BOARD OF COMMISSIONERS OF PUBLIC LANDS 1848

Managing Wisconsin's trust assets for public education.

Legislative Council Testimony 11/14/2018

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Thank you for inviting me to testify. I have read and listened to all of the testimony provided to date, and many of the presenters have been excellent. I have a few comments on the previous testimony, and then along with my colleagues, I will be happy to answer any questions.

1. Much has been said about the "Endowment Model" and the testimony of Cathleen Rittereiser, author and Executive Director of the Common Fund Institute. I am a huge fan of this model. In fact, I have personally bought copies of Ms. Rittereiser's book for every member of our Board and Investment Committee for several years.

   The main takeaway from the Endowment Model is that endowments and foundations should use the advantage of a long investment horizon to achieve higher expected returns. These increased returns are available by investing in assets that include higher risk and liquidity premiums, such as private equity, hedge funds and real estate.

   However, I was disappointed that Ms. Rittereiser did not become familiar with the objectives and constraints of BCPL and the Common School Fund (CSF) prior to her testimony. All funds must be managed inside the boundaries created by unique objectives and constraints, and full implementation of the Endowment Model can only take place in a relatively unrestricted environment.

   The increase in earnings volatility from an outsized allocation to these riskier investments is not compatible with the CSF because of two main constraints on the management of the CSF:

   - Trust Fund beneficiaries depend on a stable and secure distribution, which provides the sole source of state funding directed to public school libraries; and
   - The Wisconsin Constitution does not allow the distribution of Trust Fund principal.

   Taken together, these two constraints prevent the full implementation of the Endowment Model. The best summary of our investment policy is that BCPL incorporates important elements of the Endowment Model, but adapts that model to the objectives and constraints of the CSF.

   BCPL has adapted the Endowment Model to the Common School Fund in three separate ways:

a) First, we have established a smoothing account to supplement the distribution of earnings in down years. This account is funded by retaining income and serves as a substitute for the distribution of fund principal. This smoothing account has nearly reached our initial goal at 50% of the annual distribution, and allows for an increase in portfolio risk including the addition of assets that do not generate distributable income.

b) The second way BCPL has adapted the Endowment Model is to reduce it's scope. Please take a look at Exhibit 1 to see how University Endowments are using the model today. In 2017, the National Association of University and College Business Officers/Commonfund Study found that Endowments with over $1 Billion in assets had nearly 90% of assets invested in public equity, private equity, hedge funds, venture capital, real estate, commodities and distressed debt

   Many of these asset classes do not produce regular distributable income. Even with a fully funded smoothing account, a 90% allocation to these assets classes is too high given our objective to provide the significant, stable and secure distribution required by CSF beneficiaries.

   Our current investment policy includes target allocations to equities (15%), real estate (5%) and venture capital (3%). As the amounts held in the smoothing account increase over time, it is anticipated that our Board will want to modify these allocations to improve expected returns. But the objectives and constraints of the CSF mean that we will probably never make it to the 90% allocation currently used by large endowments.

c) The third step in adapting the Endowment Model involves the pace of implementation. Generational equity means that the needs of both current and future beneficiaries are considered and balanced in the management of the Trust Funds. Generational equity greatly impacts our view of the fiduciary responsibility at BCPL.

   Chris Anton, Manager of Investments for the BCPL counterpart in Idaho, testified about the transition his state undertook when bringing trust fund management under prudent investor standard. This is similar to the process now underway at BCPL.

   During Mr. Anton's presentation, there was no mention of the many years of reduced distributions suffered by Idaho beneficiaries under a new asset allocation. Exhibit 2 shows that the 2002 distribution was reduced by 50% within three years, and this level was not reached again for another 16 years. This reduction in distributions totaled $342 million during this 16-year period, an incredible loss to current students. BCPL believes that Idaho moved too quickly into assets that did not produce regular distributable income.

   The importance of generational equity led BCPL to hold discussions with fund beneficiaries prior to the implementation of our new Investment Policy. This committee has heard from many of these same beneficiaries, who have passionately discussed the importance of a significant, stable, and secure annual distribution. Following these discussions, BCPL adopted an approach leading to a more gradual allocation to non-income producing assets.

The effort of BCPL to maintain a stable distribution while filling the CSF smoothing account has succeeded. Exhibit 3 shows distributions for Wisconsin and Idaho Trust Funds for the years prior to and following the implementation of a new asset allocation. The BCPL Distribution recovered to 94% of the prior maximum distribution within 2 years, while the reduction in Idaho took 16 years to recover. The fact that the smoothing fund has nearly reached its initial funding level should accelerate the transition to riskier assets.

However, the pace of implementation has also been impacted by our position in the current economic cycle. In general, the relatively high cost of assets in this market climate has reduced the pace of diversification. Expert forecasts have led the BCPL Investment Committee to enter the real estate and public equity markets in a slow and measured process, rather than making quick acquisitions at what may be the height of the market. We do not think it is wise to quickly sell our quality fixed-income securities only to purchase other assets near the end of the longest bull market in history.

At the same time, we acknowledge the need to begin the diversification process. BCPL has chosen a measured pace in acquiring passively-managed ETFs to fulfill our equity allocation. Over the past 9 months, BCPL has acquired roughly $30 million in equity ETFs, and we expect to continue these acquisitions at a pace of about $1 million per week. During the past year, we have also made commitments to two local venture capital funds that had been previously vetted with significant commitments by both SWIB and WARF.

To summarize once again, I believe the best way to describe the BCPL investment policy is to say that we incorporate the important elements of the Endowment Model - increasing the expected future returns by allocating to risky and illiquid assets - but we are doing so in a prudent manner that adapts the model to the objectives and constraints of the CSF.

2. The Committee also heard from the State Treasurer, who testified that because the WRS has achieved a higher return than BCPL over the last 20 years, it was a "no-brainer" to transfer management of the Trust Funds to SWIB.

However, this idea was strongly refuted by the testimony of Rochelle Klaskin, the Interim Executive Director at SWIB. Ms. Klaskin testified that constitutional and statutory constraints on the investment of the CSF would require a different asset allocation than the WRS and could not be expected to generate the same level of returns. This analysis was confirmed by the

BOARD OF COMMISSIONERS OF PUBLIC LANDS 1848

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Legislative Fiscal Bureau memo, dated less than one year ago, that concluded that under the same constraints, SWIB returns would be similar to the returns earned by BCPL.

Furthermore, Ms. Klaskin provided testimony that fund expenses would increase dramatically under SWIB management. Transferring all assets to SWIB would cost Trust Fund beneficiaries at least $3.3 million per year, and because SWIB indicated that they would hire outside managers for the CSF, the costs would likely be substantially higher.

3. Questions have been asked during prior committee meetings about BCPL investment in tax-exempt securities. The quick answer is yes. BCPL does purchase tax-exempt bonds on occasion, but only to take advantage of an opportunity created by unusual market conditions.

   The municipal bond market is far from perfectly efficient. At certain times, individual tax-exempt municipal bonds may be priced to yield at or near the same return as similar taxable bonds. Everyone can agree that this is an unusual situation, because investors should be focused on after-tax returns. This unusual situation creates an opportunity for BCPL, because there is a high probability that these tax-exempt bonds will soon return to normal market conditions – priced to yield significantly lower than a similar taxable bond.

   One recent example was a tax-exempt bond issuance by Sun Prairie School District almost exactly one year ago today. For some reason, the underwriters had trouble selling the bond issue, and BCPL was able to purchase about $8 million of the bonds at a discount. We sold those bonds about 3 months later for a profit of about $465,000.

   BCPL is happy to purchase tax-exempt securities to take advantage of market inefficiencies, but tax-exempt investments have never been a major part of our portfolio. We currently have about $4 million in tax-exempt securities in our bond portfolio, accounting for less than ½ of 1% of managed assets.

Thank you for allowing me to testify before this committee. I hope I have answered some of your questions regarding the Investment Policy at BCPL, and I will gladly answer any questions.

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1848

Legislative Council Study Committee

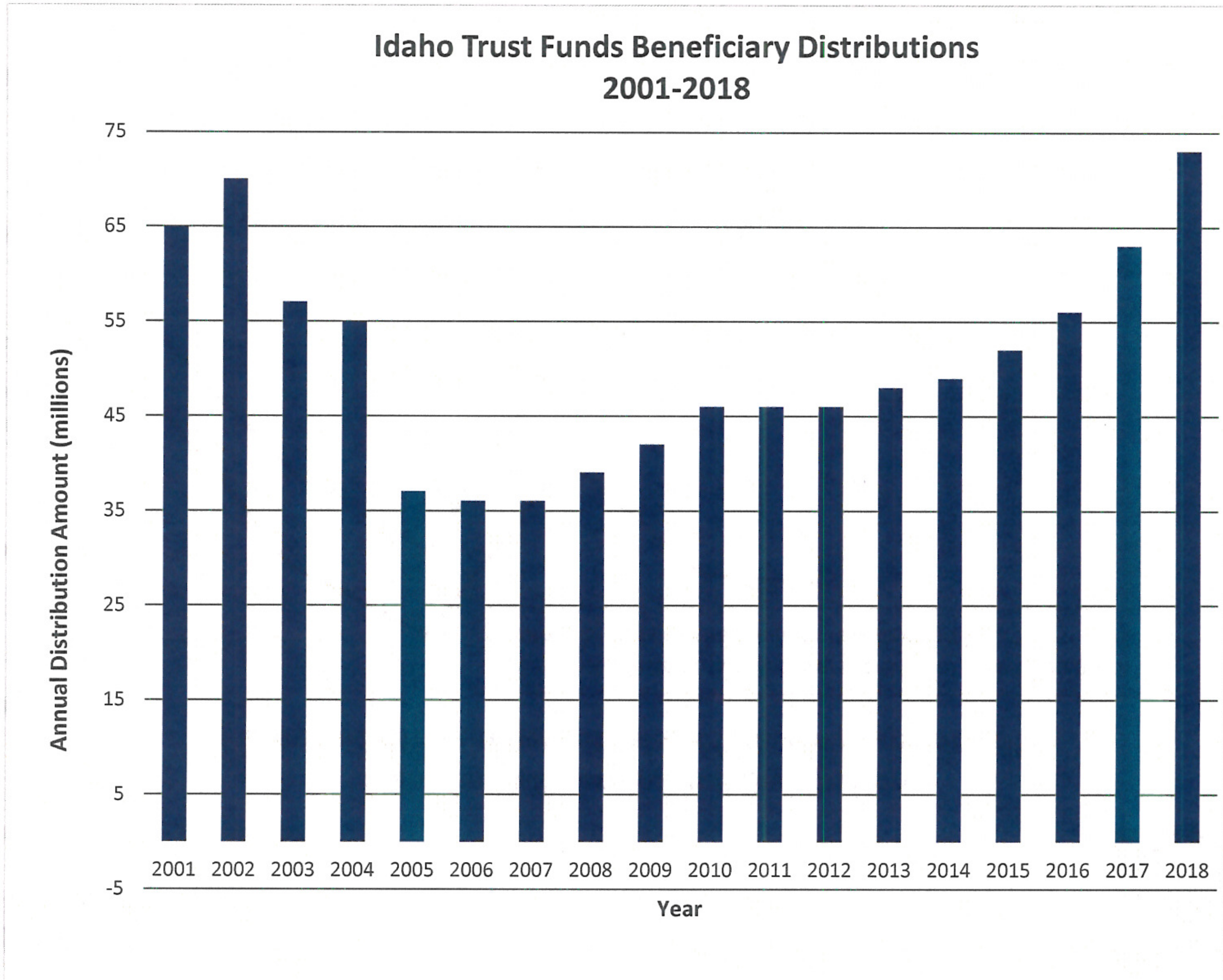
November 14, 2018

2017 NACUBO-Commonfund Study of Endowments

Asset Allocations for U.S. College and University Endowments and Affiliated Foundations, Fiscal Year 2017*

Size of Endowment	Domestic Equities %	Fixed Income %	Non-U.S. Equities %	Alternative Strategies* %	Short-term Securities/ Cash/ Other %
Over $1 Billion 13% + 19% +57% = 89% Equity and Alternatives	13	7	19	57	4
$501 Million to $1 Billion	20	9	22	42	7
$101 Million to $500 Million	27	13	22	32	6
$51 Million to $100 Million	33	17	22	22	6
$25 Million to $50 Million	37	20	19	17	7
Under $25 Million	42	24	16	11	7

Alternative strategies are categorized in the NCSE as follows: Private equity (LBOs, mezzanine, M&A funds, and international private equity); Marketable alternative strategies (hedge funds, absolute return, market neutral, long/short, 130/30, and event-driven and derivatives); Venture capital; Private equity real estate (non-campus); Energy and natural resources (oil, gas, timber, commodities and managed futures); and Distressed debt. On-campus real estate is included in the Short-term Securities/Cash/Other category.


Idaho Trust Funds Beneficiary Distributions
2001-2018
Annual Distribution Amount (millions)
75
65
55
45
35
25
15
5
-5
2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018
Year

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