suzanne Jeskewitz

Representative Suzanne Jeskewitz, Co-chair
Joint Legislative Audit Committee

Enclosure

cc: Ms. Janice Mueller
State Auditor

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State of Wisconsin Investment Board

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March 2, 2005

Honorable Carol Roessler, Co-chair
Joint Legislative Audit Committee
8 South, State Capitol
Madison WI 53707

Honorable Suzanne Jeskewitz, Co-chair
Joint Legislative Audit Committee
314 North, State Capitol
Madison WI 53707

Subject: Compensation Plan

Dear Senator Roessler and Representative Jeskewitz:

The Legislative Audit Bureau (LAB) completed a biennial performance evaluation report of the State of Wisconsin Investment Board (SWIB) in November 2004. At the time the report was issued, SWIB was in the midst of reviewing changes to simplify the compensation plan. The LAB recommended that SWIB inform the committee of these changes when completed. We agreed with the recommendation and promised to report those changes to the committee.

The purpose of this letter is to advise you that the changes to the incentive compensation plan were completed and recently adopted by the Trustees. In reviewing these changes, it is important to know that incentive compensation is based primarily on whether the benchmark is beaten and, if exceeded, additionally on four basic performance measures: persistency of performance from one year to another, comparison of performance to peers, dollars of return over the benchmark, and level of risk taken to achieve the return. These four performance measures are referred to as "excellence factors".

The changes adopted by the Board were implemented primarily to reduce the complexity of calculating the incentive compensation and will do the following:

- Measure persistency of performance based on annual results rather than quarterly results. This gives a more accurate picture of how well a portfolio or manager is performing from year to year.

- Cease considering the excellence factors for the one-year performance and instead use them only when assessing three and five year performance. Not all of the excellence factors are available for one-year returns. Therefore, this complex calculation for one-year results does not adequately differentiate performance to justify the additional complexity.

- Remove the risk component when evaluating the Fixed Fund. This factor was not found to differentiate performance sufficiently from year to year to add any value to the calculation.

- Eliminate the additional 10% for portfolios with the highest rate of return over the benchmark. Because this element is already one of the excellence factors, it was determined that the additional 10% credit was unfairly duplicative.

- Eliminate the 10% quantitative portion for portfolio managers that relates to the overall asset class and instead base their entire quantitative incentive compensation calculation on portfolio performance. By making this change, a portfolio manager will be judged solely on his or her own performance and not benefit from the out-performance of others within the same asset class. Also, it creates uniformity for all asset classes. Previously, equities and fixed income staff were eligible for the 10% based on asset class performance but private markets staff was not.

- Simplify the way that bonuses are calculated, thus reducing the potential for errors, and automate various procedures to make the process more efficient.

Two other changes to the plan were made for reasons other than simplification:

- Change the weightings of the components to calculate the incentive compensation for the WI Private Debt/Equity Portfolio Manager from 80% quantitative and 20% qualitative to 60% quantitative and 40% qualitative. This is to account for the time that is devoted to managing the venture capital funds with which SWIB has contracts.

- Specifically identify the position of Deputy Executive Director as eligible for incentive compensation using the same components and weightings as that applied to the Executive Director.

Please let me know if you have questions about any of the changes.

Sincerely,

David Mills
Executive Director

cc: Members of the Committee
Janice Mueller, Legislative Audit Bureau
Robert Lang, Legislative Fiscal Bureau

WISCONSIN STATE LEGISLATURE

Joint Legislative Committee on Audit
3/2/2005

Testimony
David Mills, Executive Director
State of Wisconsin Investment Board

Thank you for the opportunity to appear before the Committee to offer testimony on behalf of the Investment Board and answer questions with respect to the recent audit. Unfortunately, a prior business engagement prevented Board Chairman Jim Senty from appearing today, but he would be happy to meet with the Committee or Co-Chairs, should you wish.

As many of you know, I joined the State of Wisconsin Investment Board - SWIB - as its permanent Executive Director this past June. Leading this extremely large investment organization during a period of such dynamic change in the investment marketplace is a huge challenge for any leader and for me, personally. SWIB's success is of crucial importance to the Wisconsin Retirement System (WRS) members, whose funds represent over 90% of the assets we invest, the beneficiaries of the smaller trust funds that place their funds under our care, and ultimately the taxpayers of Wisconsin whose tax burdens are lower as a direct result of our success.

We recognize the importance of maintaining the trust and confidence of not only beneficiaries, but also the Legislature and Governor. I am fortunate to work with an extremely dedicated and capable board of trustees and very talented staff. We all recognize our obligation to be accountable for our performance and to operate as transparently as the nature of our business allows. Given the tools to do our jobs, we can and will continue to be successful.

Now I'd like to turn to specific comments about the audit completed as of 12/31/2003.

The Board, staff and I see this audit as fair, constructive and helpful in offering recommendations that we intend to implement. Several of those suggestions are consistent with observations made by the Board this past year and initiatives that it has asked staff to pursue independent of the release of the audit in November.

Investment Performance

The first chapter of the audit reviewed performance. We were extremely pleased that the auditors found SWIB at the top of its LAB peer group of public funds. Although pleased whenever we rank at the top over any time period, for a long-term investor such as SWIB, the news of ranking number one over the five year period is particularly welcome.

Longer term strategies often take several years to prove their worth. A perfect example of this can be found in the audit's finding that we moved from last to first among the ten peer systems since the time of the 2001 audit. The primary reason for the relatively poor showing then was a strategic asset allocation decision by the Board in the late 1990's to reduce somewhat its exposure in a stock market that appeared "over-heated" as a result of appreciation during the prior decade. As the auditors noted, when public equities performed poorly in 2000, 2001 and 2002, SWIB's "underweight" in equities served it well and is largely responsible for the positive showing now over the five year period. In other words, the long term strategy that appeared to negatively affect SWIB in its first few years of implementation now has appeared to work well, as hoped for, over the long term.

External Management Costs

The second chapter and first three audit recommendations pertain to SWIB's costs of investment management. Our investment-related expenses, in aggregate, have grown dramatically since 1999. In my formal response found at the end of the audit, I commented about this at length. In summary form, the drivers of these costs result primarily from the answers to three questions: 1) What should be the chosen asset mix (e.g. how much placed in domestic and international equities, bonds, private equity, etc;) 2) What should be the level of active management, (i.e. how much will be passively invested in indexes and how much actively managed); and 3) Should the assets be managed internally or externally?

Although we can manage assets internally for less for most strategies, that should not be the basis for investment decision making. And, although assets can be passively managed by external managers for much lower fees than if actively managed, this should not be the basis for decision making. Rather, the decision whether to manage internally or externally or invest actively or passively should be based on where we feel we can get the best net return, after factoring in cost, while taking an acceptable amount of risk. In some markets and some strategies we cannot expect to attract the specialized talent needed to invest the assets and earn the net rate of return that outside managers can provide.

The auditors identified substantial fees associated with private equity and real estate asset classes. Although fees are typically drawn from the working capital of the fund rather than paid directly by SWIB, we do not dispute that significant management fees are paid, typically to general partners. Nevertheless, these types of investments offer the opportunity for diversification into asset classes that are "uncorrelated" with the public markets, and the potential for higher returns. And, although the fees earned by managing partners for private equity, venture capital, and real estate investments can be substantial, SWIB investments consider the costs in determining an expected rate of return and evaluating an opportunity. Strategically, SWIB has concluded that investing in these asset classes is appropriate, and that we are likely to see better net returns by generally investing in funds rather than direct investments.

The auditors also noted that our use of "quantitative" strategies through commingled funds, in particular, has increased our costs over what would have been the case if passively invested. They also question whether a performance fee structure that rewards better performance is ultimately cost effective. On the one hand, we know that the use of quantitative strategies during the time period of the audit increased SWIB's cost of management by a significant amount. We also know that our use of quantitative strategies has added $357 million - after fees - since 1998. Nevertheless, we are actively reviewing our current use of performance fees and will continue to do so to ensure that we are using the approach that generates the best net return for the fund. We have already identified substantial savings in 2001, 2003, and again in 2004.

I'd like to comment briefly on a separate but related issue. Although comfortable that the use of quantitative strategies and other commingled funds by SWIB has been a cost-effective decision, we share several concerns noted by the LAB. The Board recognizes the "catch 22" that the auditors noted: on the one hand, we have somewhat constrained internal position and budget control, yet a statutory restriction of 15% for use of external active management in dedicated SWIB accounts. The auditors correctly note that these restrictions at times may prevent SWIB from making the decisions most likely to produce the best net return. When this occurs, it is to the detriment of retirement system members who count on our success and ultimately taxpayers who may pay higher contributions as a result.

The nature of today's investment marketplace is constantly changing. To be successful, SWIB must be more flexible than ever, able to adjust to opportunities and leverage its strengths as well as those of its outside managers. With this in mind, last fall the Board asked staff to undertake a comprehensive review of our current mix of strategies, investment styles and performance. This project asked staff to take a "clean slate" approach, answering the following question: "If not constrained in any way by current statutes or past practice, what would be the optimal mix of strategies and investment styles to earn the best net returns for our members while taking an appropriate level of risk?"

The LAB acknowledged the trustee project and suggested the Legislature may want to consider its outcome in determining whether any further action might be warranted. As the attachment suggests, we will present preliminary information to the Board in March, and final recommendations in April. I would be happy to provide additional information to the Joint Legislative Audit Committee at that time as well.

Compensation

The third area examined by the auditors involved the SWIB compensation plan, for which it was given the authority in 1999 Wisconsin Act 9. This compensation plan, as noted by the auditors, appears to have helped SWIB in its crucial efforts to attract and retain investment staff. Nine of 11 analysts prior to the new plan had no experience; of the 14 hired since the new plan, the average experience level has been six years.

The Investment Board expects to lose approximately twenty senior investment staff and other senior managers to retirement during the next decade. Even with the improved compensation plan it cannot compete effectively against private sector asset management firms for experienced talent at the portfolio management level and above. It must, therefore, be able to compete effectively for analysts and provide sufficient compensation incentives and career path opportunities for talented individuals to remain with SWIB for the long term.

We believe that the compensation plan flexibility provided to SWIB in Act 9 has been a definite factor in SWIB's recent investment successes, and we thank you. We recognize, however, that we must always use this flexibility in a way that rewards performance, is defensible, and ensures that it properly motivates staff to adhere to the highest ethical standards at all times.

In summary, I appreciate the opportunity to appear before you today. The Board and I recognize the importance of SWIB's performance to our members, other beneficiaries and the State as a whole. We recognize that the investment of $75 billion is a huge responsibility, and one for which SWIB must be accountable. We welcome further discussion with the Joint Committee and Legislature about the issues raised in the audit and possible solutions.

Thank you very much.

Attachment

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State of Wisconsin Investment Board

Legislative Audit Bureau
March 2005

1

Wisconsin Retirement System

- $70 billion in assets
- 9th largest U.S. public pension fund
- Over 500,000 participants
- Fixed Fund – diversified fund
- Variable Fund – stock fund reopened to new participants in 2001

2

Wisconsin Retirement System Annual Returns

Year	Fixed Fund	Variable Fund
2000	(0.8)%	(7.2)%
2001	(2.3)	(8.3)
2002	(8.8)	(21.9)
2003	24.2	32.7
2004	12.8	12.7

3

Investment Performance

- Investment performance exceeded 1-year, 5-year, and 10-year benchmarks for periods ending December 31, 2003.
- The Fixed Fund continues to exceed the actuarial expected investment results of 7.8% over the long-term.

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Five-year Comparison (as of 12/31/03)

Pension Fund	5-Year Rank
Wisconsin Fixed Fund	**1**
Washington	2
Pennsylvania Public School Employees	3
Virginia	3
California Public Employees	5
Texas Teachers	6
Florida	7
Minnesota	8
New York State Teachers	9
New Jersey	10

5

Investment Board Costs (in millions)

	1999	2003	Change
Internal Operating	$12.5	$ 16.5	32.0%
External Investment	74.9	140.2	87.2
Total	**$87.4**	**$156.7**	**79.3**

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External Manager and Advisor Fees (in millions)

Asset Class	2003 Fees
Private Equity	$ 44.9
Quantitative Funds	39.6
Real Estate	20.7
Other	22.7
Total	**$127.9**

7

Quantitative Funds

- Fees for quantitative funds represented 31 percent of external manager fees in 2003.
- SWIB's investment in quantitative funds was one of the largest among pension funds at the end of 2003.
- Average fees were 11 times more costly than index fund fees.
- We recommend SWIB report to the Legislature on the cost and value provided through its quantitative funds in comparison to other investment options.

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Costs for External Support Services (in millions)

	1999	2003	Change
Custodial Banks	$3.7	$3.3	(12.6)%
Consultants	0.7	3.9	476.5
Legal	0.4	1.4	241.5
Research	1.0	3.5	239.0
Total	**$5.8**	**$12.1**	**106.4**

9

Compensation Expenditures (in millions)

	1999	2003	Change
Base Salary	$5.9	$9.2	56.6%
Fringe Benefits	1.9	2.8	48.6
Bonus	0.4	1.0	192.6
Other	0.0	0.2	313.0
Total	**$8.2**	**$13.2**	**61.9**

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Compensation Plan

- Compensation appears to reduce staff turnover and assist in recruiting experienced staff.
- Most meritorious performers are awarded larger bonuses.
- We recommend SWIB report to the Joint Legislative Audit Committee on changes it makes to the bonus program.

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Additional Retirement Contributions

- We question whether additional retirement contributions circumvent a statutory limit on investment director positions.
- We recommend SWIB discontinue paying additional retirement contributions and pursue statutory changes if it believes additional executive positions are warranted.

12

Statutory Limits

- Budget
- Number of Authorized Staff
- Percentage of investments that may be externally managed

13

Composition of Assets Managed Using Internal and External Resources

Investment Strategy		Percent of Assets Managed
External Active Managers		10.1%
Other External Assets		
Index Funds	26.4	
Quantitative Funds	21.4	
Limited Partnerships	4.3	
Actively Managed Funds	1.3	
Subtotal		53.4
Internal Assets		36.5
TOTAL		**100.0%**

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Future Considerations

- The Legislature may wish to revisit the 15% limit on external management and the current budgetary structure.
- The Investment Board is currently analyzing an optimal mix of investment approaches.

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State of Wisconsin Investment Board

Legislative Audit Bureau
March 2005

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Progress Report on Audit Recommendations
State of Wisconsin Investment Board
for
Joint Legislative Audit Committee
March 2, 2005

The State of Wisconsin Investment Board (SWIB) is taking the following actions which address recommendations in the November 2004 performance audit by the Legislative Audit Bureau.

1. **SWIB should evaluate and, in its annual report to the Legislature, report on the cost and added value provided through its quantitative funds compared to other options, such as index funds or fixed-fee arrangements.**

   a. Our objective is to obtain the best net results for the trust funds entrusted to our care. We are conducting an extensive examination of the costs and performance of different management strategies to ensure that we are using the best mix of active management and index funds, as well as the best combination of internal and external resources. Among the issues this review is examining are: 1) the costs and net rate of return for each category of investment; 2) SWIB's investment strategies compared to its peers; 3) the optimal size for an actively managed portfolio and the resources that are required; and 4) the role of "quantitative funds". (Quantitative funds use complex modeling methods and screening tools to generate additional investment return while seeking to constrain risk)

   b. Staff will provide a preliminary report on this work to the Board of Trustees this month and more extensive additional findings and recommendations at the April Board meeting. Current budget and statutory controls can, at times, make it difficult for SWIB to manage trust fund assets in the most cost-effective way.

   c. Our annual "Goals, Strategies and Performance" report is being redesigned to provide a better understanding of our investment activities. This report, which will be submitted to the Legislature later this month, will address the progress of our review of management strategies.

   d. Ultimately, costs of management and different strategies must be judged against the <u>net</u> returns produced for SWIB's investments. We recognize we have an obligation to ensure that all trust fund dollars are spent wisely and cost effectively:

      - Our total cost of management (agency operations + fees for services) was $156 million for calendar year 2004, nearly the same as it was for 2003.

- SWIB's annualized cost for all assets declined from 25 cents per $100 under management in 2003 to 22 cents per $100 for 2004. The costs to manage the Fixed Fund reduced from 28 cents to 25 cents per $100 (or "25 basis points"). That is the first time since 1996 that our basis point costs have declined.

2. **SWIB should continually re-evaluate its contracting procedures to ensure that it is diligently analyzing and justifying the need for consulting services.**

   a. We have strengthened our contracting practices and improved reporting to the Board on contract activities. We will report to the Board in May regarding other enhancements that will provide added assurance that the need for each consulting or other contract service is carefully evaluated and monitored.

   b. As a result of a re-evaluation of needs and a contract re-bidding, SWIB has reduced its annual costs for proxy voting services by nearly $102,000.

   c. SWIB renegotiated fees for quantitative strategy portfolios in 2001, 2003 and 2004. Savings from 2004 renegotiations alone saved the trust funds $3.4 million. The projected savings in future years will vary in relationship to the manager's performance.

   d. SWIB negotiated lower broker commissions at a savings of $1.4 million. We also eliminated some services and made other contract changes for electronic research services for an additional savings of $335,000 in 2004.

3. **SWIB should include in its quarterly reports to the Legislature all costs directly charged against investment income and provide more descriptive information regarding the nature of these costs.**

   a. SWIB recently submitted the report for the 4th quarter of 2004 and included all direct charges—not just those we are required to report by statute. The report provides a description for each type of expenditure and vendor to give the reader a clearer understanding of the information contained in the report.

   b. Prior to sending the report to the Legislature, we reviewed it with LAB staff to obtain their input. We welcome feedback from Committee members as well.

4. **SWIB should reconsider its use of performance recognition payments to provide financial awards to staff independent of its larger bonus program or, at a minimum, ensure that performance recognition payments are also considered when awarding bonuses.**

   a. Only two performance recognition payments (PRP), together totaling $3,400, were granted in calendar year 2004, both for distinct activities not recognized as part of the incentive awards.

b. We have no plans to grant any PRPs in the near future. Any PRP that is approved, however, will be carefully reviewed to ensure that it does not duplicate recognition of performance included as part of incentive compensation.

5. SWIB should discontinue its practice of paying additional retirement contributions for staff not designated as executive participating employees, and pursue statutory changes if it believes additional executive positions are warranted.

a. SWIB made additional retirement contributions in December, 2004 for those staff who had been promised the payment and had worked during the year in anticipation of receiving the benefit.

b. The Executive Director advised the affected staff in December 2004 that no future payments would be made for additional retirement contributions for the purpose of providing comparability with executive level retirement benefits unless the Legislature acted to approve changes to the current statutory authority.

c. At the end of the internal/external management and cost project, the Executive Director will be in a better position to determine SWIB's needs and if any equity issues exist among investment staff who have similar or identical responsibilities. If necessary at that time, SWIB will ask the Legislature to change the current law to authorize additional executive retirement benefits.

6. SWIB should remain diligent in using the bonus program to reward only meritorious performance and report to the Joint Legislative Audit Committee, upon completion, on changes it makes to its bonus program.

a. The Board of Trustees recently adopted changes to the incentive compensation program to simplify and make the program more equitable. A letter describing the changes will be distributed to committee members this week.

b. In addition to simplifying the program, the changes also strengthen our efforts to reward meritorious performance by eliminating the asset class component of the calculation. This may have allowed a small incentive plan payment to an individual even when all portfolio benchmarks were missed.


FORWARD

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March 16, 2005

Honorable Carol Roessler, Co-chair
Joint Legislative Audit Committee
8 South, State Capitol
Madison WI 53707

Honorable Suzanne Jeskewitz, Co-chair
Joint Legislative Audit Committee
314 North, State Capitol
Madison WI 53707

Subject: Compensation Plan

Dear Senator Roessler and Representative Jeskewitz:

I just discovered that the attached letter from Executive Director Dave Mills was inadvertently not mailed as promised earlier this month. I apologize for the delay and any inconvenience this may have caused you.

Sincerely,

Sandy Drew

Sandy Drew
Legislative and Beneficiary Liaison

Attachment

cc: Members of the Committee
Janice Mueller, LAB


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WISCONSIN STATE LEGISLATURE
Joint Legislative Audit Committee
Committee Co-Chairs:
State Senator Carol Roessler
State Representative Suzanne Jeskewitz

March 23, 2005

Mr. David Mills, Executive Director
State of Wisconsin Investment Board
121 East Wilson Street
Madison, Wisconsin 53702

Dear Mr. Mills:

Thank you for your testimony before the Joint Legislative Audit Committee on March 2, 2005. Your presentation was helpful in our examination of the findings presented in the Legislative Audit Bureau's evaluation of the State of Wisconsin Investment Board (report 04-13).

We also wish to acknowledge receipt of your letter, dated March 16, 2005, which updates the Committee on the changes to the incentive compensation plan that were recently completed and adopted by the Investment Board. Your letter carefully explains that simplification was the principal factor motivating these changes to the plan. We appreciate your efforts, and those of your staff, to keep the Committee appropriately apprised of this information.

Thank you for assistance. We look forward to working collaboratively with you in the future.

Sincerely,

Carol Roessler
Senator Carol A. Roessler, Co-chair
Joint Legislative Audit Committee

Suzanne Jeskewitz
Representative Suzanne Jeskewitz, Co-chair
Joint Legislative Audit Committee

cc: Janice Mueller
State Auditor

SENATOR ROESSLER
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REPRESENTATIVE JESKEWITZ
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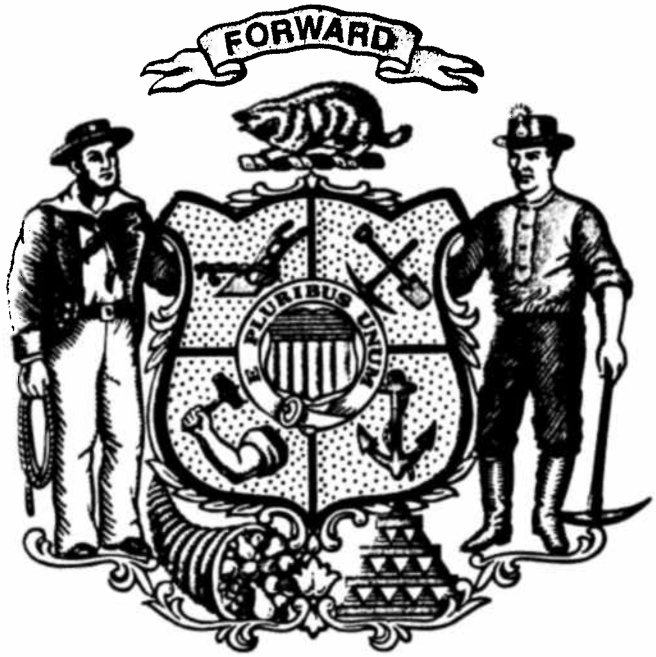
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March 31, 2005

Honorable Scott Fitzgerald, Co-Chair
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Honorable Carol A. Roessler, Co-Chair
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Honorable Suzanne Jeskewitz, Co-Chair
Joint Committee on Audit
PO Box 8952
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Dear Senators and Representatives:

I am writing to explain why I have decided to delay filing until next month the report on investment strategies and goals required by s. 25.17 (14m). I hope that you are in agreement with my decision, which I believe will result in the Legislature receiving much more complete and up-to-date information in the report.

In the latter part of 2004, the Board asked staff to begin a comprehensive strategic review of internal and external management and active versus passive investment strategies. The purpose of the project was to determine where SWIB has earned the best net return, given an appropriate level of risk, and what changes might be necessary to allow SWIB to continue to effectively invest the $75 billion under its care in the years ahead.

When the Legislative Audit Bureau (LAB) presented its management and performance audit of SWIB in November, it raised further questions regarding the extent and cost of using external managers, noting the adverse effect that certain statutory provisions may have on SWIB's selection of investment strategies. We included consideration of the issues raised in the audit as part of our strategic project.

Earlier this month I provided the Joint Legislative Committee on Audit with a status report, indicating that we would present recommendations to the Investment Board at its meeting on April 13. Following the Board meeting, we will finalize our report on goals and strategies for 2005 and forward it for your review. As agreed, I will also return to the Joint Legislative Committee on Audit to discuss our plans for responding to specific audit findings.

I hope my decision to delay the report meets with your approval. I am confident that the report will be much more meaningful to you and your colleagues. Please contact me if you have questions or would like me to provide further information.

Sincerely,

David C. Mills
Executive Director

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

WISCONSIN STATE LEGISLATURE

State of Wisconsin Investment Board

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April 28, 2005

Senator Scott Fitzgerald, Co-Chair
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Mr. Robert Marchant
Senate Chief Clerk
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Mr. Patrick Fuller
Assembly Chief Clerk
PO Box 8952
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Members of the Legislature:

As provided in section 25.17(14m) of the Statutes, attached is our annual report to the Legislature regarding investment goals, long-term strategies and performance. As a follow-up to our discussions with the Joint Legislative Audit Committee, this report also addresses a number of findings and recommendations in the Legislative Audit Bureau's November 2004 management review of SWIB.

Major observations about 2004:

- Assets under management grew from $69.1 billion at the end of 2003 to $74.7 billion as of December 31, 2004, an increase of $5.6 billion.

- The 12.8% return for the Fixed Retirement Trust Fund surpassed the 11.7% return for its performance benchmark in 2004. The Fund also exceeded its benchmark on a five-year and ten-year basis. The Fixed Fund is invested in a diversified mix of stocks, bonds, real estate and other assets. A fourth quarter surge in US stocks combined with strong returns from international markets, private equity and real estate contributed to the Fund's favorable return.

- The 12.7% return for the Variable Retirement Trust Fund trailed the 13.4% return for its performance benchmark in 2004. The Variable Fund invests in domestic and international stocks. An overweighting in small cap technology stocks, adverse developments for several pharmaceutical stocks, and earnings disappointments for several other mid cap and large cap stocks contributed to the Fund's under-performance in 2004. However, at year-end, the Variable Fund remained ahead of its five-year and ten-year benchmarks.

- The 1.3% return for the State Investment Fund (SIF) slightly lagged the 1.4% return for its performance benchmark in 2004. The SIF was ahead of its five-year and ten-year benchmarks at year-end. The SIF is a cash management fund for state agencies, local governments and the Wisconsin Retirement System.

- During fiscal year 2004, SWIB made over $684.3 million in new investments in Wisconsin companies. Wisconsin investments are subject to the same due diligence and fiduciary responsibility standards that apply to all other investments.

- Our total cost of management in 2004 was $156.7 million, the same as in 2003. Relative to assets, our total cost fell from 25 cents for each $100 managed in 2003 to 22 cents in 2004.

To take advantage of changing opportunities in the marketplace, SWIB must be more flexible than ever and able to leverage the strengths of our staff as well as those of our outside managers. We recently completed an extensive review to ensure that we are using internal and external resources cost effectively to achieve optimal net investment returns.

Our review: (1) compared SWIB's mix of portfolio management styles and net returns to those our peers; (2) modeled the potential effects on net returns and risk from alternative mixes of internal and external management and active and passive management; and (3) compared SWIB's budget and management authority to that of our peers. Findings were presented to the Board earlier this month.

Overall, our review suggests that SWIB is generally well positioned in the use of internal and external resources and mix of active and passive management styles. However, we have identified a number of potential ways in which we could enhance our position. We are pursuing improvements in these areas. Several relate to topics raised in the LAB audit, and they are discussed in more detail in the attached report. I would welcome the opportunity to discuss them with you.

Please let me know if you have any questions or comments about the report.

Sincerely,

David C. Mills
Executive Director

cc: Members, Joint Committee on Finance
Members, Joint Legislative Audit Committee
Robert Lang, Legislative Fiscal Bureau
Janice Mueller, Legislative Audit Bureau

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May 3, 2005

Honorable Scott Fitzgerald, Co-Chair
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Members of the Legislature:

Pursuant to s. 25.17 (14r), Wis. Stats., I have attached a revised copy of SWIB's "Investment Policy, Objectives, and Guidelines" recently adopted by the Board of Trustees plus a copy that shows the language added or deleted as a result of the changes. In summary, these amendments:

1. *Change the types of investments that the private equity portfolio may make.* Investments in private equity, primarily leveraged buyouts and venture capital, comprise approximately 2.6% of the assets of the Fixed Trust Fund. The changes reflect the Board's decision to make fewer direct private equity investments and more investments in limited partnerships. Except for follow-on funds and secondary fund purchases, the Board's private equity consultant will review all initial prospective investments and confirm that they meet appropriate standards for a prudent investor. In addition, the amendments require the Board to approve all direct private equity investments if: (1) SWIB owns more than 50% of a company or is the lead investor; and (2) if investments made outside the US, including emerging markets, exceed 33% of the portfolio. These amendments maximize use of SWIB's internal resources, provide access to a broader range of investments than when making direct investments and should reduce risk and volatility.

2. *Grant greater authority to the Chief Investment Officer (CIO) – Private Markets and portfolio managers.* Under the new guidelines, the CIO has authority to review and approve

all proposed private equity investments up to $200 million and up to $150 million for real estate investments, which previously would have been submitted to the staff Risk and Investment Committee for approval. The amendments grant staff authority to take any actions necessary to protect, maintain or enhance SWIB's investments. Real estate staff may select up to five advisors that will have discretion of up to $100 million in capital within predetermined SWIB guidelines. The emphasis for private equity portfolios to invest in limited partnerships means less risk and volatility in the portfolios, thus justifying the higher limits. The result is that staff has authority and the flexibility to invest in these funds, without having to await the results of a Committee meeting. In the current very competitive marketplace in which partnerships are often oversubscribed, this will allow staff to secure a position in those partnerships that afford the potential to earn the highest return.

3. *Replace the Risk and Investment Committee with an Investment Committee and a Compliance Committee and clarify the duties of each committee.* The former staff committee, comprised of senior managers, reviewed investment, compliance and operational issues and made recommendations to the Board. As part of the agency's strategic initiatives, staff recommended and the Trustees approved creation of two committees to replace the Risk and Investment Committee and to utilize staff more efficiently. The Investment Committee, composed primarily of investment staff and chaired by the Executive Director, concentrates on the markets, investment strategies and specific investments. The Compliance Committee, composed primarily of support managers and chaired by the Deputy Executive Director, reviews procedures and processes to assure that all laws governing the agency and policies adopted by the Trustees are followed.

4. *Revise the annual comprehensive asset allocation review for the Fixed Trust Fund by creating a two-year cycle involving a biennial comprehensive review in year one and an off-year planning format that considers necessary adjustments and new initiatives in year two of the cycle.* The comprehensive review will continue to include an asset/liability modeling process designed to determine a suitable target allocation for each asset class, to contemplate a long-term time horizon (5-7 years) and to project the long-term impact of poor, normal and above average market results on the Fixed Trust Fund. During the off-year, the Board will fine-tune the asset allocations and make structural or other interim changes as justified. This process reflects the fact that long-term assumptions regarding liabilities and investment markets do not change significantly enough each year to warrant a comprehensive annual asset allocation review.

5. *Modify targeted asset allocations for the Fixed Trust Fund to reflect changes for 2005.* During its first off-year review, the Trustees established a 2% allocation for a multi-asset class. SWIB had created a multi-asset portfolio, but there had not been an explicit allocation for it. As an administrative matter, the Wisconsin Private Debt Portfolio and the NML Real Estate Mortgages are now part of the private markets asset class rather than fixed income. These changes were made to complete a previous repositioning of portfolios and to establish a better alignment for certain classes of investments.

6. *Create a 1% multi-asset allocation for the Variable Retirement Trust Fund for 2005 by lowering* the US equities' allocation 1%. This is in keeping with the change made to the Fixed Fund.

7. *Include minor modifications to the guidelines for the Wisconsin Private Debt Portfolio to* clarify the portfolio's primary responsibility and area of authority.

8. *Require each portfolio manager for each asset class to provide an update on portfolio strategies to the Board at least twice a year.* Prior guidelines only addressed updates by the Private Markets Group.

9. *Clarify that the Guidelines apply only to internally managed portfolios.* Guidelines for externally managed portfolios or funds are included in the contract SWIB has with the individual external manager.

10. *Clarify the authority of U.S. equities portfolios to invest in a broad range of equity investments including convertible bonds, preferred stocks, exchange traded funds (ETFs), American depository receipts (ADRs), initial public offerings and securities when issued.* All of these items are publicly traded on the US markets, but some are relatively new in the last decade and reflect the changing markets. The amendments merely make it clear that these investments are within the existing authority for U.S equities portfolios.

11. *Increase the current authority of fixed income portfolios to invest in Rule 144A investments.* Rule 144A of the Federal Securities Act makes it easier for institutional investors to buy and sell unregistered securities, which are private debt investments of public issuers that are not available to non-institutional investors. These bonds are frequently registered as a public bond at a later date. The amendment to the Guidelines increases from 10% to 40% the amount of a portfolio's market value that may be invested in Rule 144A investments.

12. *Add or change benchmarks for certain portfolios.* The Board changed the benchmarks for the private equity portfolios to measure their performance more accurately against other private equity portfolios.

13. *Change soft risk parameters for equities and private market portfolios.* "Soft risk parameters" are intended to monitor various types of risk in a portfolio or asset class. If the parameters are exceeded, additional internal discussion and review are triggered. The new parameters for public equities are generally more conservative than the previous ones and, for some portfolios, will reduce volatility and enhance diversification. The changes to the private equity portfolios are more focused toward buyouts and less on venture capital. The one change that affects real estate increases from 40% to 50% the maximum exposure that the portfolio can have in a single property type.

14. *Increase from $450 million to $500 million the amount that SWIB invests in the WI Certificate of Deposit (CD) Program.* Under contract with SWIB, Bankers' Bank administers the program. SWIB purchases the CDs from participating Wisconsin banks and thrifts, thus providing them with additional capital to meet several local credit needs.

15. *Set the parameter for rebalancing public equities around the entire asset class rather than applying it separately to US equities and international equities.* When market activities cause the value of an asset class to exceed the limits of its target range by 10%, assets are sold and cash is reinvested in an asset class that is below its target. This activity is referred to as "rebalancing". Under the new guidelines, the Chief Investment Officer (CIO) – Equities has authority to consider within specific limits both domestic and international allocations when a rebalance is necessary, rather than rebalancing the domestic and international allocations separately. The CIO of Fixed Income already had this authority, which gives the CIOs more flexibility to move the funds within their own areas based on the attractiveness of domestic versus international markets.

16. *Clarify that the Global Bond Portfolio many only invest in publicly traded fixed income securities.* The original intent was that this portfolio could not trade in privately traded global fixed income securities, and it has not done so since inception. The amendment merely codifies the intent and practice.

17. *Establish separate guidelines for U.S. Treasury Inflation Protected Securities (TIPS).* TIPS provide a hedge against inflation and an important strategic and tactical complement to traditional fixed income strategies. Previously, they were considered under the guidelines for the Corporate/Government Portfolio.

18. *Incorporate minor amendments to include statute cites, name changes, and rewording of existing Guidelines.*

SWIB's "Investment Goals, Strategies and Performance Report" was filed last week and provides a more detailed discussion of strategy and investment changes being implemented as a result of changes to the Guidelines. Please contact me if you have any questions.

Sincerely,

David C. Mills
Executive Director

Enclosures