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An Evaluation:

State of Wisconsin
Investment Board

August 2007

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. Positive returns continued through 2006.

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 threeand 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.

Key Facts and Findings

The Investment Board managed a total of $88.4 billion at the end of 2006.

2006 annual returns were 15.8 percent for the Core Fund and 17.6 percent for the Variable Fund.

At the end of 2006, domestic equities missed their one-, three-, and five-year benchmarks.

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 markets investments include private equity, real estate, and Wisconsin private equity and debt investments.

Private equity and real estate investments provided strong returns during 2005 and 2006. 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.

2006 annual returns were 28.7 percent for private equity and 30.1 percent for real estate.

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

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

The Wisconsin private equity portfolio was established in 2000 to focus on venture capital funds active in Wisconsin and the Midwest.

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: earlystage 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 ***(p. 51** and **59).***

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