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STATE OF WISCONSIN
Legislative Audit Bureau

REPORT HIGHLIGHTS

Report 16-15
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State Auditor
Joe Chrisman

State of Wisconsin Investment Board

The State of Wisconsin Investment Board (SWIB) invests assets for the Wisconsin Retirement System (WRS), the State Investment Fund, and five other state insurance and trust funds. Assets under management by SWIB totaled $99.1 billion as of December 2015. Two funds of the WRS—the Core Fund and the Variable Fund—accounted for 92.8 percent of assets under management. The WRS provides retirement benefits to more than 600,000 state public employees and employees of participating local governments. The Department of Employee Trust Funds (ETF) is responsible for managing the operations of the WRS, and SWIB is responsible for managing WRS investments. SWIB had 173.35 full-time equivalent (FTE) positions as of December 2015.

We have completed an evaluation of SWIB, under s. 25.17 (51m), Wis. Stats. In completing this evaluation of SWIB, we:

analyzed investment returns by comparing them to performance benchmarks established by SWIB, the long-term expected rate of return assumption, investment returns of other large public pension plans, and SWIB's objectives of the 2010 Core Fund asset allocation plan;

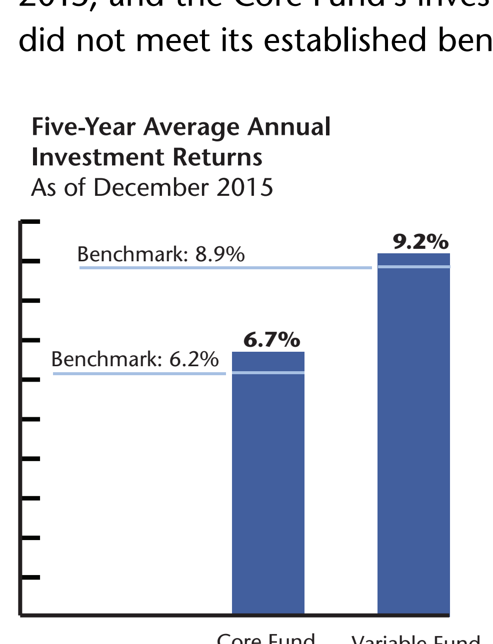
reviewed investment expenses, including changes SWIB has made that have increased its internal operating budget, overall investment costs, and compensation;
examined SWIB's approach to investing assets in Wisconsin venture capital companies; and

assessed the Board of Trustees' governance structure and compared it to other public pension plans.

Investment Performance

The five-year annual investment return of 6.7 percent and 9.2 percent for the Core Fund and Variable Fund, respectively, exceeded established benchmarks of 6.2 percent and 8.9 percent, respectively. Both the Core Fund and Variable Fund had negative one-year investment returns for 2015, and the Core Fund's investment return did not meet its established benchmark.

Five-Year Average Annual Investment Returns
As of December 2015



We also analyzed trends in the Core Fund's 20-year investment returns compared to the long-term expected rate of return assumption (return assumption) used by the WRS actuary. We found that this trend, if continued, may affect WRS contribution rates.

The Core Fund's five-year investment return ranked ninth among ten large public pension plans. The lower rank was attributable to asset allocation differences among pension plans and, in part, to new investment strategies that did not perform well in 2015. These strategies were implemented following a new asset allocation plan for the Core Fund, which SWIB approved in 2010.

One of the investment objectives of the new Core Fund plan was to minimize fluctuations in investment returns to stabilize both WRS contributions and annuity adjustments. We note that investment returns of some of these strategies have consistently underperformed established benchmarks or have exhibited fluctuations. For example, SWIB has held hedge fund investments since 2011, although it is unclear whether the hedge fund strategy has yet met SWIB's expectations. SWIB staff indicated that hedge funds continue to provide important diversification to the Core Fund.

SWIB will continue to implement the 2010 asset allocation plan at a measured pace because of market conditions. Therefore, it remains too soon to evaluate the overall effectiveness of the asset allocation plan.

Investment Expenses

No general purpose revenue (GPR) directly supports SWIB's operations. SWIB charges certain investment expenses directly against investment earnings and operating expenses to the funds it manages. 2011 Wisconsin Act 32, the 2011-13 Biennial Budget Act, authorized SWIB to establish its own operating budget and to create and eliminate staff positions.

SWIB's expenses increased from $258.7 million in 2011 to $323.9 million in 2015, or by 25.2 percent. The increase in expenses can be attributed to several factors, including an 18.9 percent increase in assets under management over this time period, information systems implementation expenses, and external investment fees for more complex investment strategies. In addition, compensation costs have increased due to compensation plan changes and an additional 48.1 full-time equivalent positions, which were authorized to increase internal management of assets and to support SWIB's implementation of new information systems.

A cost benchmark study continues to identify that SWIB's costs are lower than other large public plans with a similar mix of assets. We found the performance fees paid to hedge fund managers have declined since 2013. In contrast to hedge funds, for which SWIB pays performance fees annually, agreements with private equity and real estate fund managers include provisions for "carried interest," which, if earned, is a type of performance fee or profit sharing. We found that SWIB does not consistently track carried interest amounts nor are they considered in SWIB's overall investment expenses.

SWIB establishes compensation based on a peer group. SWIB authorized $9.6 million in bonuses for its employees for 2015 investment performance. The Core Fund had a one-year absolute return of -0.4 percent in 2015 that triggered a bonus deferral policy, which was subsequently waived by the Board.

Wisconsin Venture Capital Investments
SWIB regularly makes investments in Wisconsin through public stocks and bonds, private debt, and private equity. As of June 2015, it invested $809.4 million in companies headquartered or with a significant presence in Wisconsin. SWIB's Wisconsin private equity portfolio invests primarily in venture capital funds with a focus on Wisconsin and the midwest. However, nearly three-fourths of the $151.3 million invested in the Wisconsin private equity portfolio, was not invested in Wisconsin companies.

SWIB focuses its venture capital investments in start-up companies to meet its fiduciary responsibility to provide prudent and cost-effective investment returns. Other Wisconsin programs, such as the Badger Fund of Funds, authorized by 2013 Wisconsin Act 41, and the Wisconsin Economic Development Corporation, have different investment objectives than SWIB.

Board Oversight

The Board of Trustees is made up of nine members, including two participants of the WRS, the Secretary of the Department of Administration, and six individuals appointed by the Governor and confirmed by the Senate. Although the Board's fiduciary responsibilities have remained largely unchanged, its authority over investment types and internal operating expenses, including budget and position authority, has expanded in recent years and increased the importance of the Board's oversight.

The Board relies on periodic updates from staff and consultants to fulfill its fiduciary responsibilities, and the Board met 10 times during 2015. In reviewing other large public plans' governance structures, we found that other boards have more committees on average than SWIB.

The Board's Strategic Planning and Corporate Governance Committee has a wide range of responsibilities and met most frequently in 2015. This committee currently approves SWIB's internal operating budget, although this reflected only 13.4 percent of the 2015 estimated total cost of management. No board committee charter includes an explicit oversight responsibility to monitor actual investment expenses.

Recommendations

We recommend that the State of Wisconsin Investment Board work with the Board of Trustees to:

☑ develop policies and procedures to ensure that carried interest amounts are tracked for all portfolios in a consistent manner and reported annually to the Board of Trustees *(p. 36)*;

☑ develop guidance language for the bonus deferral policy to consider when evaluating whether to waive a deferral *(p. 45)*;

☑ present internal operating budget-to-actual reporting to the Board quarterly *(p. 60)*;

☑ increase the content and frequency of information to the Board on the total cost of management, including those expenses charged directly to earnings *(p. 60)*; and

☑ include in the Board's next self-evaluation an assessment of whether its existing committee structure or committee charters should be revised *(p. 60)*.

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Legislative Audit Bureau
www.legis.wisconsin.gov/lab

(608) 266-2818

22 East Mifflin Street
Suite 500
Madison, Wisconsin 53703