



## Legislative Fiscal Bureau

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Joint Committee on Finance

Paper #485

### Operating Budget Authority and Assessment Process (Investment Board)

#### *Bill Agency*

[LFB 2007-09 Budget Summary: Page 365, #1]

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#### **CURRENT LAW**

Under current law, the State of Wisconsin Investment Board (SWIB) is required to estimate, on July 1 and January 1 its operating expenses for the next six-month period and to assess each fund for which it has management responsibility for its share of the expenses in an equitable manner. The Board's assessment may not exceed the greater of \$20,352,800 or 0.0275% of the average market value of the assets of the funds at the end of each month between November 30 and April 30 of the preceding fiscal year. The Board may, however, request that it be allowed to assess an additional 0.0025% for a fiscal year with the approval of the Joint Committee on Finance under a 14-day passive review process. Base budget authority for general program operations in 2006-07 is \$22,474,700 PR.

#### **GOVERNOR**

Eliminate SWIB's statutory annual budget floor of \$20,352,800 and provide that the total amount that the Board may assess the funds for which it has management responsibility may not exceed, in each fiscal year, the greater of the amount that: (a) the Board could have assessed the funds in the second year of the prior fiscal biennium; or (b) 0.0325% of the average market value of the assets of the funds at the end of each month between November 30 and April 30 of the prior fiscal year. Require the Board annually, no later than June 15th, to certify to the Department of Administration and the Joint Committee on Finance the maximum amount that the Board may assess the funds in the next fiscal year.

Provide that on September 1, of each year the Board would be required to assess each fund for its share of the Board's operating expenditures for the current fiscal year in an equitable manner.

## **DISCUSSION POINTS**

1. Since 1999-00, the general program operations of SWIB have been funded by providing the agency a percent of assets for staff resources and overall administrative costs. A basis point is the equivalent of \$0.01 per \$100 of assets. Under current law, SWIB's general program operations is provided \$0.0275 per \$100 of assets (or 2.75 basis points). Current law also specifies the manner in which the asset base is established for this calculation (the average market value of the assets of the funds at the end of each month between November 30 and April 30 of the preceding fiscal year), and establishes a minimum funding level (\$20,352,800).

2. While the bill would repeal the current budget floor (\$20,352,800), it reestablishes a budget floor at the amount that the Board could have assessed the funds in the second year of the prior fiscal biennium. For example, if the bill's provision was in place for 2007-08 and total average assets for the period November 30, 2006, and April 30, 2007, were less than \$69.2 billion, SWIB's operating budget would be set at \$22,474,700 PR in 2007-08, the amount established in the second year of the 2005-07 biennium (the 2006-07 base budget amount). This amount is \$2,121,900 higher than the floor under current law (\$20,352,800 PR). Therefore, the SB 40 provision would essentially ensure at least the continuation of 2006-07 base-level funding in 2007-08 and 2008-09.

3. SWIB budget authority, established through the basis-point calculation, is unique in that, unlike other state agencies, SWIB does not request or receive standard budget adjustments, nor does it require approval for spending initiatives within its formula-based operations budget. All cost-to-continue factors and funding for internal functions and new initiatives must be supported within the formula-based operations budget. SWIB also has independent authority, within the formula-based operations budget, to devise and implement a compensation plan applicable to its employees.

4. On June 14, 2006, SWIB reported that the average market value of the assets of the funds at the end of each month between November 30, 2005, and April 30, 2006, was \$81.726 billion. As a result, adjusted base budget authority for 2006-07 was established at \$22,474,700 PR. This base budget amount supports the internal operations of SWIB, including 104.5 PR positions.

5. At this time, the projected SWIB budget expenditures for 2006-07 total \$19,989,400 as shown in Table 1.

**TABLE 1**

**2006-07 Projected Expenditures**

<u>Cost Category</u>	<u>Amount</u>
Salaries*	\$10,432,000
Incentive Awards	2,921,900
Fringe Benefits	3,386,500
Supplies & Equipment	2,616,000
Information Technology	<u>633,000</u>
Total Expenses	\$19,989,400

\*Includes \$94,000 for limited-term employee salaries.

6. The incentive awards or bonuses identified in Table 1 are paid through a plan authorized under s. 25.16(7) of the statutes to SWIB staff each spring, based on investment and other relevant performance during the preceding calendar year. SWIB officials indicate the intent of the bonus plan is to provide an incentive for superior staff performance and to retain experienced and capable staff.

7. SWIB officials indicate that, barring unusual fluctuations in the investment market, the asset basis for its 2007-08 budget authority calculation is likely to be about \$90.2 billion. This would provide budget authority or approximately \$24.8 million in 2007-08.

8. The total assets that have provided the basis in each fiscal year for the SWIB operations budget is shown in Table 2. The amount for 2007-08 is an estimate.

**TABLE 2**

**Total SWIB Assets  
2000-01 to 2007-08**

<u>For Fiscal Year Budget</u>	<u>Total Assets (Billion)</u>	<u>Percent Change</u>
1999-00	\$64.4	
2000-01	71.1	10.3%
2001-02	67.9	-4.5
2002-03	63.9	-5.9
2003-04	59.7	-6.6
2004-05	70.5	18.1
2005-06	74.0	5.0
2006-07	81.7	10.4
2007-08	90.2	10.4

9. Based on these total assets, the basis-point formula or the statutory budget floor has resulted in general program operations budgets for SWIB in recent years, as shown in Table 3. The amount for 2007-08 is an estimate and is calculated under the current law factor of 2.75 basis points.

**TABLE 3**

**SWIB Operations Budgets  
1999-00 to 2007-08**

<u>Fiscal Year</u>	<u>Basis-Point Budget (Millions)</u>	<u>Percent Change</u>
1999-00	\$14.5	
2000-01	19.6	35.2%
2001-02	18.7	-4.6
2002-03	17.7*	-5.3
2003-04	17.7*	0.1
2004-05	19.4	9.4
2005-06	20.4	5.0
2006-07	22.5	10.4
2007-08	24.8	10.4

\*Budget authority established at budget floor in effect for that fiscal year.

10. Under current law, the actual budget levels for the 2007-08 fiscal year will be determined by the average month-end market value of assets under management for the period November 30, 2006, through April 30, 2007. The actual budget levels for the 2008-09 fiscal year will be determined by the average month-end market value of assets under management for the period November 30, 2007, through April 30, 2008.

11. SWIB manages the investment of a number of funds on behalf of the state. Table 4 lists these funds and their respective assets as of December 31, 2006.

**TABLE 4**

**State Funds under SWIB Management  
December, 31, 2006**

<u>Fund</u>	<u>Assets (in Millions)</u>	<u>Percent of Total</u>
Wisconsin Retirement System (WRS)		
Core Retirement Investment Trust Fund	\$76,033	86%
Variable Retirement Investment Trust Fund	<u>7,143</u>	<u>8</u>
Total Wisconsin Retirement System	\$83,176	94%
State Investment Fund	\$4,337	5%
Other Funds		
Injured Patients and Families Compensation Fund	\$749	1%
State Life Insurance Fund	80	<0
Local Government Property Insurance Fund	53	<0
Historical Society Trust Fund	12	<0
Tuition Trust Fund (EdVest)	<u>10</u>	<u>&lt;0</u>
Total Assets	\$88,416	100%

12. As of December 31, 2006, the assets of the WRS (which comprise 94% of total SWIB investment assets) were managed in three ways: (a) \$17,064 million [20.5%] of total assets were managed internally by SWIB staff; (b) \$12,912 million [15.5%] were externally managed in dedicated accounts [in which securities are held in SWIB's name]; and (c) \$53,200 million [64.0%] were externally managed in commingled accounts [generally a mix of passive index funds or other commingled accounts in which SWIB's investments are commingled with other investors and the underlying securities are owned in the name of the fund manager].

13. SWIB's costs to manage funds internally and other general operating expenses are assessed proportionately to the funds. Under current law, SWIB is required to estimate, on July 1 and January 1 its operating expenses for the next six-month period and to assess each fund for which it has management responsibility for its share of these estimated expenses. Depending on variable transaction activity within the funds for the period, billing amounts can vary significantly. The bill would allow SWIB to make one annual assessment to the funds (on September 1, of each year) based on its actual operating budget. As a result, a more certain assessment could be made and within fiscal year variation reduced.

14. The cost for externally managed assets are directly charged to the funds listed in the above table. SWIB reports on these costs quarterly to the Joint Committee on Finance, the Joint Committee on Audit, and the Secretary of DOA. In calendar year 2006, these costs totaled \$192.9 million.

15. The provisions under the bill reflect a SWIB proposal that was presented to the administration after agency budget requests were submitted. The proposal is the culmination of a lengthy planning process that focused on issues raised in a 2004 Legislative Audit Bureau (LAB) evaluation of SWIB, particularly the need to address the rising costs of external management of the state's investment assets. The proposal also reflects an internal evaluation made in consultation with a new Chief Investment Officer, hired in June, 2006.

16. It appears that these efforts are aimed at repositioning SWIB's investment strategies, reducing external management costs by enhancing internal operations, and creating a greater capability to quickly adapt to new market opportunities. All of these objectives rely on the additional funding that would be provided under the bill's provisions.

17. In a November, 2004, an LAB program evaluation analyzed the investment management costs of SWIB. The LAB report noted that in 2003 the average cost of externally managed assets (32 basis points) was more than triple the average cost of internally managed assets (9 basis points). The LAB also highlighted the consistent cost increases in: (a) external investment management and advisor costs (an 87.2% increase from 1999 to 2003); and (b) external support services such as custodial bank fees, consultant and speaker fees, legal fees, and electronic research services (a 106.4% increase from 1999 to 2003).

18. External investment management costs have continued to rise since 2003. In 2004, external investment management and advisor costs were virtually the same as in 2003. However, these costs increased by 7.3% in 2005, and 26.4% in 2006. This trend may be expected given the growth in managed assets and SWIB's stable position authority in recent years. SWIB officials indicate that the trust funds have grown by \$15 billion in the last six years while staffing levels have remained unchanged.

19. Finally, the LAB evaluation pointed out that SWIB may be limited by the statutory formula for setting its operational budget under current law and that "In light of increasing costs and increasing use of external managers and advisors, changes to these limits may be warranted to further promote the most effective use of resources and to provide increased accountability over a larger portion of the Investment Board's costs."

20. In response to the LAB report, the 2005-07 biennial budget act (2005 Wisconsin Act 25) raised the statutory budget floor from \$17,720,500 to \$20,352,800 beginning in 2006-07. However, the statutory formula (2.75 basis points) was not changed.

21. As noted above, in response to the LAB report and to address other internal considerations, SWIB has initiated a restructuring that included the hiring of a Chief Investment Officer in June, 2006, to lead a strategic reorganization of internal functions. According to SWIB officials, the implementation of further contemplated changes require the additional funding that would result from the increase to the basis-point factor from 2.75 to 3.25. The following discussion points will focus on SWIB's strategic objectives, the specific initiatives being proposed and their costs, and the potential benefits for state investment earnings.

22. The SWIB planning effort has led to strategic objectives to: (a) reorient internal portfolios and staff into global sector portfolios that reflect trends toward greater global market interdependence; (b) strengthen the internal investment process by employing additional quantitative analytic tools and screening processes; (c) reverse the flow of assets to more expensive forms of external management; and (d) develop greater flexibility to implement new investment strategies at the most opportune time.

23. Based on these strategic objectives, SWIB has developed nine potential initiatives. To address these initiatives, SWIB officials indicate that a basis-point (operational) budget increase of about \$3.9 million would be needed (plus an estimated \$0.9 million in additional direct charges that would be expensed directly to the funds). These initiatives are listed in Table 5 with a brief description of each item and the projected budgetary need.

**TABLE 5**

**Potential SWIB Initiatives**

<u>Initiative</u>	<u>Description</u>	<u>Basis-Point Budget Increases [Other Direct Charges]</u>
1. Global sector portfolio	Realignment of internally managed large company equity and international equity portfolios into a \$6.0 billion global portfolio with ten separate sectors. [Additional staff would be required.]	\$1,600,000 [\$500,000]
2. Equities index portfolio	Transfer \$11.0 billion in externally managed domestic large company equities to an internally managed large company index portfolio. [Additional staff would be required.]	\$200,000 [\$40,000]
3. Optimize enhanced index funds allocation	Transfer funds from certain externally managed high-fee portfolios to lower cost portfolios in an optimized weighted approach designed to reduce external management costs. [No additional staff required.]	\$0 [\$0]
4. Convert from external to internal management of certain portfolios*	Transition \$2.5 billion to \$4.0 billion from various external enhanced index portfolios to the global sector portfolio. [No additional staff required.]	\$0 [\$0]
5. Equities enhanced index portfolio*	Internally manage a quantitative large company portfolio. [Additional staff would be required.]	\$1,500,000 [\$240,000]

<u>Initiative</u>	<u>Description</u>	<u>Basis-Point Budget Increases</u> <u>[Other Direct Charges]</u>
6. Risk and quantitative analysis	Enhance mathematical and statistical approaches to investment and risk management to more deliberately position investments to achieve the highest rate of return. [Additional staff would be required.]	\$200,000 [\$80,000]
7. Real estate analysis	Provide additional support for developing investment strategy, analyzing new investments, monitoring portfolios, performing due-diligence work on properties and limited partnership funds. [Additional staff would be required.]	\$200,000 [\$0]
8. Global fixed income index portfolio	Transfer \$700 million from external index portfolios to an internally managed passive global fixed income portfolio. [Additional staff would be required.]	\$100,000 [\$25,000]
9. Currency overlay	Develop a currency overlay capacity within SWIB to manage risk exposure to changes in value of foreign currency relative to the dollar. [Additional staff would be required.]	\$100,000 [\$25,000]
Total Basis-Point Budget Costs [Total Direct Charges]		\$3,900,000 [\$900,000]

\*Initiative contingent on the implementation of the global sector portfolio initiative (#1).

24. While SWIB officials indicate that seven of these nine initiatives would require additional staff, they do not provide detail on the specific number at this time. Since SWIB general operations are PR-funded, SWIB plans to seek additional position authority through a request to the Joint Committee on Finance under s. 16.515 of the statutes. The initial request will likely be submitted in the Fall of 2007.

25. Each of the nine initiatives is also viewed by SWIB as having a beneficial financial impact on the funds due to lowering external management costs and/or increasing earnings. These cost reductions and enhanced earnings would more than offset the increase in operation costs and direct charges projected for the initiatives. Table 6 summarizes these cost savings and projected earnings increases. Amounts in the table are characterized as negative or positive according to their effect on net returns.



**TABLE 6****Potential SWIB Initiatives  
Estimated Effect on Net Returns**

<u>Initiative</u>	<u>Reductions Due to Basis-Point Budget Plus Direct Charges</u>	<u>Increases Due to Reduced External Management Costs</u>	<u>Increases Due to Increases in Investment Return</u>	<u>Estimated Increase in Net Return</u>
1 Global sector portfolio	-\$2,100,000	\$0	\$21,000,000 <sup>1</sup>	\$18,900,000
2 Equities index portfolio	-240,000	900,000	600,000	1,260,000
3 Optimize enhanced index funds allocation	0	4,600,000	0	4,600,000
4 Convert from external to internal management of certain portfolios	0	4,200,000 <sup>2</sup>	140,000	4,340,000
5 Equities enhanced index portfolio	-1,740,000	5,100,000	0	3,360,000
6 Risk and quantitative analysis	-280,000	0	3,200,000	2,920,000
7 Real estate analysis	-200,000	0	6,300,000 <sup>3</sup>	6,100,000
8 Global fixed income index portfolio	-125,000	560,000	85,000	520,000
9 Currency overlay	<u>-125,000</u>	<u>0</u>	<u>1,900,000</u>	<u>1,775,000</u>
Total	-\$4,810,000	\$15,360,000	\$33,225,000	\$43,775,000

<sup>1</sup> Minimum projected increase. Actual SWIB projection is \$21.0 to \$28.0 million.

<sup>2</sup> Minimum projected reduction. Actual SWIB projection is \$4.2 million to \$6.8 million.

<sup>3</sup> Maximum projected increase. Actual SWIB projection is up to \$6.3 million.

26. The gains in net revenue identified above are expected to take time to develop. If the budget provisions are approved, however, the Committee may want to know the progress on the implementation of the initiatives in the 2007-09 biennium and early indications of performance gains. This could be accomplished through a nonstatutory provision to require SWIB to report, on or before January 31, 2009, and January 31, 2010, to the Joint Committee on Audit and the Joint Committee on Finance on the implementation and outcomes of initiatives commenced as a result of the increase in the basis-point operating budget. These reporting dates would coincide with the end of SWIB's normal calendar-year portfolio performance assessment.

27. In addition, it should be noted that the LAB is required to conduct a management evaluation of SWIB every two years. This report typically examines SWIB's investment results and costs against several standards and would provide an independent assessment of the progress of the initiatives to the Legislature.

28. These initiatives will require funding that cannot be provided under the current law factor of 2.75 basis points. According to SWIB officials, when the basis-point budget determination provision was instituted in 1999-00, it was projected to be adequate to meet SWIB's needs, if investments maintained about a 6% annual rate of growth. Assets have actually grown an average of 4.7% since the basis point formula was initiated in 1999-00. While asset growth for the last two years shown in Table 1 has been 10.4%, in three consecutive earlier years, assets actually declined. Further, SWIB officials indicate that long-term expectations for growth in most asset classes are

now lower than was previously the case.

29. Another factor that will tend to suppress asset growth somewhat in future years is the payment of WRS retirement benefits. SWIB indicates that annual WRS benefit payments increased from \$1.4 billion in 2001 to \$2.0 billion in 2006, and is expected to reach \$3.0 billion by 2011. These figures reflect the increasing number of retirements among the "baby-boomer" generation. As these retirement benefit payments increase, the total assets of the WRS core and variable funds will be affected accordingly. In turn, this phenomenon affects the amounts authorized for SWIB's operations budget.

30. Given these factors, SWIB argues that maintaining current internal operations on the 2.75 basis points provided under current law would be a challenge; funding the initiatives described above would not be possible. For example, in order to continue current operations and to begin some of the initiatives discussed above, SWIB would project a budget need of \$25.1 million in 2007-08. However, the 2.75 basis-point budget would only produce \$24.8 million in 2007-08 for operations, about \$300,000 less than needed. SWIB indicates that in 2008-09, an operating budget of about \$29.4 million would be required to fully implement some of the initiatives. Even if assets increase again at 10.4%, the 2.75 basis points would only produce an operating budget of \$27.3 million.

31. At 2.75 basis points, the implementation of the new initiatives could not be accomplished. Similarly, SWIB officials indicate, there could not be any reversal of the trend to utilize more costly external management of the funds' investments. As described above, external management costs have increased through recent years and, SWIB argues, would continue to grow if the 2.75 basis-point rate is maintained. [It should be noted that external costs would likely continue to grow under the proposed 3.25 basis points as well, but at a lower rate.]

32. Under the bill's provision to increase the basis point factor to 0.0325% of the average market value of the assets (3.25 basis points), SWIB's operating budget would increase to \$29.3 million in 2007-08 (based on estimated total assets of \$90.2 billion), or \$4.2 million higher than the projected budget of \$25.1 million. If total assets increase by 3.8% in the following year (the average increase in total assets since 1999-00), the 2008-09 SWIB operating budget would be \$30.4 million. This amount is approximately \$1.0 million higher than the projected 2008-09 operating budget of \$29.4 million.

33. The SWIB general program operations appropriation account is a PR continuing appropriation, meaning that unspent monies remain in the appropriation and are available for expenditure in a subsequent year. SWIB maintains a reserve of such funds in two accounts. At the end of 2005-06, the balances included: (a) \$5.1 million in an account to support incentive awards for SWIB personnel; and (b) \$0.8 million for general program operations. SWIB indicates that these surpluses are maintained at levels considered to adequate to meet needs and are not built up to excessive levels. Officials maintain that if reserves are adequate and budgeting indicates that 3.25 basis points would produce an unnecessary operating amount, the funds would be assessed at a level less than 3.25 basis points. SWIB also indicates that a portion of past reserves has occasionally

been reallocated back to the funds because they were not necessary for SWIB's operations. Officials point out that SWIB has a fiduciary responsibility for the assets of the various funds.

34. The SWIB strategic planning objectives and related initiatives reflect an extensive effort to develop approaches to enhance overall earnings and to transfer some assets from more costly external management to less costly internal management. The proposed basis point increase under the bill provides SWIB with the necessary resources to pursue these objectives. Therefore, the Committee may wish to approve the Governor's provision.

35. Given the uncertainties and variability of investment returns it is not possible to select a basis-point factor that will exactly produce an amount that matches projected spending. However, it can be argued that the application of 3.25 basis points for the operating budget in 2007-08, which would produce an estimated surplus of \$4.2 million, is unnecessary. An increase to 2.85 basis points for the calculation of the 2007-08 operating budget would cover the projected costs of \$25.1 million and still provide a reserve of approximately \$0.6 million. Under this alternative, the Committee would provide an operating budget calculated on 2.85 basis points in 2007-08 and 3.25 basis points in 2008-09.

36. Alternatively, the Committee could delete the provisions; however, as noted above, doing so would preclude SWIB's ability to pursue the planned initiatives (and the net gains in investment returns associated with the initiatives) and to positively affect the rising costs of external management. Maintaining current law could also limit SWIB's ability to maintain the current level of internal operations with the possible consequence of relying still more on more costly external management.

## **ALTERNATIVES TO BILL**

1. Approve the Governor's recommendation to eliminate SWIB's statutory annual budget floor of \$20,352,800 and provide that the total amount that the Board may assess the funds for which it has management responsibility may not exceed, in each fiscal year, the greater of the amount that: (a) the Board could have assessed the funds in the second year of the prior fiscal biennium; or (b) 0.0325% of the average market value of the assets of the funds at the end of each month between November 30 and April 30 of the prior fiscal year. Require the Board annually, no later than June 15<sup>th</sup>, to certify to the Department of Administration and the Joint Committee on Finance the maximum amount that the Board may assess the funds in the next fiscal year.

Provide that on September 1, of each year the Board would be required to assess each fund for its share of the Board's operating expenditures for the current fiscal year in an equitable manner.

2. Modify the Governor's recommendation by providing that the total amount that the Board may assess the funds for which it has management responsibility may not exceed, in 2007-08, the greater of the amount that: (a) the Board could have assessed the funds in the second year of the prior fiscal biennium; or (b) 0.0285% of the average market value of the assets of the funds at

the end of each month between November 30 and April 30 of the prior fiscal year. [Under this alternative, the basis-point factor for 2008-09 and subsequent years would be 0.0325% of the average market value of the assets of the funds at the end of each month between November 30 and April 30 of the prior fiscal year.]

3. In addition to Alternative 1 or Alternative 2, under a nonstatutory provision, require SWIB to report, on or before January 31, 2009, and January 31, 2010, to the Joint Committee on Audit and the Joint Committee on Finance on the implementation and outcomes of initiatives commenced as a result of the increase in the basis-point operating budget provided under the bill.

4. Delete provision.

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