

☛ **07hr_JC-Au_Misc_pt31**



☛ Details: Legislative Audit Bureau Report 07-10: An Evaluation: State of Wisconsin Investment Board

(FORM UPDATED: 08/11/2010)

WISCONSIN STATE LEGISLATURE ... PUBLIC HEARING - COMMITTEE RECORDS

2007-08

(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) (October 2012)



STATE OF WISCONSIN

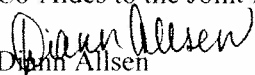
Legislative Audit Bureau

22 E. Mifflin St., Ste. 500
Madison, Wisconsin 53703
(608) 266-2818
Fax (608) 267-0410
Leg.Audit.Info@legis.state.wi.us

DATE: July 31, 2007

Janice Mueller
State Auditor

TO: Lewis Rosser and Pamela Matthews
Co-Aides to the Joint Legislative Audit Committee

FROM: 
Dawn Allsen
Financial Audit Director

SUBJECT: Report 07-10: An Evaluation of the State of Wisconsin Investment Board

As required by s. 25.17 (51m), Wis. Stats., we have completed our fourth biennial evaluation of the State of Wisconsin Investment Board, which manages a total of \$88.4 billion in assets, of which over 94 percent consists of Wisconsin Retirement System assets. As in past evaluations, we reviewed the Investment Board's performance in managing the retirement system assets. We also completed a focused review of the holdings, strategies, procedures, and practices of the Investment Board's private markets group, which manages private equity, real estate, and Wisconsin private equity and debt investments.

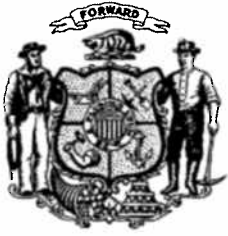
The Core and Variable retirement funds provided mixed returns for periods ending December 31, 2005 and 2006. The Core Fund ranked in the middle in comparison to nine other public pension funds surveyed. International equities, real estate, and private equity were among the Investment Board's better performing asset classes, while domestic equities was the most notable underperforming asset class. The Investment Board is taking steps to improve the performance of the domestic equities, which we will monitor in future audits. We also include a recommendation that the Investment Board re-evaluate its policies and procedures for making investments that affect the Variable Fund because that Fund's performance was less than that of the overall equities held by both retirement funds.

Overall, we found the Investment Board has improved its management of private markets investments. Correspondingly, the private markets investments provided strong returns in 2005 and 2006. We do offer recommendations for improvement in some of the more technical areas, including use of transition portfolios and benchmarks for the real estate portfolios.

Finally, our report includes an informational chapter on Wisconsin investments. The Investment Board has been making loans to Wisconsin companies through its Wisconsin private debt portfolio since 1983. It established the Wisconsin private equity portfolio in 2000 to focus on venture capital funds active in Wisconsin and the Midwest. While the private debt portfolio is providing solid returns, we believe it is too early to assess the success of the private equity portfolio. We include a recommendation that the Investment Board report to the Legislature on the performance of the Wisconsin private equity portfolio.

The Investment Board has been responsive to our recommendations and has included in its audit response detailed steps and timetables it plans to take in response to each audit recommendation.

This report will be released on Wednesday, August 1, at 9:00 a.m. Please contact us if you have any questions.

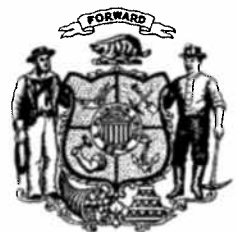


The following document was too large to scan into the committee record. The cover and table of contents, if available, have been scanned for your convenience.

Most large publications have been added to the Theoblod Legislative Library's collections. Search LRBCat (<http://lrbcats.lrb.wisconsin.gov/>) for availability.

For further assistance, contact the reference desk at (608) 266-0341 or lrb.reference@legis.wisconsin.gov.

State of Wisconsin - Legislative Reference Bureau
1 East Main Street, Suite 200
Madison, WI 53703



**Report 07-10
August 2007**

An Evaluation

State of Wisconsin Investment Board

2007-2008 Joint Legislative Audit Committee Members

Senate Members:

Jim Sullivan, Co-chairperson
Julie Lassa
Russell Decker
Alan Lasee
Robert Cowles

Assembly Members:

Suzanne Jeskewitz, Co-chairperson
Samantha Kerkman
Kitty Rhoades
David Cullen
Joe Parisi

LEGISLATIVE AUDIT BUREAU

The Bureau is a nonpartisan legislative service agency responsible for conducting financial and program evaluation audits of state agencies. The Bureau's purpose is to provide assurance to the Legislature that financial transactions and management decisions are made effectively, efficiently, and in compliance with state law and that state agencies carry out the policies of the Legislature and the Governor. Audit Bureau reports typically contain reviews of financial transactions, analyses of agency performance or public policy issues, conclusions regarding the causes of problems found, and recommendations for improvement.

Reports are submitted to the Joint Legislative Audit Committee and made available to other committees of the Legislature and to the public. The Audit Committee may arrange public hearings on the issues identified in a report and may introduce legislation in response to the audit recommendations. However, the findings, conclusions, and recommendations in the report are those of the Legislative Audit Bureau. For more information, write the Bureau at 22 E. Mifflin Street, Suite 500, Madison, WI 53703, call (608) 266-2818, or send e-mail to leg.audit.info@legis.wisconsin.gov. Electronic copies of current reports are available on line at www.legis.wisconsin.gov/lab.

State Auditor – Janice Mueller

Audit Prepared by

Diann Allsen, *Director and Contact Person*

Brandon Brickner

Aimee Wierzba

Director of Publications – Jeanne Thieme

Report Design and Production – Susan Skowronski

CONTENTS

Letter of Transmittal	1
Report Highlights	3
Introduction	9
Investment Performance of the Wisconsin Retirement System	17
Investment Goals and Strategies	18
Composition of Core Fund	19
Investment Strategy Decisions	22
Performance Compared to Benchmarks	24
Comparison to Other Public Pension Funds	28
Allocation and Investment Decisions for the Variable Fund	30
Private Markets Investments	33
History of Private Markets Group	33
Prior Concerns and Recommendations	34
Staffing Issues	37
Transition Portfolios	38
Decreased Presence in Private Equity Markets	39
Management Improvements	41
Strategic Changes	41
Improved Due-Diligence and Monitoring Procedures	42
Performance of Private Investments	44
Private Equity Investments	44
Real Estate Investments	46
Benchmarks	47
Future Challenges	49
Wisconsin Investments	53
Overview of Asset Classes	53
Wisconsin Private Debt Portfolio	55
Wisconsin Private Equity Portfolio	56

Appendices

- Appendix 1—Investment Board Organization Chart
- Appendix 2—Five-Year Comparison of Core and
Variable Fund Asset Allocations
- Appendix 3—Performance of the Investment Board's
Individual Asset Classes

Response

From the Executive Director of the State of Wisconsin Investment Board



STATE OF WISCONSIN

Legislative Audit Bureau

22 E. Mifflin St., Ste. 500

Madison, Wisconsin 53703

(608) 266-2818

Fax (608) 267-0410

Leg.Audit.Info@legis.wisconsin.gov

Janice Mueller
State Auditor

August 1, 2007

Senator Jim Sullivan and
Representative Suzanne Jeskewitz, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Sullivan and Representative Jeskewitz:

We have completed an evaluation of the State of Wisconsin Investment Board, as directed by s. 25.17(51m), Wis. Stats. As of December 31, 2006, the Investment Board managed a total of \$88.4 billion in investments that included assets of the Wisconsin Retirement System, the State Investment Fund, and five smaller insurance and trust funds.

The retirement funds provided mixed returns for periods ending December 31, 2005 and 2006. The Core Fund exceeded all of its benchmarks. The Variable Fund met or exceeded all of its benchmarks in 2005 but lagged its three- and five-year benchmarks at the end of 2006. We include a recommendation for the Investment Board to re-evaluate its policies and procedures for making decisions affecting the Variable Fund's performance.

The Core Fund's performance ranked in the middle in comparison to nine other public pension funds surveyed as of December 2006. A relatively lower allocation to private equity and real estate and underperformance of its domestic equities contributed to this ranking.

In past years, the Investment Board encountered difficulties in the management of private markets investments. It has made organizational, staffing, and procedural changes to address these concerns. Correspondingly, its private markets investments have provided strong returns in recent years.

The Investment Board manages two private markets portfolios with a Wisconsin emphasis. The Wisconsin private debt portfolio is providing solid returns. However, it is too early to assess the long-term success of the Wisconsin private equity portfolio, which was established in 2000.

We appreciate the courtesy and cooperation extended to us by the Investment Board. A response from the Board's Executive Director follows the appendices.

Respectfully submitted,

Janice Mueller
State Auditor

JM/DA/ss

Report Highlights ■

Most, but not all, performance benchmarks have been met.

The Investment Board has improved its management of private markets investments.

Private markets investments provided strong returns in 2005 and 2006.

The Investment Board manages two private markets portfolios with a Wisconsin emphasis.

The Investment Board faces several challenges in maintaining a successful private markets program in the future.

The State of Wisconsin Investment Board manages the assets of the Wisconsin Retirement System, the State Investment Fund, and five other state insurance and trust funds. Two Wisconsin Retirement System funds—the Core Retirement Investment Trust and the Variable Retirement Investment Trust—account for 94.1 percent of all assets under its management. They fund retirement benefits for more than 540,000 current and former state and local government employees.

In total, the Investment Board managed \$88.4 billion in assets as of December 31, 2006. Its domestic and international investments included stocks, bonds, real estate, private equity, private debt (including direct loans to Wisconsin companies), and cash.

The Investment Board's nine-member Board of Trustees establishes long-term investment strategies and policies. The Executive Director, professional staff in 99.5 other full-time equivalent positions in the State's unclassified civil service system, and 4.0 classified employees are responsible for day-to-day investment management. For some investments, external managers and advisors supplement staff resources or provide expertise that would otherwise not be available.

Statutes require the Legislative Audit Bureau to perform a biennial management audit of the Investment Board. In addition to reviewing its performance in managing Wisconsin Retirement System assets, we reviewed the holdings, strategies, procedures, and practices of the Investment Board's private markets group.

Investment Performance

A rebound in investment markets during 2003 brought both retirement funds double-digit returns that were among their highest in the preceding 20 years. As shown in Table 1, positive returns continued through 2006.

Table 1

Annual Returns

Year	Core Fund	Variable Fund
2002	(8.8)%	(21.9)%
2003	24.2	32.7
2004	12.8	12.7
2005	8.6	8.3
2006	15.8	17.6

The Core Fund met or exceeded all of its benchmarks at the end of 2005 and 2006. The Variable Fund met or exceeded all of its benchmarks at the end of 2005 but lagged its three- and five-year benchmarks at the end of 2006.

International equities, real estate, and private equity were among the Investment Board's better performing asset classes. The most notable underperforming asset class was domestic equities, which missed one-, three-, and five-year benchmarks at the end of 2006. In response, the Investment Board has undertaken several steps to reorganize equity portfolios and staff in an effort to improve performance.

As of December 2006, the Core Fund's performance ranked in the middle compared to nine other public pension funds. A lower allocation of assets to private equity and real estate compared to the top-performing pension funds, and under-performance of its domestic equities contributed to its middle ranking.

The Variable Fund's performance lags the composite performance of all equity portfolios in both retirement funds managed by the Investment Board. We include a recommendation for the Investment Board to re-evaluate its policies and procedures for making decisions affecting the Variable Fund's performance.

Management of Private Markets Investments

Private markets investments include private equity, real estate, and private debt. These investments can offer the potential for higher returns, although at a higher risk.

The Investment Board encountered difficulties in the management of several of its private markets investments in past years because it did not have an adequate structure, resources, and controls in place to support their success. Beginning in 2002, it took several steps to address these concerns. One of the major steps was to establish a private markets group to manage all private markets investments under one managing director. The Investment Board also made strategic changes to help reduce the level of risk associated with its private equity investments, and it improved due-diligence procedures and increased its monitoring efforts.

Performance of Private Markets Investments

Private equity and real estate investments provided strong returns during 2005 and 2006. As shown in Table 2, both asset classes significantly exceeded their benchmarks in each year. One of the major contributing factors to private equity's performance was the successful liquidation of several investments in a private equity transition portfolio. Strong returns on international investments benefited real estate performance.

Table 2

Performance of Private Equity and Real Estate Investments One-Year Returns for 2005 and 2006

Asset Class	2005		2006	
	Return	Benchmark	Return	Benchmark
Private Equity	44.2%	30.4%	28.7%	20.3%
Real Estate	28.2	19.2	30.1	17.6

A continuing challenge in evaluating performance for the private markets investments is establishing appropriate benchmarks. Since 2000, the Investment Board has changed or modified its private

equity benchmarks five times as industry-wide performance data have become more available.

Benchmarks for real estate, which is a more established asset class, have not changed as frequently. However, we believe the Investment Board should regularly analyze whether its benchmarks continue to be appropriate, based on the strategies and investments included in the real estate portfolios. For example, the current benchmark for the real estate funds portfolio does not consider that portfolio's international investments, which contributed significantly to its performance and represented 55.7 percent of its value at the end of 2005, and 43.7 percent as of September 30, 2006.

Wisconsin Investments

The Investment Board regularly makes investments in Wisconsin through the various asset classes it manages. It has invested almost \$1.4 billion in companies headquartered or with a significant presence in Wisconsin, including a private debt portfolio and a private equity portfolio with a Wisconsin emphasis.

On December 31, 2006, the Wisconsin private debt portfolio was valued at \$352.7 million, which represented loans and investments with 31 different Wisconsin companies. That portfolio has had relatively steady performance over the past several years, and it exceeded all of its benchmarks for periods ending December 31, 2005 and 2006.

The Wisconsin private equity portfolio was established in 2000 to focus on venture capital funds active in Wisconsin and the Midwest. Through 2006, the Investment Board has committed \$180.0 million to four venture capital firms. Of that amount, \$77.7 million has been invested, including \$32.5 million in Wisconsin companies.

The Wisconsin private equity portfolio had negative returns and significantly underperformed its benchmarks for all periods at the end of 2005 and 2006. The Investment Board attributes the underperformance to the fact the portfolio is relatively new: early-stage private equity investments are expected to earn below-benchmark returns until several years have passed. Consequently, it will be important to closely monitor the performance of this portfolio in future years, to ensure it provides the level of return that meets the Investment Board's fiduciary responsibilities.

Future Challenges

The Investment Board faces several challenges in maintaining a successful private markets program in the future. One major challenge is meeting its allocation targets as competition for private market investments increases.

The Investment Board is implementing or considering several options for increasing its access to private markets investments, including hiring an additional private equity consultant to identify more investment opportunities. As it evaluates options for increasing investments in these markets, the Investment Board should also ensure that it has corresponding procedures and controls in place to properly protect its interests, and to ensure prudent investments.

At the same time, recent staff turnover suggests the Investment Board will face continuing challenges in hiring and retaining staff with skills to develop and monitor complex and higher-risk investment strategies in the private equity investments.

Recommendations

Our recommendations address the need for the Investment Board to:

- ☑ re-evaluate its policies and procedures for making allocation and investment decisions that affect the Variable Fund (*p. 31*);
- ☑ review closely the process of and decisions made by investment staff in the placement of investments into transition portfolios (*p. 39*);
- ☑ regularly analyze the continuing appropriateness of its benchmarks for the real estate portfolios (*p. 49*); and
- ☑ in its annual report to the Legislature, report on its success in increasing its investments in private markets and on the performance of its Wisconsin private equity portfolio (*pp. 51 and 59*).

■ ■ ■ ■



WISCONSIN STATE LEGISLATURE

Joint Legislative Audit Committee

Committee Co-Chairs:
State Senator Jim Sullivan
State Representative Suzanne Jeskewitz

For Immediate Release

August 1, 2007

For More Information Contact:

Senator Jim Sullivan
Representative Suzanne Jeskewitz

(608) 266-2512

(608) 266-3796

Audit Assesses Asset Management Practices at SWIB

(Madison) Today, the nonpartisan Legislative Audit Bureau (LAB) released its statutorily required, biennial evaluation of the State of Wisconsin Investment Board (SWIB). As of December 31, 2006, SWIB managed \$88.4 billion in assets. Two Wisconsin Retirement System funds—the Core Retirement Investment Trust and the Variable Retirement Investment Trust—account for 94.1 percent of all assets managed by SWIB and fund retirement benefits for more than 540,000 current and former state and local government employees.

In its comprehensive report, LAB found that the Core Fund met or exceeded all of its benchmarks at the end of 2005 and 2006. In December 2006, the Core Fund's performance ranked in the middle compared to nine other public pension funds. The Variable Fund met or exceeded all of its benchmarks at the end of 2005, but lagged its three-year and five-year benchmarks at the end of 2006. The Variable Fund's performance lags the composite performance of all equity portfolios in both retirement funds managed by SWIB. In its report, LAB includes a recommendation for SWIB to re-evaluate its policies and procedures for making decisions affecting the Variable Fund's performance.

SWIB's private equity and real estate investments provided strong returns during 2005 and 2006. However, a continuing challenge in evaluating performance for the private markets investments is the establishment of appropriate benchmarks. For example, LAB recommends that SWIB should regularly analyze its real estate portfolio benchmarks, which do not currently reflect the portfolio's international investments that contributed to nearly half of its value in 2005 and 2006.

LAB's report also indicates SWIB has invested \$1.4 billion in companies that are headquartered or have a significant presence in Wisconsin. On December 31, 2006, the Wisconsin private debt portfolio was valued at \$325.7 million, which represented loans and investments with 31 different Wisconsin companies. This portfolio exceeded all its benchmarks at the end of 2005 and 2006. SWIB has also committed \$180.0 million to four venture capital firms through the Wisconsin private equity portfolio, which was established in 2000 to focus on venture capital funds active in Wisconsin and the Midwest. Of that amount, \$77.7 million has been invested, including \$32.5 million in Wisconsin companies. However, this portfolio has significantly underperformed its benchmarks for the periods at the end of 2005 and 2006. LAB recommends close monitoring of portfolio performance in future years.

Co-chairs Sullivan and Jeskewitz indicate that the Joint Legislative Audit Committee will hold a public hearing on the audit report this fall. Interested members of the public are invited to testify before the Joint Legislative Audit Committee at that time. Copies of the audit report may be obtained from LAB's Web site at www.legis.wisconsin.gov/lab or by calling (608) 266-2818. A podcast of the report highlights for report 07-10 is also available on LAB's Web site.

###

SENATOR SULLIVAN
P.O. Box 7882 • Madison, WI 53707-7882
(608) 266-2512 • Fax (608) 267-0367

REPRESENTATIVE JESKEWITZ
P.O. Box 8952 • Madison, WI 53708-8952
(608) 266-3796 • Fax (608) 282-3624