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An Evaluation:

State of Wisconsin
Investment Board

November 2004

Report Highlights ■

Both retirement funds exceeded investment performance benchmarks in 2003.

External investment management costs have increased significantly.

The compensation plan revisions of 2000 led to significant increases in salaries and bonuses for investment staff.

Statutory limits in the Investment Board's internal budget and use of external investment management may warrant changes.

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 Fixed Retirement Trust and the Variable Retirement Trust—account for more than 90 percent of all assets under its management and fund retirement benefits for more than 500,000 current and former state and local government employees.

In total, the Investment Board managed $69.1 billion in assets as of December 31, 2003. Its investments included domestic and international stocks and bonds, real estate, direct loans to private companies, alternative investments such as private equity, and cash. The Investment Board's nine-member Board of Trustees establishes long-term investment strategies and policies. The Executive Director, 100.5 fulltime equivalent professional staff 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 analyzed significant increases in investment costs that are related to external management and support services, and we reviewed revisions to a staff compensation plan that were implemented in 2000.

Investment Performance

A rebound in investment markets during 2003 brought both retirement funds double-digit returns that were among their highest in the past 20 years. 2003 annual returns were 24.2 percent for the Fixed Retirement Trust Fund and 32.7 percent for the Variable.

Annual Returns		
Year	Fixed Fund	Variable Fund
1999	15.7%	27.8%
2000	(0.8)	(7.2)
2001	(2.3)	(8.3)
2002	(8.8)	(21.9)
2003	24.2	32.7

Despite losses from 2000 through 2002, the retirement funds also outperformed their one-, five-, and ten-year benchmarks at the end of 2003. Furthermore, the Fixed Retirement Trust Fund continues to exceed the actuarially expected investment results of 7.8 percent over the long-term.

Key Facts and Findings

The Investment Board managed a total of $69.1 billion at the end of 2003.

2003 annual returns were 24.2 percent for the Fixed Retirement Trust Fund and 32.7 percent for the Variable.

Costs for the services of external investment managers and advisors were $140.2 million in 2003.

Staff compensation costs were $13.2 million in 2003.

Bonus payments totaled $1.8 million in 2004, or more than five times the total paid in 1999.

Relative to nine other public pension funds, the Fixed Retirement Trust Fund's performance improved. Its five-year return as of December 31, 2003, was first among the ten funds surveyed for our current and previous evaluation. In our 2001 evaluation, the Fixed Fund had ranked last in performance.

The improvement was related, in part, to a relatively smaller allocation of Fixed Fund assets to domestic stocks as U.S. markets declined from 2000 through 2002. As a result, losses were smaller than those of other public pension funds.

External Management Costs

In addition to its own operating costs, the Investment Board incurs costs for the services of external investment managers and advisors. Both internal and external costs have increased in the past five years, but external costs have increased more significantly. In 2003, they were $140.2 million and represented 89.5 percent of the Investment Board's total costs.

Average Unclassified Compensation for 2003		
Average Compensation	Investment Staff	Support Staff
Salary	$112,802	$58,485
Bonus[1]	32,292	5,469
Total Compensation[2]	142,159	63,478

[1] Bonuses for 2003 performance were paid in 2004. Average bonus awards are calculated based on the number of staff who received a bonus award for 2003.
[2] Totals were based on 55 staff for investment staff and 46 staff for support staff.

Costs associated with externally managed investments in quantitative funds represented 28.2 percent of external investment expenses in 2003. These funds are somewhat similar to index funds, but they aim for higher earnings based on quantitative analysis of individual companies, market segments, and economic trends.

Management fees for quantitative funds have two components: a base that reflects the market value of assets under management, and a performance fee that allows the external fund manager to share the excess return if a fund exceeds established performance thresholds. Under such a structure, fees depend upon how well funds perform. When funds exceed performance thresholds, fees increase significantly.

Investment Board Staff Compensation Expenditures By Calendar Year (In Millions)	
Year	Expenditures
1999	$ 8.2
2000	11.2
2001	11.3
2002	13.3
2003	13.2

Compensation Plan

Compensation for its own staff represented 8.4 percent of the Investment Board's total costs in 2003. Expenditures for staff compensation increased $5.0 million, or 61.0 percent, over 1999 levels, in large part because of changes to the compensation plan that were authorized under 1999 Wisconsin Act 9 and took effect in 2000. Staff compensation expenditures were $13.2 million in 2003.

The restructured compensation plan also allows increased performance bonuses for investment and support staff. Since the plan's implementation in 2000, the Investment Board has awarded more than $6.7 million in bonuses. In 2004, bonus payments totaled $1.8 million, or more than five times the total paid in 1999.

For 2003 performance, the average bonus payment was $32,292 for investment staff, and $5,469 for support staff. Bonuses ranged from a high of $162,492 to a low of $0. Under the new compensation plan, overall compensation for investment staff, including salaries and bonuses, has increased to 74.3 percent of the Investment Board's private-sector peer group. The Investment Board's compensation levels compare favorably to those of other public pension funds.

Increased compensation levels appear to have helped the Investment Board recruit and retain experienced staff, although market conditions have also affected staffing efforts. We include a recommendation for the Investment Board to remain diligent in rewarding only meritorious performance through its bonus program.

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In addition to salaries and performance bonuses, the Investment Board compensates its staff in other ways, including performance recognition payments, signing and guaranteed bonuses, and additional retirement contributions.

We question whether the Investment Board is circumventing its statutory limit on investment director positions, which have a higher retirement formula factor. The statutory limit for the Investment Board is 11 positions. However, since 2001 the Investment Board has paid $121,796 in additional retirement contributions to give six portfolio managers and the Human Resource Director equivalent executive-level retirement benefits.

Future Considerations

The Investment Board's internal budget is limited by a statutory formula and the number of staff authorized. The percentage of investments that may be externally managed is also limited by statute. 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 increase accountability over the Investment Board's costs. Under current limits, investment management decisions are not necessarily driven by the most cost effective options available.

At the same time, it is unclear whether the Investment Board is fully meeting the intent of the statutory limit on external management. More detailed reporting may also be useful to the Legislature and others.

The Investment Board recently began a project, which it plans to complete in spring 2005, to analyze the optimal mix of investment approaches and to identify related statutory changes that may be needed to achieve that mix. The Legislature may wish to consider the results of the Investment Board's project as it deliberates changes to the statutory limits.

Recommendations

Our recommendations address the need for the Investment Board to:

- evaluate and, in its annual report to the Legislature, report on the cost and added value provided through its quantitative funds in comparison to other investment options *(**p. 35**)*;

- continually evaluate its contracting procedures to ensure that it is diligently analyzing and justifying the need for consulting services *(**p. 38**)*;

- include in its quarterly reports to the Legislature all costs directly charged against investment income, and provide more descriptive information regarding the nature of these costs *(**p. 45**)*;

- reconsider its use of performance recognition payments to provide financial awards to staff independent of its larger bonus program, or ensure that performance recognition payments are also considered when awarding bonuses *(**p. 58**)*;

- discontinue its practice of paying additional retirement contributions for staff not designated as executive participating employees, and pursue statutory changes if it believes additional executive positions are warranted *(**p. 60**)*; and

- remain diligent in using the bonus program to reward only meritorious performance and report to the Joint Legislative Audit Committee, upon completion, on changes it makes to its bonus program *(**p. 64**)*;

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