



STATE OF WISCONSIN

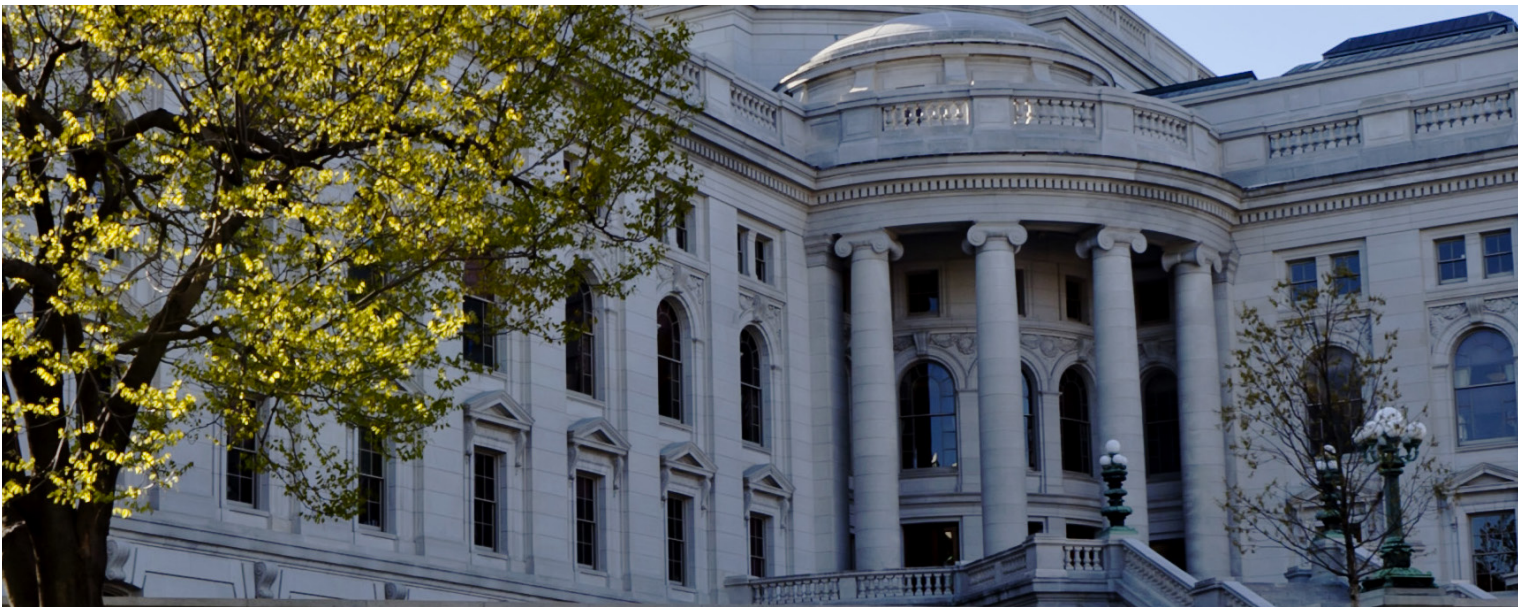
# Legislative Audit Bureau

NONPARTISAN • INDEPENDENT • ACCURATE

Report 22-12  
September 2022

## Retirement Funds Investment Activity Calendar Year 2021

*State of Wisconsin Investment Board*



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# Retirement Funds Investment Activity

## Calendar Year 2021

*State of Wisconsin Investment Board*



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Legislative Audit Bureau

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Report 22-12  
September 2022

## Legislative Audit Bureau

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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.

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## Opinions Published Separately

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The financial statements and our unmodified opinions on them are included in the State of Wisconsin Investment Board's *2021 Retirement Funds Annual Report*.





STATE OF WISCONSIN

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# Legislative Audit Bureau

Joe Chrisman  
State Auditor

22 East Mifflin Street, Suite 500  
Madison, Wisconsin 53703

Main: (608) 266-2818  
Hotline: 1-877-FRAUD-17

[www.legis.wisconsin.gov/lab](http://www.legis.wisconsin.gov/lab)  
[AskLAB@legis.wisconsin.gov](mailto:AskLAB@legis.wisconsin.gov)

September 7, 2022

Senator Robert Cowles, Co-chairperson  
Joint Legislative Audit Committee  
State Capitol  
Madison, Wisconsin 53702

Dear Senator Cowles:

As required by ss. 13.94 (1) (df) and 25.17 (51), Wis. Stats., we have completed a financial audit of the Core Retirement Investment Trust Fund (Core Fund) and the Variable Retirement Investment Trust Fund (Variable Fund) managed by the State of Wisconsin Investment Board (SWIB) as of and for the year ended December 31, 2021. SWIB invests assets of the Wisconsin Retirement System (WRS) through the Core Fund and Variable Fund, and together these funds are known as the Retirement Funds. The financial statements report the investment activity for the Retirement Funds. The financial statements, and our unmodified opinions on them, are included in SWIB's *2021 Retirement Funds Annual Report*, which may be found on SWIB's website.

Net investment position provides a measure of overall financial condition. On the basis of generally accepted accounting principles (GAAP), the net investment position of the Core Fund increased from \$120.2 billion as of December 31, 2020, to \$136.3 billion as of December 31, 2021. The Core Fund reported net investment income of \$15.9 billion in 2020 and \$20.0 billion in 2021. The one-year investment return, net of all fees and costs, increased from 15.2 percent in 2020 to 16.9 percent in 2021. The Core Fund investment return in 2021 is largely attributed to strong investment returns from private equity and public equity investments.

The net investment position of the Variable Fund increased from \$9.6 billion as of December 31, 2020, to \$10.9 billion as of December 31, 2021. The Variable Fund reported net investment income of \$1.4 billion in 2020 and \$1.8 billion in 2021. The one-year investment return, net of all fees and costs, increased from 17.5 percent in 2020 to 20.0 percent in 2021. The Variable Fund investment return in 2021 is largely attributed to strong investment returns from public equity investments.

SWIB changed how it accounts for certain external investment management fees beginning in 2021. As a result, SWIB reported \$49.5 million in external investment management fees in its 2021 financial statements, compared to the \$432.4 million it reported in 2020. Based on SWIB's information, SWIB's external investment management fees in 2021 totaled \$571.5 million. We recommend SWIB increase the transparency of its reporting of external investment management fees in its annual financial reports.

The Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters, which is required by *Government Auditing Standards*, begins on page 15.

We appreciate the courtesy and cooperation extended to us by SWIB staff in completing this audit.

Respectfully submitted,

Joe Chrisman  
State Auditor

JC/CS/ss





## Introduction

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***SWIB invests the assets of the Wisconsin Retirement System through the Core Fund and the Variable Fund, which together are known as the Retirement Funds.***

The Wisconsin Retirement System (WRS) provides post-employment benefits to participating state and local government employees. The Department of Employee Trust Funds (ETF) is responsible for administering the WRS, including collecting employee and employer contributions and paying benefits. SWIB invests the assets of the WRS through the Core Retirement Investment Trust Fund (Core Fund) and the Variable Retirement Investment Trust Fund (Variable Fund). The Core Fund is a diversified fund that typically is invested for the long term in several types of investments and provides less volatile investment returns. The Variable Fund is a public equities securities fund, or stock fund, that provides returns that are typically more volatile than the Core Fund. Together these funds are known as the Retirement Funds. SWIB reports the investment activity of the Retirement Funds in the financial statements that are included in its *2021 Retirement Funds Annual Report*, which may be found on SWIB's website. These financial statements are prepared by SWIB using generally accepted accounting principles (GAAP) prescribed by the Governmental Accounting Standards Board (GASB).

### Audit Results

***We provided unmodified opinions on the financial statements of the Core Fund and the Variable Fund investment activity as of and for the year ended December 31, 2021.***

As required by Wisconsin Statutes, we completed an audit of the financial statements and related notes, of the Core Fund and the Variable Fund, as of and for the year ended December 31, 2021. The financial statements include information on the investment activity of the Core Fund and the Variable Fund, including important disclosures, such as those related to deposit and investment risk and fair value measurements as of December 31, 2021. To complete our audit of the financial statements, we reviewed SWIB's internal controls over

financial reporting, tested financial transactions, and reviewed the financial statements, notes, and required supplementary information that were prepared by SWIB management. We provided unmodified opinions on the financial statements and related notes as of and for the year ended December 31, 2021.

We also issued our Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters, which is required by *Government Auditing Standards*, and begins on page 15.

## Total Investment Assets

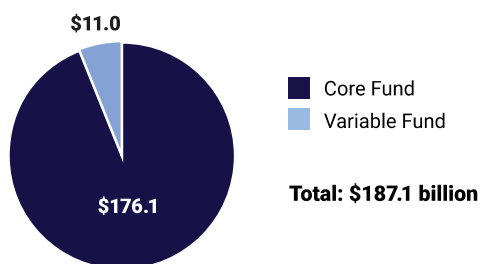
***The Core Fund accounted for 94.1 percent of the total investment assets of the Retirement Funds as of December 31, 2021.***

On a GAAP basis, total investment assets of the Retirement Funds increased from \$157.9 billion as of December 31, 2020, to \$187.1 billion as of December 31, 2021, or by 18.5 percent. As of December 31, 2021, the Core Fund accounted for \$176.1 billion (94.1 percent) of the total investment assets of the Retirement Funds and the Variable Fund accounted for \$11.0 billion (5.9 percent), as shown in Figure 1.

Figure 1

### Total Investment Assets Retirement Funds

As of December 31, 2021  
(in billions)



The Core Fund investment assets include cash balances and receivables related to investment sales, as well as investments. The Core Fund investments include a distinct mix of investment types, including public equities, fixed income instruments, derivative instruments, and private fund investments, which are made up largely of private equity and real estate limited partnerships. The Variable Fund is a public equities securities fund that provides returns that are typically more volatile than the Core Fund. The Variable Fund investment assets include cash balances and receivables, in addition to investments comprised mostly of public equities and preferred securities.

## Net Investment Income

***The Core Fund and the Variable Fund reported net investment gains in 2021 of \$20.0 billion and \$1.8 billion, respectively.***

On a GAAP basis, the net investment income reported by the Core Fund increased from \$15.9 billion in 2020 to \$20.0 billion in 2021, or by 25.8 percent. The one-year investment return, net of all fees and costs, increased from 15.2 percent in 2020 to 16.9 percent in 2021. One-year investment returns exceeded the Core Fund benchmark of 16.3 percent in 2021. On a GAAP basis, the net investment income reported by the Variable Fund increased from \$1.4 billion in 2020 to \$1.8 billion in 2021, or by 28.6 percent. The one-year investment return, net of all fees and costs, increased from 17.5 percent in 2020 to 20.0 percent in 2021. One-year investment returns lagged the Variable Fund benchmark of 20.2 percent in 2021.

***SWIB reported that the 20-year investment return for the Core Fund was 7.9 percent.***

SWIB has a fiduciary responsibility to prudently invest the assets of the Retirement Funds in a diversified manner to meet WRS funding needs, while minimizing the risk of large losses. SWIB's investment strategy is to meet the long-term expected rate-of-return assumption. In December 2021, the ETF Board decreased the long-term expected rate-of-return assumption from 7.0 percent to 6.8 percent. As of December 31, 2021, SWIB's 20-year return for the Core Fund, net of external manager fees but not other costs, was 7.9 percent. SWIB reported that one-year, five-year, and ten-year investments returns for the Core Fund, as of December 31, 2021, also exceeded the long-term expected rate-of-return assumption.

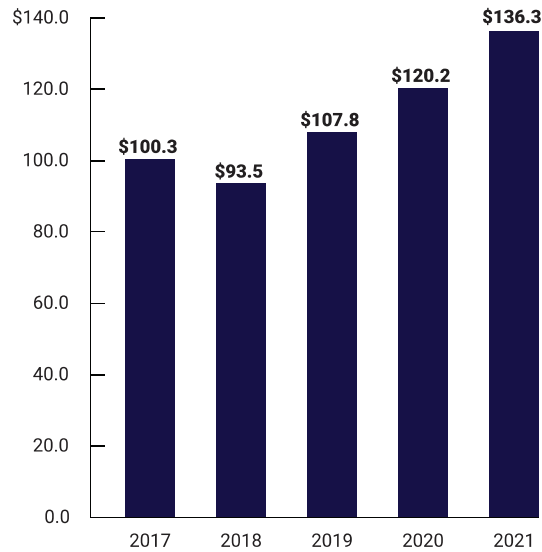
## Net Investment Position

***The net investment position of the Core Fund increased from \$120.2 billion as of December 31, 2020, to \$136.3 billion as of December 31, 2021.***

Net investment position, which is the investment assets less investment liabilities, is a measure of overall financial condition. As shown in Figure 2, the net investment position of the Core Fund increased on a GAAP basis from \$120.2 billion as of December 31, 2020, to \$136.3 billion as of December 31, 2021, or by 13.4 percent. The increase is largely attributed to strong overall investment returns from private equity and public equity investments. From December 31, 2017, through December 31, 2021, the net investment position of the Core Fund increased by \$36.0 billion, or by 35.9 percent.

Figure 2

**Net Investment Position  
Core Fund**  
As of December 31  
(in billions)

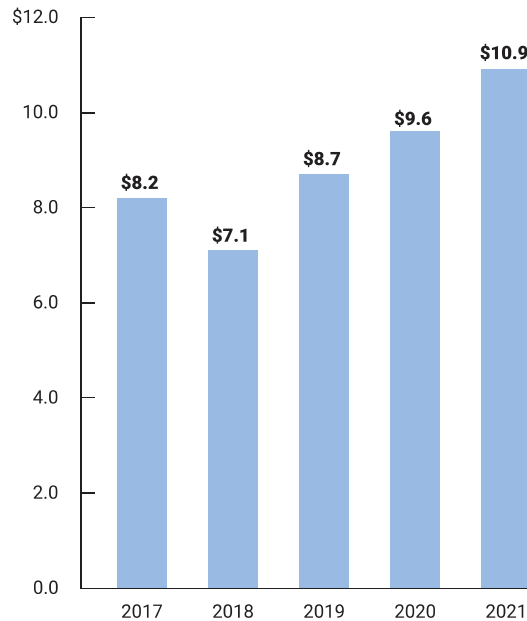


***The net investment position of the Variable Fund increased from \$9.6 billion as of December 31, 2020, to \$10.9 billion as of December 31, 2021.***

As shown in Figure 3, the net investment position of the Variable Fund increased from \$9.6 billion as of December 31, 2020, to \$10.9 billion as of December 31, 2021, or by 13.5 percent. The increase is primarily attributed to strong overall investment returns from public equity investments. From December 31, 2017, through December 31, 2021, the net investment position of the Variable Fund increased by \$2.7 billion, or by 32.9 percent.

Figure 3

**Net Investment Position  
Variable Fund**  
As of December 31  
(in billions)



## External Management of Investments

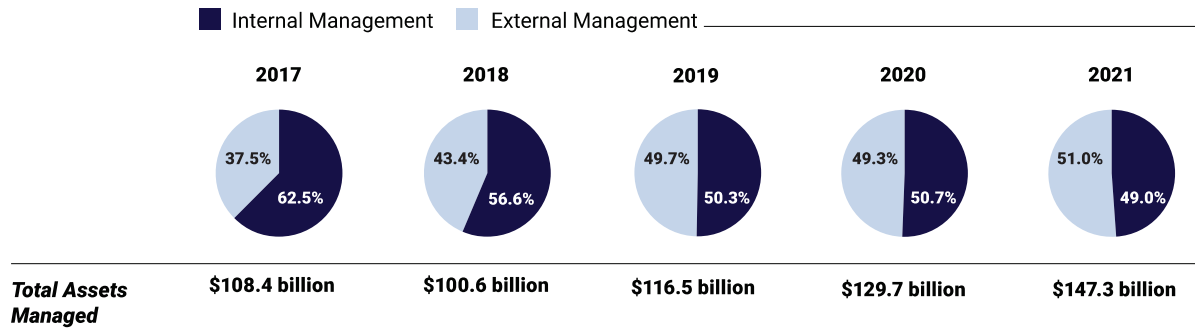
SWIB's investment strategy for the assets of the Retirement Funds employs a mix of internal and external management of assets. Historically, SWIB's goal has been to increase the percentage of assets managed internally because external management is more expensive. However, as we discussed in report 22-8, the percentage of assets managed internally has decreased.

***As of December 31, 2021,  
49.0 percent of the assets of  
the Retirement Funds were  
managed internally  
by SWIB.***

Total assets managed, which are the total investment assets less related investment liabilities, are reported by SWIB in quarterly reports, which are required to be submitted to the Legislature under s. 25.17 (13m), Wis. Stats. As shown in Figure 4, as total assets managed have increased, the percentage of assets managed internally by SWIB has decreased from 62.5 percent as of December 31, 2017, to 49.0 percent as of December 31, 2021.

Figure 4

**Internal and External Management  
Retirement Funds' Total Assets Managed<sup>1</sup>**  
As of December 31



<sup>1</sup> Total assets managed, which are the total investment assets less related investment liabilities, are reported by SWIB in quarterly reports, which are required to be submitted to the Legislature under s. 25.17 (13m), Wis. Stats.

***SWIB attributed increases in external management of investments to an increased use of external managers who execute more-complex strategies.***

As noted in report 22-8, SWIB staff attributed increases in external management of investments to an increased use of external managers who execute more-complex strategies that require investment infrastructure and capabilities that SWIB does not possess. SWIB noted that these strategies are an important component of its efforts to meet the 6.8 percent long-term expected rate-of-return assumption for the Retirement Funds. SWIB also noted that it continues to seek to improve its information technology infrastructure and to recruit investment staff with expertise to manage a portion of the assets managed by external managers while offering competitive compensation.

***In 2021, SWIB changed how it accounts for certain external investment management fees charged by external managers.***

Management fees are charged by external investment managers who invest in assets, including private equity limited partnerships and hedge funds. In its 2021 financial statements, SWIB reported \$49.5 million in external investment management fees compared to the \$432.4 million reported in its 2020 financial statements. The lesser amount reported in 2021 is not the result of a reduction in external investment management fees, which SWIB indicated totaled \$571.5 million in calendar year 2021. Rather, SWIB changed how it accounts for certain external investment management fees beginning in 2021 by no longer reporting these fees in the separate external investment management fees account on the financial statements. Instead, SWIB reported the fees in the Net Increase (Decrease) in the Fair Value of Investments account. Based on SWIB's information, the largest amount of external investment management fees in 2021 was for private equity limited partnerships, as shown in Table 1.

Table 1

**External Investment Management Fees<sup>1</sup>**  
For the Year Ended December 31  
(in millions)

Investment Type	2021	2020
Private Equity Limited Partnerships	\$ 218.6	\$130.8
Hedge Funds	192.8	195.4
Public Market Investments <sup>2,3</sup>	92.2	50.6
Real Estate Limited Partnerships	67.9	55.6
<b>Total</b>	<b>\$571.5</b>	<b>\$432.4</b>

<sup>1</sup> Excludes carried interest, which is a type of performance fee paid when a fund manager liquidates an investment and the rate-of-return exceeds an agreed-upon minimum rate.

<sup>2</sup> Includes investments in separately managed accounts, commingled investments, and fund investments, largely in equities and public fixed income.

<sup>3</sup> For the year ended December 31, 2021, includes \$49.5 million in external investment management fees billed to SWIB and reported in the External Investment Management Fees account on the Statement of Changes in Net Investment Position.

***We found that 6 of the 12 public pension plan financial reports we reviewed provided more transparent information on external investment management fees than SWIB provided in its 2021 Retirement Funds Annual Report.***

SWIB indicated that it made this change, in part, because it does not directly pay certain external investment management fees, which are reported to SWIB by external managers net of the value of the investments. We reviewed the most recently available financial reports of 12 other public pension plans to determine how each plan reported external investment management fees. Although each plan employs different investments and strategies, and operates under unique statutory requirements, comparisons of financial reporting approaches are helpful in understanding the commonality of SWIB's approach. We note that 6 of the 12 plans we reviewed provided more transparency than SWIB's approach, including:

- 3 plans indicated that external investment management fees were reported as an expense on the financial statements, which provides more transparency than SWIB's approach;
- 3 plans reported external investment management fees as an adjustment to investment earnings and included information on the specific amounts in notes to the financial statements, or in a separate schedule in the report, which provides more transparency than SWIB's approach;
- 2 plans indicated that external investment management fees were reported in investment earnings without

additional disclosure of the fees, which is like the approach used by SWIB; and

- the remaining 4 plans did not provide clear disclosure on how external management investment fees were reported.

We discussed our concerns with SWIB management, who indicated that after considering reporting practices of its peer public pension funds, the accounting guidance in this area, and investment industry practice, it was not considering any changes or additional disclosures in its *2021 Retirement Funds Annual Report*. SWIB management also noted that it includes the external investment management fees in quarterly reports to the Legislature. However, the inclusion of fee information in reports to the Legislature is not a substitute for inclusion of the information in SWIB's annual report.

***SWIB should take steps to increase the transparency of the external investment management fees in its annual report.***

To improve transparency, SWIB should provide specific information on external investment management fees, such as by including a note disclosure or a separate schedule in its annual financial report. Further, SWIB should provide specific information on external investment management fees to ETF, which is responsible for preparing the WRS financial statements. Such information will assist ETF in transparently reporting external investment management fees in its financial reporting.

### **☑ Recommendation**

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*We recommend the State of Wisconsin Investment Board:*

- *provide specific information on external investment management fees in its annual financial report;*
- *provide specific information on external investment management fees to the Department of Employee Trust Funds to assist it in transparently reporting external investment management fees in its financial reporting; and*
- *report to the Joint Legislative Audit Committee by November 30, 2022, on the status of its efforts to implement these recommendations.*

## **Securities Lending Collateral**

***Wisconsin Statutes and Board of Trustee policies allow SWIB to use investments of the Retirement Funds to enter into securities lending transactions.***

Board of Trustee policies allow SWIB to use investments of the Retirement Funds to enter into securities lending transactions. These transactions involve SWIB temporarily transferring securities to a borrower in exchange for collateral, which can be in the form of cash or securities. The cash collateral SWIB receives is reinvested by its custodial bank into two cash collateral pools until the securities are returned from the borrower.



***SWIB implemented a new strategy in 2021 to use a portion of the securities lending cash collateral to provide liquidity for other investment strategies.***

SWIB implemented a new strategy in 2021 to use a portion of the securities lending cash collateral held by its custodial bank to increase SWIB's liquidity. In this strategy, called a cash release program, the cash collateral is transferred from the custodial bank to SWIB's cash accounts to provide SWIB liquidity for other investment strategies. SWIB noted that using the cash from the securities lending collateral pool is less expensive than other available financing options. However, SWIB may have to quickly return the cash collateral if there was a widespread return of lent securities. SWIB limits the amount of securities lending collateral that can be released from the custodial bank's collateral pool to ensure there is adequate cash available. SWIB staff were not aware whether other public pension plans used this strategy. Securities lending activity was disclosed in the most recently available financial reports of the nine public pension plans we reviewed. We contacted these nine public pension plans in August 2022, and each plan indicated that it does not use a securities lending collateral cash release program.

***As of December 31, 2021, SWIB transferred \$761.0 million in total from the cash collateral pool held by its custodial bank to SWIB's cash account.***

As of December 31, 2021, SWIB transferred a total of \$761.0 million from the cash collateral pool held by its custodial bank to SWIB's cash account. As a result, SWIB reported a securities lending collateral liability in the Core Fund of \$1.1 billion, but only reported a securities lending collateral asset of \$360.5 million, which was the amount that remained in the cash collateral pool held by its custodial bank. After we questioned its financial reporting for this activity, SWIB contacted GASB to discuss the appropriate accounting and disclosure for this new securities lending activity. As a result of its discussion with GASB, SWIB adjusted its securities lending note disclosure to report that the \$761.0 million was held as cash and cash equivalents as of December 31, 2021.

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# Auditor's Report







## Legislative Audit Bureau

Joe Chrisman  
State Auditor22 East Mifflin Street, Suite 500  
Madison, Wisconsin 53703Main: (608) 266-2818  
Hotline: 1-877-FRAUD-17[www.legis.wisconsin.gov/lab](http://www.legis.wisconsin.gov/lab)  
[AskLAB@legis.wisconsin.gov](mailto:AskLAB@legis.wisconsin.gov)**Independent Auditor's Report on Internal Control over  
Financial Reporting and on Compliance and Other Matters**Senator Robert Cowles, Co-chairperson  
Joint Legislative Audit CommitteeMembers of the Board of Trustees, and  
Mr. Edwin Denson, Executive Director/Chief Investment Officer  
State of Wisconsin Investment Board

We have audited the financial statements and the related notes of the Core Retirement Investment Trust Fund and the Variable Retirement Investment Trust Fund (Retirement Funds) managed by the State of Wisconsin Investment Board (SWIB) as of and for the year ended December 31, 2021, and have issued our report thereon dated September 1, 2022. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, which is issued by the Comptroller General of the United States. The financial statements and related auditor's opinions have been included in SWIB's *2021 Retirement Funds Annual Report*.

**Internal Control over Financial Reporting**

Management of SWIB is responsible for establishing and maintaining effective internal control over financial reporting (internal control). In planning and performing our audit of the financial statements, we considered SWIB's internal control as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of SWIB's internal control. Accordingly, we do not express an opinion on the effectiveness of SWIB's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent misstatements, or to detect and correct misstatements on a timely basis. A *material weakness* is a deficiency or a combination of deficiencies in internal control such that there is a reasonable possibility that a material misstatement of the financial statements of the Retirement Funds will not be prevented, or that a material misstatement will not be detected and corrected on a timely basis. A *significant deficiency* is a deficiency or a combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

## Compliance and Other Matters

As part of obtaining reasonable assurance about whether the financial statements of the Retirement Funds are free from material misstatement, we performed tests of compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the financial statements. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

## Purpose of This Report

This report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be used when considering SWIB's internal control and compliance. The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of SWIB's internal control or on compliance. Accordingly, this report is not suitable for any other purpose.

LEGISLATIVE AUDIT BUREAU



September 1, 2022