

AN EVALUATION

*State of Wisconsin  
Investment Board*

*01-18*

*November 2001*

**2001-2002 Joint Legislative Audit Committee Members**

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State Auditor - Janice Mueller

Editor of Publications - Jeanne Thieme

Audit Prepared by

Diann Allsen, Director and Contact Person  
Mary Watson  
Connie Christianson  
Mark Shikoski

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State of Wisconsin \ LEGISLATIVE AUDIT BUREAU

JANICE MUELLER  
STATE AUDITOR

22 E. MIFFLIN ST., STE. 500  
MADISON, WISCONSIN 53703  
(608) 266-2818  
FAX (608) 267-0410  
Leg.Audit.Info@legis.state.wi.us

November 6, 2001

Senator Gary R. George and  
Representative Joseph K. Leibham, Co-chairpersons  
Joint Legislative Audit Committee  
State Capitol  
Madison, Wisconsin 53702

Dear Senator George and Representative Leibham:

We have completed an evaluation of the State of Wisconsin Investment Board, as directed by s. 25.17(51m), Wis. Stats. As of December 31, 2000, the Investment Board managed a total of \$67.0 billion in investments that included assets of the Wisconsin Retirement System, the State Investment Fund, and five smaller insurance and trust funds.

The Investment Board has recently been successful in exceeding its performance benchmarks for the Fixed Retirement Trust Fund, which represented 81.8 percent of the assets under its management in 2000. However, the Fixed Retirement Trust Fund's long-term returns continue to lag those of other large public pension funds. As of June 30, 2000, its five-year returns ranked last among ten funds we surveyed.

We focused our analysis on the Investment Board's Opportunity Portfolio for the Fixed Retirement Trust Fund, which is a higher-risk portfolio that has focused on private equity investments in emerging markets in Asia and Eastern Europe. The portfolio, which has assets of approximately \$1 billion, has failed to meet its performance benchmarks and is not meeting expectations of earning higher returns than the Investment Board achieves through its more traditional investments. In light of the lagging returns and controversy surrounding certain investments in South Korea, support for the portfolio among members of the Board of Trustees is divided. Another area of concern is the Board of Trustees' involvement in the Opportunity Portfolio. Of particular concern is the fact that some trustees own public stock in entities associated with the portfolio. These interests have previously not been publicly disclosed. We suggest that to avoid the appearance of conflicts of interest, the Investment Board revisit its policies to ensure trustees comply with provisions of the State Ethics Code.

We appreciate the courtesy and cooperation extended to us by the Investment Board. A response from the Board's Executive Director is Appendix 5.

Respectfully submitted,

A handwritten signature in cursive script that reads 'Janice Mueller'.

Janice Mueller  
State Auditor

JM/DA/ss



The mission of the State of Wisconsin Investment Board is to provide prudent and cost-effective management of funds it holds in trust, including assets of the Wisconsin Retirement System, the State Investment Fund, and five smaller state insurance and trust funds. As of December 31, 2000, the Investment Board managed a total of \$67.0 billion in investments that included domestic and international stocks and bonds, real estate, direct loans to private companies, alternative investments, and cash.

Statutes require the Legislative Audit Bureau to perform a biennial management audit of the Investment Board, as well as annual financial audits of its investment activities. The biennial management audit requirement was implemented in 1999, in response to a March 1995 disclosure that \$95.3 million had been lost from the State Investment Fund because of improper use of investment instruments known as derivatives. In our first management audit, released in October 1999, we found that steps had been taken to improve investment practices. However, we also found that, at the time, the Investment Board had not consistently met its investment performance benchmarks for the Fixed Retirement Trust Fund. At the end of 2000, that fund represented 81.8 percent of assets under the Investment Board's management.

This report includes another review of the Investment Board's performance in managing Wisconsin Retirement System assets in the Fixed Retirement Trust Fund. Our major focus, however, is the Opportunity Portfolio, which is a higher-risk portfolio that focuses on unconventional or alternative investment instruments and strategies within the United States and internationally.

Strong financial markets and low interest rates in the 1990s created a period of sustained growth in Wisconsin Retirement System assets, which increased by almost 170 percent from 1991, when they totaled \$23.9 billion, through 1999, when they were \$64.2 billion. However, during the latter half of 2000 markets weakened, and as of December 31, 2000, Wisconsin Retirement System assets had declined to \$62.1 billion. Most recently, markets have been adversely affected by the September 11, 2001 terrorist attacks.

Assets of the Fixed Retirement Trust Fund are allocated among a wide variety of investment types, or classes, to ensure that exposure to the risk of any particular investment is limited. Over the last five years, the Investment Board has decreased the portion of assets allocated to domestic equities (stocks) and increased its allocation to international

investments. Nevertheless, domestic equities constitute the largest asset class and accounted for 36 percent of the Fixed Retirement Trust Fund's assets as of December 31, 2000. The second-largest asset class is domestic fixed-income securities, which accounted for 31 percent. International investments accounted for 22 percent, and the remaining 11 percent of the Fixed Retirement Fund's assets consisted of alternative investments, real estate, and cash holdings.

To assess the effectiveness of the Investment Board's overall investment strategy, we measured its performance in two ways: 1) we compared the Board's investment returns to benchmarks established by the Board of Trustees; and 2) we compared the Fixed Retirement Trust Fund's performance to that of other large public pension funds.

The Fixed Retirement Trust Fund earned double-digit returns for five consecutive years in the late 1990s. However, the market downturn in the second half of 2000 negatively affected investment returns, as reflected in a loss of 0.8 percent for the Fixed Retirement Trust Fund in 2000. Despite the short-term loss, the Investment Board exceeded its one-, five-, and ten-year performance benchmarks for the period ending December 31, 2000. The benchmarks represent the market-based returns the Investment Board attempts to exceed. For example, the Fixed Retirement Trust Fund's one-year return of negative (-)0.8 percent exceeded its market-based benchmark of negative (-)1.4 percent, while the five-year return of 12.0 percent exceeded the benchmark of 11.4 percent.

In our 1999 audit, we had suggested the Investment Board review several of its investment strategies and reassess whether its returns on staff-intensive and higher-risk investments warranted the level of assets and resources that had been committed to them. One area we suggested for reassessment was the level of resources allocated to small cap stocks, which typically represent companies with capitalization levels of less than \$1.0 billion. In our 1999 audit, we noted that the Investment Board's emphasis on small cap stocks appeared to be affecting the Fixed Retirement Trust Fund's overall performance.

In a turnaround of its 1998 performance, the Small Cap Portfolio exceeded its benchmarks in both 1999 and 2000. In fact, its one-year return of 49.2 percent in 1999 was more than double a benchmark of 20.6 percent. In 2000, its one-year return of negative (-)0.2 percent was significantly less, although it exceeded a benchmark of negative (-)3.0 percent. Although the Investment Board believes that its most current returns validate its strategy, the 1999 and 2000 returns also demonstrate the volatility of the small cap stock performance.

Similarly, we believe the Investment Board should continue to assess its level of commitment to international equities. We again found that returns for international equities have lagged domestic equities: as of December 31, 2000, the average five-year return for international equities



was 13.5 percent, compared to 17.0 percent for domestic equities. The cost to manage \$1.0 billion of international equities was almost four times greater than the cost to manage \$1.0 billion of domestic equities.

Comparing the returns of several large pension funds can provide perspective for assessing the relative effectiveness of the Investment Board's overall strategy. The Investment Board's long-term returns do not compare favorably with those of other funds we surveyed. For example, its five-year return was tenth among ten public pension funds we surveyed. However, the Investment Board has improved in short-term rankings; it ranked third among the ten funds for one-year returns. This improvement contrasts with the one-year ranking of 9 among 12 funds that we reported in 1999.

As the Investment Board evaluates its investment strategies and asset allocation decisions, one area that warrants focused attention is the Opportunity Portfolio, which includes some of its most high-risk investments. The Opportunity Portfolio, which represents 2 percent of Fixed Retirement Trust Fund assets, was established in 1995 to capitalize on investment opportunities that did not easily match the objectives of the Investment Board's other portfolios.

The Investment Board expects higher returns over the long term from the Opportunity Portfolio than from its more traditional portfolios, but performance has been mixed. The portfolio exceeded its one-year performance goals for 1996 and 1997, but it has not met its benchmarks in subsequent years. Its annualized average return from inception through June 30, 2001 was 7.7 percent, compared to a benchmark of 16.3 percent. As of June 30, 2001, its one-year return was negative (-)17.0 percent, which significantly lagged a benchmark of 15.0 percent, and its five-year annualized average return of 4.0 percent lagged a benchmark of 15.9 percent.

Although the Opportunity Portfolio's overall returns have fallen short of benchmarks and expectations, the portfolio has had several successful investments. An early emphasis on domestic equities contributed to its early success during a period in which domestic equities performed well. Eight of the ten largest dollar gains realized were from sales of investments that had been made during the portfolio's first three years. The largest dollar gain, however, was from a relatively recent investment: the Investment Board realized a gain of \$44.7 million on Philip Morris stock purchased in October 1999 and sold in April 2001.

The decline in the Opportunity Portfolio's performance is, in part, attributable to staffing changes that occurred in 1998, when the portfolio's investment director retired and the portfolio manager resigned. The unusual nature of the portfolio's investments and related strategies made it difficult for other investment staff to readily assume responsibility for it. Therefore, the Investment Board began to liquidate portions of the

Opportunity Portfolio in 1998, at a time when the domestic stock market experienced a short-term decline and emerging markets were continuing a decline that had begun in 1997.

The portfolio has also realized significant losses with more recent investments. The two largest dollar losses were Korean investments that were made in 1999 and 2000 and sold in 2001, including stock in a South Korean computer chip maker that was purchased in June 2000 and sold one year later at a loss of \$91.9 million.

The Opportunity Portfolio has been undergoing a period of transition as the Investment Board implements new strategies. Since late 1999, its investments have been focused in financial services, cement, and energy. Emerging markets in Asia and Eastern Europe have been targeted for investment. In addition, the Investment Board has also developed strategic partnering relationships through the Opportunity Portfolio, which allow it to purchase significant equity stakes in companies without the fees and taxes that are typically associated with limited partnerships and private equity funds. At the same time, however, the advantages and safeguards that are available through limited partnerships and private equity funds may be diminished with some forms of strategic partnering.

The most extensive and complex of three major strategic partnering relationships, and the one that appears to offer the Investment Board the least protection, has directly exposed it to the complexities and risks that can be encountered in emerging markets. In July 1999, the Investment Board entered into a strategic partnering relationship with an investment management company that is currently known as iRegent Group Limited, to form a holding company that is currently known as Korea OnLine Limited (KOL). The Investment Board has invested \$110.0 million in KOL with the purpose of acquiring South Korean financial services companies and forming an integrated entity to provide securities trading, banking, and insurance services.

Between 1999 and 2000, KOL acquired controlling interests in a bank, an insurance company, an asset management company, and two securities companies in South Korea. However, a number of problems have affected these companies: the South Korean government suspended operations of the bank after a run on its deposits; the insurance company was liquidated less than one year after it was acquired; and the asset management company is being liquidated because a regulatory decision by the South Korean government apparently left it with no viable product line.

Based on the events at KOL, the Investment Board estimates the original \$110.0 million investment's value was \$15.9 million as of June 30, 2001. After paying an accounting consulting firm \$60,000 for help in further assessing the current risks associated with KOL and the related companies, the Investment Board recently hired a New York law

firm and forensic auditors to review the KOL investments and to determine whether the Investment Board's proceeds have been directed to the appropriate entities and applied in compliance with terms of its investment agreements.

Another controversial Opportunity Portfolio investment is the Investment Board's September 2000 purchase of \$8.3 million of distressed bonds from the Wisconsin-based Heartland Advisors, Inc. The investment agreement includes a provision that allows the Investment Board to sell the bonds back to Heartland's parent company, Heartland Holdings, at the end of two years for the purchase price plus a 20 percent annual return, which would total approximately \$12.0 million. This provision is personally guaranteed by Heartland's founder and president, and the Investment Board believes that Heartland will fulfill its obligations if the provision is invoked.

However, the soundness and appropriateness of the investment was questioned when Heartland repriced many of the bonds in its municipal bond funds significantly lower than the prices that had been carried on its books. Soon after the repricing, several investors filed suits seeking damages and the Securities and Exchange Commission began an investigation. Concerns have also been raised about the relationship between Heartland and the chair of the Investment Board's Board of Trustees, and about his role in the transaction. The trustee is also a member of the board of directors of Heartland Group, Inc., which contracts with Heartland Advisors to manage the Heartland series of mutual funds. In addition, Heartland Advisors is a major tenant of an office building in Milwaukee developed and managed by the trustee's investment and real estate company.

Both the trustee and Investment Board staff have indicated the trustee's role was limited to facilitating the initial contact between Heartland and the Investment Board. In addition, the Board's minutes indicate that the trustee recused himself from discussion and from votes on the Heartland transaction. Whether the trustee influenced the investment beyond his referral, either directly or indirectly, because of his role as chair of the Board of Trustees, is difficult to determine from the limited documentation maintained by the Investment Board. However, we found no evidence that direct influence had been exerted, and Investment Board staff told us the trustee's referral did not affect their decision on the investment.

In light of both lagging returns and the controversy surrounding investments such as Heartland and iRegent, the Board of Trustees has become increasingly divided in its support for the Opportunity Portfolio. In a vote of confidence taken on May 16, 2001, the trustees voted 5-3 to continue the portfolio. However, some supporters have indicated that although they believe it may take time for strategies used in the

Opportunity Portfolio to fully realize higher returns, their support may decrease if the portfolio does not begin realizing higher returns in the next two to three years.

Investment Board trustees and staff have been evaluating and instituting changes in policies and procedures for the Opportunity Portfolio since early 2001. One concern is that trustees have become directly involved in portfolio management. On advice from outside fiduciary advisors, the Investment Board has taken steps to more clearly delineate the governance role of trustees and the investment management role of staff. A major change has been to reduce the trustees' involvement in individual investment decisions and to increase reporting and discussion among investment staff and trustees on investment strategies and the portfolio's performance. Another major change initiated by the Investment Board is that investments under consideration for the Opportunity Portfolio are now first reviewed by a risk management committee that is staffed only by senior Investment Board staff, with no trustee involvement.

In addition to the steps it is already taking, we believe the Investment Board should develop policies and procedures that define the analytical steps and documentation standards that should be met before entering into investment transactions and relationships in the Opportunity Portfolio. We found limited documentation to support investment decisions.

Adding to concerns about the trustees' involvement in specific investments has been the fact that some trustees also have economic interests in some entities associated with the Opportunity Portfolio. For example, we found that three current trustees and two former trustees have owned public stock in iRegent, the Investment Board's strategic partner in KOL. In most cases, minutes from Investment Board meetings indicate that trustees appropriately recused themselves from consideration of the related investments. However, we found one instance in which two trustees who reported they owned public stock in iRegent did not recuse themselves from a July 2000 vote to invest \$80.0 million in a joint venture with KOL.

Whether this instance represents a conflict of interest under the State Ethics Code is debatable, because we cannot determine whether the trustees' votes on the KOL transaction would have substantially affected their financial interests in iRegent. However, the votes, at a minimum, present an appearance of a conflict that the trustees should have taken steps to avoid. We suggest the Investment Board revisit its policies on trustee actions on investments in which trustees may have a personal or economic interest.

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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. Its mission is to provide prudent and cost-effective management of the funds it holds in trust, through investment returns that are consistent with the purpose and risk profile of each fund.

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**The Investment Board managed \$67.0 billion in assets as of December 31, 2000.**

As of December 31, 2000, assets under the Investment Board's management totaled \$67.0 billion, including:

- \$62.1 billion in the Wisconsin Retirement System, which accounted for 92.8 percent of assets under management at the end of 2000 and represents pension funds for over 470,000 current and former employees of the State and most local governments;
- \$4.2 billion in the State Investment Fund, which accounted for approximately 6.2 percent of assets under management at the end of 2000 and provides short-term investment and cash management for state funds, the Wisconsin Retirement System, and over 1,100 local units of government that choose to participate in the Local Government Investment Pool; and
- a total of approximately \$0.7 billion in the Patients Compensation Fund, the State Life Insurance Fund, the Local Government Property Insurance Fund, the Historical Society Endowment Fund, and the Tuition Trust Fund, which together accounted for less than 1 percent of assets under the Investment Board's management at the end of 2000.

The Department of Employee Trust Funds administers the Retirement System and has responsibility for its day-to-day management, while the Investment Board invests the Retirement System's assets to finance post-retirement benefits. To manage these assets, the Investment Board buys, holds, and sells a mix of investment vehicles, including:

- domestic and international equities (stocks) and bonds;
- real estate;

- direct loans to private companies, which are known as private placements;
- alternative investments, which are broadly defined as investments other than publicly traded stocks, bonds, and cash, and which offer the prospect of greater returns than traditional investments but also involve increased risk; and
- cash.

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**The Board of Trustees establishes investment strategies and policies.**

The nine-member Board of Trustees is responsible for establishing the Investment Board's long-term investment strategies and policies, as well as for developing investment guidelines and monitoring investment performance. Two of the trustees are participants in the Wisconsin Retirement System, and one is the Secretary of the Department of Administration or his designee. The remaining six trustees are appointed by the Governor with consent of the Senate, and four of these six are required to have at least ten years of investment experience. Appointed trustees serve six-year terms.

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**Investment Board staff are responsible for day-to-day investment decisions.**

The trustees have delegated day-to-day investment management decisions to the Investment Board's professional staff, which includes the Executive Director, who is appointed by the Board of Trustees; 96.5 professional investment staff in the unclassified civil service system; and 7.0 support staff in the classified service.

The Executive Director develops and recommends investment policies for the Board's adoption and, each year, with advice from senior investment staff and professional consultants, develops a plan for allocating the assets of each of the eight funds shown in Table 1 into portfolios that include various types (or classes) of investments. Plans are submitted to the Board of Trustees for review and approval in January, and they are subsequently included in the Investment Board's annual report to the Legislature.

The Board's professional investment staff research, select, buy, and sell specific investment vehicles that they expect to perform according to the strategies and policies established by the Board of Trustees. The Investment Board also hires external managers to invest and manage certain assets.

Table 1

**Funds Managed by the Investment Board**

<u>Description of Fund</u>	<u>Value as of 12/31/2000</u>	<u>Types (Classes) of Investments</u>
<b>WISCONSIN RETIREMENT SYSTEM</b>		
Fixed Retirement Trust Fund <i>Diversified balanced portfolio that funds guaranteed benefits to beneficiaries</i>	\$54,789,000,000	Equities, fixed-income, real estate, limited partnerships, private equity
Variable Retirement Trust Fund <i>Equity portfolio that funds variable benefits for those who elect to participate</i>	7,334,000,000	Equities
<b>STATE INVESTMENT FUND</b>		
<i>Pool of state agency and local government cash balances</i>	4,176,000,000*	U.S. Treasury securities, certificates of deposit, repurchase agreements, commercial paper
<b>OTHER FUNDS</b>		
Patients Compensation Fund <i>Provides medical malpractice insurance for Wisconsin's health care providers</i>	556,400,000	Fixed-income, equities
State Life Insurance Fund <i>Offers life insurance policies up to \$10,000 for Wisconsin residents who choose coverage</i>	67,600,000	Fixed-income
Local Government Property Insurance Fund <i>Provides property insurance coverage to participating local units of government</i>	27,700,000	Fixed-income
Historical Society Endowment Fund <i>Includes gifts and grants made to the State Historical Society</i>	12,400,000	Fixed-income, equities
Tuition Trust Fund <i>Funds EdVest Wisconsin, a savings program for college expenses</i>	7,700,000	Fixed-income
<b>TOTAL</b>	<u>\$66,970,800,000</u>	

\* Excludes retirement funds invested in the State Investment Fund.

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**The Fixed Retirement Trust Fund represented 81.8 percent of assets under management in 2000.**

The Investment Board manages assets of the Wisconsin Retirement System in two funds:

- The larger Fixed Retirement Trust Fund is a balanced fund that provides income to support guaranteed retirement benefits for Wisconsin Retirement System participants. It represented 81.8 percent of assets under the Investment Board's management at the end of 2000. Approximately 48.2 percent of the Fixed Retirement Trust Fund assets are managed internally.
- The smaller Variable Retirement Trust Fund, for which returns are typically more volatile than the Fixed Retirement Trust Fund, is primarily invested in stocks. Approximately 9.3 percent of Wisconsin Retirement System participants had elected to place a portion of their pension accounts in it in 2000, when it represented 11.0 percent of assets under the Investment Board's management. As a result of enactment of 1999 Wisconsin Act 11, the Variable Fund was recently reopened to participants active in the system after 2000. Approximately 33.3 percent of Variable Fund assets are managed internally.

The Investment Board uses both active and passive strategies to manage these funds' portfolios. Active portfolio management seeks to increase investment returns by selecting individual investments on a company-by-company basis, without attempting to match the mix represented in the market as a whole. Passive management seeks to replicate a market index, such as the Standard and Poor's (S&P) Index of 500 widely held common stocks, and to match its returns. Both active and passive portfolio management can be prudent and cost-effective strategies.



As trustees of public funds, Investment Board trustees and staff are held by s. 25.15(2)(a), Wis. Stats., to the “prudent person” standard of responsibility in developing and implementing investment strategies that appropriately balance risk and return. Under this standard, they are directed to manage investment assets with the care, skill, and diligence that a prudent person would exhibit acting in a similar capacity, with similar resources, and for similar types of funds.

The Investment Board’s operating costs for staff salaries and fringe benefits, supplies, and permanent property are funded through assessments to the various funds managed by the Investment Board, as authorized by its program revenue appropriation. In addition, the Investment Board is allowed to charge certain costs directly to current investment income of the funds, rather than to its program revenue appropriation. These costs include fees paid to external investment managers and costs for other support services, such as custodial banking, consultant fees, electronic research services, and legal fees.

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**The Investment Board’s  
operating costs totaled  
\$102.9 million in calendar  
year 2000.**

As shown in Table 2, the Investment Board’s total annual costs have increased from \$70.7 million in calendar year 1998 to \$102.9 million in 2000, an increase of 45.5 percent. A significant portion of the increase in costs represents an increase in fees paid to external investment managers, which totaled \$62.6 million in 2000. The 42.4 percent increase in staff salaries and fringe benefits is in large part related to additional funding authority and flexibility for investment staff compensation that the Legislature provided in 1999 Wisconsin Act 9, to reduce a disparity between compensation of Investment Board staff and investment professionals in the private sector. The increased compensation funding has allowed the Investment Board to increase base salaries and bonuses for investment staff through a pay incentive system that rewards all unclassified employees who exceed their performance benchmarks, demonstrate exemplary performance, or contribute in non-investment performance categories. The current system has been in place since July 1, 2000.

Table 2

**Investment Board Operating Costs**  
(by calendar year)

	<u>CY 1998</u>	<u>CY 1999</u>	<u>CY 2000</u>	<u>Percentage Change</u>
Funded by Program Revenue Appropriation:				
Salaries and fringe benefits	\$ 7,875,845	\$ 8,178,501	\$ 11,218,716	42.4%
Supplies and permanent property	<u>4,502,837</u>	<u>4,294,339</u>	<u>3,891,541</u>	(13.6)
Subtotal	12,378,682	12,472,840	15,110,257	22.1
Charged to Current Investment Income:				
External investment manager fees	38,557,665	51,494,579	62,598,931	62.4
Real estate advisory fees	13,246,360	16,565,342	17,733,079	33.9
Custodial bank fees	3,564,807	3,722,922	3,742,714	5.0
Consultant fees	1,307,804	677,495	855,397	(34.6)
Legal fees	365,151	415,318	657,190	80.0
Electronic research services	<u>0</u>	<u>1,027,553</u>	<u>1,495,969</u>	—
Subtotal	57,041,787	73,903,209	87,083,280	52.7
Soft Dollars*	<u>1,318,422</u>	<u>1,026,912</u>	<u>707,447</u>	(46.3)
Total	\$70,738,891	\$87,402,961	\$102,900,984	45.5

\* Includes credits received for performing trades with certain brokers. The Investment Board uses these credits to purchase electronic data services, investment publications, institutional memberships, and other miscellaneous items.

Source: Investment Board

Statutes require the Legislative Audit Bureau to perform a biennial management audit of the Investment Board, as well as annual financial audits of its investment activities. The biennial management audit requirement, s. 25.17(51m), Wis. Stats., was implemented in 1999, in response to a March 1995 disclosure that \$95.3 million had been lost from the State Investment Fund because of improper use of investment instruments known as derivatives. In our first management audit under this requirement (report 99-16), we found that steps had been taken to improve investment practices. However, we also found that the Investment Board had not consistently met its investment performance benchmarks for the Fixed Retirement Trust Fund.

This report includes another review of the Investment Board's performance in managing Wisconsin Retirement System assets in the Fixed Retirement Trust Fund. It compares investment returns for the Fixed Retirement Trust Fund to market conditions, performance benchmarks established by the Investment Board, and the performance of other public pension funds. Our major focus, however, has been one of three alternative portfolios the Investment Board has established for the Fixed Retirement Trust Fund: the Opportunity Portfolio, which is a higher-risk portfolio that focuses on unconventional or alternative investment instruments and strategies within the United States and internationally. We both assessed investment policies and procedures for the Opportunity Portfolio and completed a detailed analysis of selected investments.

To conduct our evaluation, we:

- compared one-, five-, and ten-year returns to performance benchmarks established by the Investment Board;
- reviewed investment policies and guidelines, documents supporting individual investments, other Investment Board materials, and financial records;
- interviewed Investment Board staff and trustees; and
- surveyed the managers of other public pension funds, to determine the type and extent of alternative investments in the funds they manage.

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## Investment Performance of the Fixed Retirement Trust Fund

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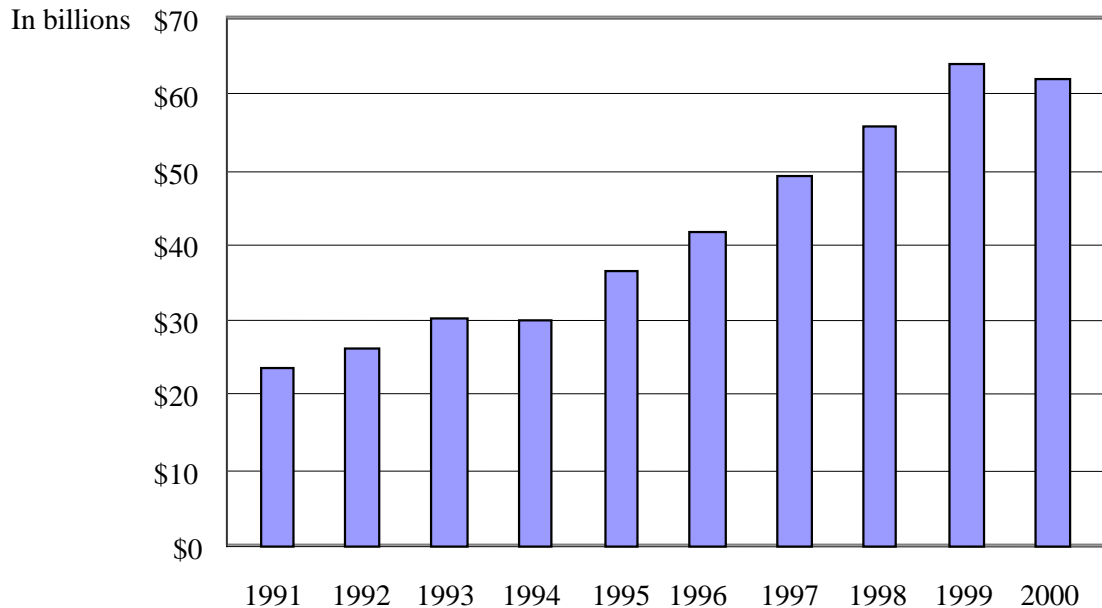
**Wisconsin Retirement System assets were \$62.1 billion as of December 31, 2000.**

Like many other institutional and individual investors, the Investment Board benefited from the strong U.S. financial markets and low interest rates of the 1990s. Under its management, Wisconsin Retirement System assets increased by almost 170 percent from 1991, when they totaled \$23.9 billion, through 1999, when they were \$64.2 billion. However, during the latter half of 2000 markets became more volatile and unpredictable, and Wisconsin Retirement System assets lost value. By December 31, 2000, the combined value of assets in the Fixed and the Variable funds had declined to \$62.1 billion, as shown in Figure 1.

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Figure 1

### Wisconsin Retirement System Assets (as of December 31)



Absolute growth or decline in assets does not necessarily express how well investments are being managed or whether an effective investment strategy has been developed and implemented. As noted, market volatility can affect investment returns and the rate at which assets grow. Further, external events and factors outside of the Investment Board's control, such as the September 11, 2001 terrorist attacks, can significantly affect overall markets and investment returns. Considering the volatility and uncontrollable factors that affect markets and investment returns, it can be difficult to measure the effectiveness of an investment organization in managing the investments under its control. However, to provide an overall perspective on the Investment Board's investment activities and decisions, we assessed the effectiveness of the Investment Board's management of Wisconsin Retirement System assets in two ways.

First, we compared the one-, five-, and ten-year returns it achieved for the Fixed Retirement Trust Fund to the performance benchmarks established for that fund by the Board of Trustees. This comparison illustrates how well the Investment Board has performed in relation to the market but provides only a partial view of the effectiveness of its overall investment strategies. Therefore, we also compared the Fixed Retirement Trust Fund's performance to the performance of other large public pension funds.

### **Investment Goals and Strategies**

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**The basic investment objective of the Fixed Retirement Trust Fund is long-term earnings.**

The basic investment objective of the Fixed Retirement Trust Fund is to provide earnings that, along with contributions from Wisconsin Retirement System employers and participants, will be sufficient for the system to pay projected pension benefits over time. Since 1992, the Investment Board's minimum investment goal for the Fixed Retirement Trust Fund has been an annual average return of 8.0 percent over the long term. That is the minimum rate the Fund's actuary believes is necessary to pay projected benefits to retirees over the course of their lives. A secondary goal is to exceed a performance benchmark established by the Board of Trustees, which reflects the performance of general market indices.

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**Asset allocation decisions are critical to investment management and performance.**

To achieve these goals, the Investment Board has established an investment strategy for the Fixed Retirement Trust Fund that it refines each year, within the general investment policies and restrictions set forward in s. 25.15, Wis. Stats. As part of this process, the Board of Trustees, the Executive Director, and senior investment staff make several key decisions. One of the most critical involves allocating assets among various investment classes and portfolios. Some pension experts believe that up to 90 percent of the variation in performance among investment entities is the result of overall investment or asset allocation decisions, not the selection of individual investments.

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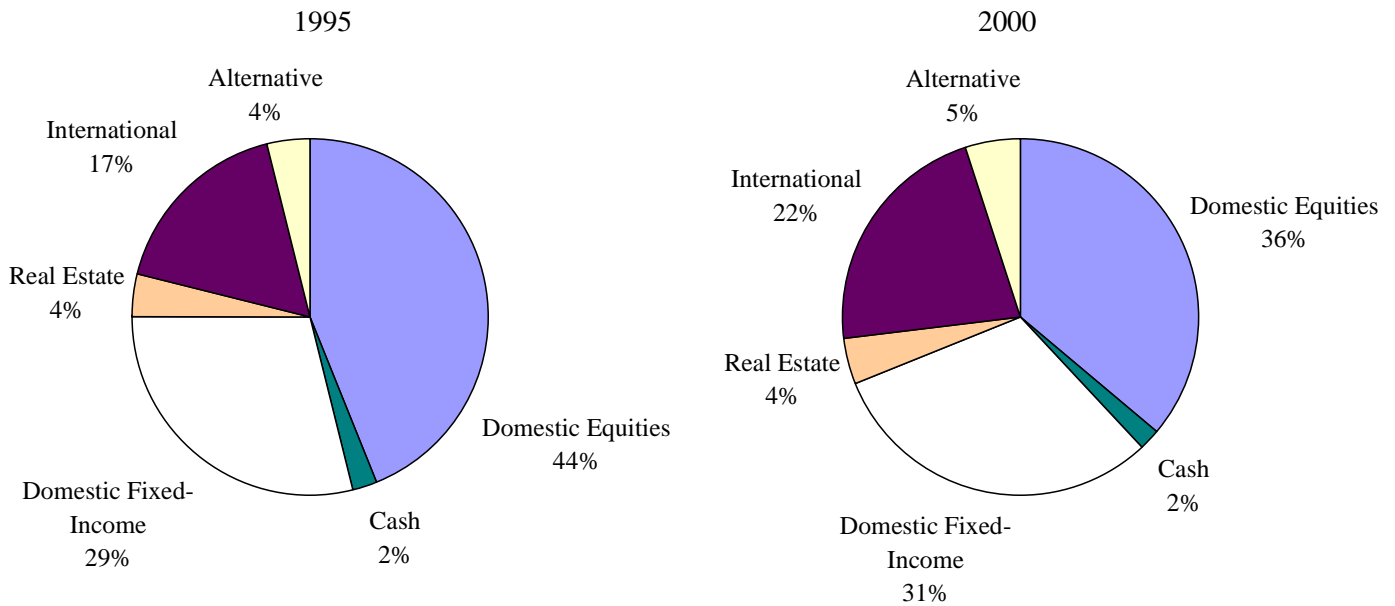
**Since 1995, the Investment Board has increased its allocation to international investments.**

As shown in Figure 2, the Investment Board's allocation of the Fixed Retirement Trust Fund's assets to general classes of investments has changed over the last five years. The Investment Board has decreased the portion of assets allocated to domestic equities and increased its allocation to international investments. In 1995, 44 percent of the Fixed Retirement Trust Fund's assets were invested in domestic equities; by 2000, the portion of assets allocated to this class of investment had declined to 36 percent.

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Figure 2

**Asset Allocation for the Fixed Retirement Trust Fund**  
(as of December 31)



## Fund Composition

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**Domestic equities represent the largest asset class for the Fixed Retirement Trust Fund.**

Even with the decrease in the portion of assets allocated to domestic equities, this asset class, which consists of common stock in U.S. companies, constituted the Fixed Retirement Trust Fund's largest asset class and accounted for \$19.8 billion of its \$54.8 billion in assets at the end of 2000. The Fixed Fund's domestic equities are managed through ten portfolios or funds that are diversified among small, medium, and large companies. Three portfolios are actively managed internally by Investment Board staff, and four are managed externally by outside managers. The Investment Board also invests in three passive index funds that contain the same mix of stocks as market indices.

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**The Investment Board manages one of the largest private placement portfolios among public pension funds.**

Domestic fixed-income investments constitute the second-largest asset class and accounted for \$17.0 billion of the Fixed Retirement Trust Fund's assets at the end of 2000. Assets in this class include U.S. government bonds and corporate bonds purchased in public markets, corporate debt securities, and U.S. Treasury and agency debt securities. Domestic fixed-income assets are actively managed by Investment Board staff through two public bond portfolios and passively managed in a public bond index fund. The Investment Board also manages one of the largest portfolios of direct loans to businesses among all public pension funds in the United States. In 2000, these privately negotiated loans, known as private placements, totaled \$3.6 billion and included \$385.3 million in a program to target investments in Wisconsin companies. Also included in domestic fixed-income investments in 2000 was \$0.5 billion in private commercial real estate mortgages.

At the end of 2000, international investments included \$9.5 billion in international equities and \$2.7 billion in international fixed-income securities. Approximately half of these investments are actively managed externally by outside managers hired by the Investment Board. The fixed-income portfolios are global portfolios and may invest in U.S. or foreign debt obligations. A small portion of the international equity and fixed-income investments, \$0.7 billion, has been invested in portfolios focused on emerging markets, which is a category of international investments that focuses on developing economies in Asia, Eastern Europe, and Latin America.



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**The Investment Board classifies three portfolios, with a total value of \$2.5 billion, as alternative investments.**

The Investment Board's alternative investment class, which accounted for \$2.5 billion of the Fixed Retirement Trust Fund's assets at the end of 2000, emphasizes equities but allows investing across investment classes in both domestic and foreign markets. The Investment Board classifies three portfolios of the Fixed Retirement Trust Fund as alternative investments:

- the Private Equity Portfolio (\$1.4 billion), which purchases ownership stakes primarily in domestic companies that are not publicly traded;
- the Biotech Venture Capital Portfolio (\$4.0 million), which makes funds available for start-up firms and small biotechnology businesses located primarily in Wisconsin and the Midwest; and
- the Opportunity Portfolio (\$1.1 billion), which focuses on opportunistic investments in both domestic and international markets and in ownership stakes in privately held foreign companies in emerging markets.

Alternative investments are typically subject to less disclosure than is required for publicly traded securities, and while this class of assets often offers the prospect of greater returns, it also involves increased risk.

Real estate investments, which accounted for \$2.0 billion of the Fixed Retirement Trust Fund's assets at the end of 2000, include shopping malls, office buildings, and other real estate owned directly by the Investment Board, as well as investments in real estate funds and partnerships that acquire and manage real estate investments. The Investment Board's real estate investments, which are managed in one portfolio, include domestic and international holdings, although all international holdings are purchased through real estate funds rather than as direct investments.

Cash accounted for \$1.2 billion of the Fixed Retirement Trust Fund's assets at the end of 2000. Temporary cash balances awaiting permanent investment are invested in short- and intermediate-term obligations of the U.S. government and its agencies, as well as high-quality commercial bank and corporate debt obligations.

## Investment Strategy Decisions

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**Diversification among different investment classes is important in asset allocation.**

Determining an appropriate asset allocation for a pension fund includes balancing risks with expected returns. Certain investment classes, such as international investments, entail greater degrees of both risk and expected return. Others entail less risk but have correspondingly lower expected rates of return. Therefore, an important principle of successful asset allocation is diversification, which limits exposure to the risks associated with any particular investment class. Because the various investment classes react differently to changes in the business cycle, inflation rates, and foreign exchange rates, diversifying a fund across several investment classes can add value by minimizing risk and stabilizing the rate of return.

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**Approximately 27 percent of the Fixed Retirement Trust Fund was invested in passive index funds.**

A second key investment management decision is whether to actively or passively manage investments. The benefits of a passively managed portfolio are that it will likely perform as well as the index it is designed to mimic, and it will cost less to administer because little company-specific investment research is needed. Actively managed portfolios, on the other hand, may provide additional value by outperforming the market, but they also carry the risk of potentially earning less than passively managed portfolios, and at a higher cost. Before 1991, most Fixed Retirement Trust Fund investments were actively managed. In 1991, the Investment Board began using a passively managed index fund that holds investments identical to the S&P 500. Subsequently, the Investment Board has increased its use of passively managed funds to mimic several other market indices; approximately 27 percent of the Fixed Retirement Trust Fund was invested in passive index funds as of December 31, 2000.

A third key investment management decision is whether to use Investment Board staff to make investment decisions and execute security trades or to hire external managers to perform these functions. External managers can provide expertise not available from internal staff or can supplement internal staff resources. However, costs for external investment management typically exceed those for internally managed funds. Also, external management decreases control and oversight over investment decisions. Wisconsin Statutes require the Investment Board to manage investments primarily internally; only 15 percent of pension fund investments may be managed externally. As of December 31, 2000, 13.4 percent of total Wisconsin Retirement System assets were actively managed externally.

## Performance Compared to Benchmarks

The Fixed Retirement Trust Fund earned double-digit investment returns for five consecutive years in the late 1990s, as shown in Table 3. However, the market downturn in the second half of 2000 negatively affected investment returns, as reflected in a short-term loss of 0.8 percent in 2000.

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Table 3

**Fund Retirement Trust Fund Annual Returns**  
(for years ending December 31, 1995-2000)

<u>Year</u>	<u>Annual Return</u>
2000	(0.8)%
1999	15.7
1998	14.6
1997	17.2
1996	14.4
1995	23.1

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**Investment performance benchmarks were exceeded in 2000.**

Despite the 0.8 percent short-term loss as of December 31, 2000, the Investment Board continued to exceed its minimum investment goal for the Fixed Retirement Trust Fund, which is an annual average return of 8.0 percent over the long term. As of December 31, 2000, the five-year rate of return was 12.0 percent, and the ten-year rate of return was 12.6 percent. Furthermore, as shown in Table 4, the Fixed Retirement Trust Fund outperformed its one-, five-, and ten-year benchmarks, which represent the market-based returns that the Investment Board attempts to exceed.

Table 4

**Fixed Retirement Trust Fund Performance**

<u>Period Ending December 31, 2000</u>	<u>Average Annual Rate of Return</u>	<u>Investment Benchmark</u>
1-year	(0.8)%	(1.4)%
5-year	12.0	11.4
10-year	12.6	12.0

**Individual and composite benchmarks have been established for the Fixed Retirement Trust Fund.**

The Investment Board focuses primarily on five-year performance in assessing its management strategies for the Fixed Retirement Trust Fund, and also in evaluating the performance of its professional investment staff. Ten-year benchmarks provide a longer perspective that is consistent with a focus on long-term performance, and one-year benchmarks are useful for fine-tuning investment decisions. One-, five-, and ten-year performance benchmarks that have been established for each of the portfolios in the Fixed Retirement Trust Fund are reflected in the composite benchmark for the fund. Each of these benchmarks requires approval by the Board of Trustees.

Since July 1, 1999, market indices have been used as benchmarks for all internally managed Fixed Retirement Trust Fund portfolios except the Private Equity Portfolio, the Biotech Venture Capital Portfolio, and the Opportunity Portfolio, for which no relevant indices exist. A portfolio that is actively managed is expected to earn a higher rate of return than the index used as a benchmark. For example, the benchmark for the Large Cap Portfolio, a domestic equities portfolio that includes stocks of companies that have more than \$5.0 billion in invested capital, is the S&P 500 Index, which measures stock performance of larger domestic companies. Because the Large Cap Portfolio is actively managed, it would be expected to earn returns in excess of the S&P 500 Index.

Prior to mid-1999, the Investment Board also incorporated returns of peer groups, or other actively managed portfolios that had similar risk and style parameters, in its benchmarks. However, beginning July 1, 1999, the peer group component was removed because the Investment Board believed it was increasingly difficult to identify and monitor comparable actively managed portfolios. Removal of the peer group component had a negligible effect on the benchmarks for the Fixed Retirement Trust Fund.

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**All investment classes except for alternative investments exceeded one-year benchmarks in 2000.**

Returns for three investment classes of the Fixed Retirement Trust Fund lagged their five-year benchmarks as of December 31, 2000: alternative investments, international fixed-income, and real estate. In contrast, all investment classes except for alternative investments outperformed their one-year benchmarks, despite declining returns. For example, although investments in domestic equities, the largest asset class, had a return of negative (-)4.6 percent during 2000, the one-year performance benchmark for this asset class was negative (-)7.0 percent. In comparison, domestic equities returned 26.0 percent in 1999 and averaged 17.0 percent over the last five years. Appendix 1 compares the performance of the entire Fixed Retirement Trust Fund and each of its investment classes to benchmarks for the one-, five-, and ten-year periods ending December 31, 2000, 1999, and 1998.

### **Follow-up to Performance Issues**

In our 1999 audit, we noted a trend of declining performance relative to benchmarks: the Investment Board had not met either its one- or five-year benchmarks for the Fixed Retirement Trust Fund as of December 31, 1998. In light of the declining investment performance noted during our 1999 audit, we suggested the Investment Board review several of its investment strategies and reassess whether returns on staff-intensive and higher-risk investments warranted the level of assets and resources that had been committed to these investments.

One area we suggested that the Investment Board reassess was the level of resources allocated to small cap stocks, which typically represent companies with a capitalization level of less than \$1.0 billion. At the time of our 1999 audit, the Investment Board had one of the largest small cap stock portfolios in the country. The portfolio's size was over three times larger than the average small cap portfolio at the time. In our 1999 audit, we suggested that the Investment Board's emphasis on small cap stocks had affected the Fixed Retirement Trust Fund's overall performance, because the Small Cap Portfolio had fallen short of its one-, five-, and ten-year benchmarks for the period ending December 31, 1998. For example, at that point in time the five-year return was 9.8 percent, compared to a benchmark of 14.4 percent. In addition, returns were significantly less than returns for large cap stocks; the five-year return for the S&P 500 Index Fund was 24.0 percent, or more than twice that of the Small Cap Portfolio.

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**A portfolio of small cap stocks returned 49.2 percent in 1999 and negative (-)0.2 percent in 2000.**

Despite the lagging performance shown in its 1998 returns, the Investment Board continued to emphasize small cap stocks because it believed they remained significantly underpriced relative to stocks of larger companies. The Investment Board points to performance of small cap stocks in 1999 and 2000 as validation of its strategy. In a turnaround of its 1998 performance, the Small Cap Portfolio exceeded its benchmarks in both 1999 and 2000. In fact, its one-year return

of 49.2 percent in 1999 was more than double a benchmark of 20.6 percent. The Small Cap Portfolio's one-year return for 2000 was negative (-)0.2 percent, but it exceeded a benchmark of negative (-)3.0 percent. The 1999 and 2000 returns, however, also demonstrate the volatility of small cap stock performance.

In 1999, we also suggested that the Investment Board continue to assess its allocation of assets to international investments and determine whether it was receiving adequate returns to compensate for the risks and costs associated with these investments. In our 1999 audit, we noted that its average five-year return of 12.8 percent for international equities was significantly less than its average five-year return of 18.6 percent for domestic equities. Fixed-income returns were relatively more comparable for international and domestic portfolios.

In this audit, we have again found that returns for international equities have lagged domestic equities: as of December 31, 2000, the average five-year return for international equities was 13.5 percent, compared to 17.0 percent for domestic equities. In contrast, returns for international fixed-income securities have exceeded those for domestic fixed-income securities: the average five-year return for international fixed-income securities was 7.3 percent, compared to 6.5 percent for domestic fixed-income securities. With an average five-year return of 15.7 percent as of December 31, 2000, fixed-income securities in emerging markets significantly outperformed the other fixed-income securities.

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**International investments cost up to seven times more to manage than domestic investments do.**

However, these comparisons do not factor in the difference in costs associated with managing international versus domestic securities. As shown in Table 5, the Investment Board's costs for managing \$1.0 billion of international equities were almost four times greater than its costs for managing \$1.0 billion of domestic equities during 2000, and the costs for managing \$1.0 billion of international fixed-income securities were almost seven times greater than the costs for managing \$1.0 billion of domestic fixed-income securities. Although we recognize the Investment Board's goal of diversifying the assets under its management through international investments, we continue to believe that the relative returns and costs of domestic versus international investments warrant continued assessment during the asset allocation process.

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Table 5

**Comparison of Average Costs to Manage \$1.0 Billion of Investments**  
(in 2000)

<u>Asset Class</u>	<u>Costs to Manage</u>
International Equities	\$2,188,200
International Fixed-Income	2,056,800
Domestic Equities	556,200
Domestic Fixed-Income	297,400

Source: Investment Board

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**Private Placements  
Portfolio returns were  
12.5 percent during 2000.**

Finally, in 1999 we suggested that the Investment Board regularly evaluate whether it has realized sufficient benefits and returns for maintaining one of the largest private placement portfolios among public pension funds. We questioned whether the Investment Board was receiving a premium over public bonds that would compensate for the additional resources required for its more staff-intensive Private Placements Portfolio. However, the Private Placements Portfolio has fared relatively well in recent market conditions. The portfolio exceeded all its benchmarks as of December 31, 2000, and its one-year return of 12.5 percent in 2000 significantly exceeded a benchmark of 9.0 percent. In addition, its five-year return of 7.0 percent compared favorably to the Intermediate Government/Corporate Public Bond Portfolio's five-year return of 5.9 percent.

**Comparison to Other Public Pension Funds**

Like managers of other public pension funds, the Investment Board generally does not measure its performance against that of a peer group, because even other public funds of similar size or purpose are likely to have different asset mixes, investment styles, tolerable risk levels, and statutory or other restrictions on allowable investments. Furthermore, the equities option that Wisconsin offers its retirement system participants through the Variable Fund appears to be unique among public pension funds. However, comparing the overall returns and investment strategies of several large public pension funds can provide perspective for assessing the relative effectiveness of the Investment Board's overall investment strategy and asset allocation decisions.

One-, five-, and ten-year investment returns for the Fixed Retirement Trust Fund and nine other public pension funds are shown in Table 6. Appendix 2 provides additional information on total assets and asset allocation for the ten public pension funds we compared.

Table 6

**Comparison of Pension Funds' Overall Rates of Return**  
(for periods ending June 30, 2000)

<u>Pension Fund</u>	<u>Five-year</u>		<u>One-year</u>		<u>Ten-year</u>	
	<u>Return</u>	<u>(Rank)</u>	<u>Return</u>	<u>(Rank)</u>	<u>Return</u>	<u>(Rank)</u>
<b>Wisconsin Investment Board Fixed Retirement Trust Fund*</b>	<b>14.7%</b>	<b>10</b>	<b>12.5%</b>	<b>3</b>	<b>12.7%</b>	<b>6</b>
New Jersey Division of Investments	17.7	1	11.9	5	14.2	1
Virginia Retirement System	17.1	2	15.4	1	na	
Florida Retirement System Trust Fund	16.9	3	10.5	6	14.1	2
New York State Teachers Retirement System	16.5	4	6.9	10	13.7	3
Minnesota Combined Funds	16.2	5	9.6	8	13.4	4
California Public Employees Retirement System	15.6	6	10.5	6	na	
Pennsylvania Public School Employees Retirement System	15.5	7	12.2	4	na	
Teachers Retirement System of Texas	15.5	7	7.9	9	13.3	5
Washington State Investment Board	15.2	9	14.2	2	na	

\* These returns differ from those shown in Table 4 because the period of analysis was changed to allow comparisons with the other public pension funds we surveyed.

na = Not available



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**The Investment Board's five-year return ranked last among ten public pension funds surveyed.**

As noted, the Investment Board focuses primarily on five-year performance in assessing its management strategies for the Fixed Retirement Trust Fund. As of June 30, 2000, its five-year return of 14.7 percent was tenth among the ten funds we surveyed. Its ten-year return of 12.7 percent was sixth among the six funds that maintain ten-year return information. These longer-term rankings are similar to those we reported in 1999.

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**The Investment Board's one-year return was third among ten public pension funds surveyed.**

However, in short-term rankings the Investment Board's performance has improved since our 1999 report. At 12.5 percent, the Fixed Retirement Trust Fund was third among ten funds in overall rate of return for the one-year period that ended June 30, 2000. This contrasts with the one-year rank of ninth among 12 funds that we reported in 1999. The improvement is likely related to the Investment Board's success in exceeding its benchmarks for the period that ended June 30, 2000, including exceeding the benchmarks of several actively managed equities portfolios by several percentage points. As discussed in our 1999 report, the Fixed Retirement Trust Fund's relatively low five-year ranking may result from its relatively smaller share of domestic equities compared to other public pension funds during the 1990s, while U.S. markets were strong. The domestic equities market performed at historically high levels until mid-2000, and pension funds that were heavily weighted in that area realized high returns for many years.

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## Opportunity Portfolio

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In recent years, the Investment Board has sought opportunities in alternative investment classes that offer the prospect of greater returns but also involve increased risk. Three portfolios that totaled \$2.5 billion and represented approximately 5 percent of the Fixed Retirement Trust Fund's assets as of December 31, 2000, are classified by the Investment Board as alternative investments:

- the Private Equity Portfolio;
- the Biotech Venture Capital Portfolio; and
- the Opportunity Portfolio.

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**Investments in the Opportunity Portfolio are among the Investment Board's most high-risk investments.**

Alternative investments in the Opportunity Portfolio, which was established in 1995 to capitalize on opportunities that did not easily match the objectives of the Investment Board's other portfolios, are among the Investment Board's most high-risk investments because of their unusual, opportunistic, and illiquid nature.

In return for increased risk associated with the Opportunity Portfolio, the Investment Board hopes to attain higher returns than it achieves through its more traditional portfolios. However, returns for the Opportunity Portfolio have been mixed. Recent changes in the portfolio's strategy and structure are not likely to yield desired results for a number of years, and the Board of Trustees' support for the portfolio is divided. Furthermore, we believe the Investment Board needs to ensure its analytical steps and decisions regarding portfolio investments are adequately documented and supported.

### Portfolio History

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**The Opportunity Portfolio was established in 1995.**

The Opportunity Portfolio's nature and composition have evolved since its creation in 1995. Two portfolios were originally established in 1995: one with an equity focus, and one with a fixed-income focus. However, the fixed-income portfolio was eliminated later that year, after the investment director responsible for that portfolio left the Investment Board in the wake of the derivatives loss in the State Investment Fund. The Opportunity Portfolio has since remained a single portfolio with an equity focus.

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**The portfolio's original emphasis was on domestic and international public equities.**

Its initial investment director was a senior investment manager of the Investment Board who was provided extensive latitude and discretion in his approach and strategies. Consistent with his public market background, the investment director's emphasis was on domestic and international public equities, which represented an estimated 60 to 80 percent of the portfolio during its first three years. However, he also invested in U.S. government fixed-income instruments, derivatives, and investment funds in emerging markets such as Russia and Poland. The investment director developed no overall investment strategies for the portfolio, but rather pursued a number of different investment strategies that he believed had merit. From 1995 through 1998, the investment director made 200 different investments and maintained an average of 55 investments in the portfolio.

In the spring of 1998, this investment director announced his retirement from the Investment Board. Soon after, the Opportunity Portfolio's manager, who was the only other investment staff member familiar with the portfolio, announced that he was resigning. The unusual nature of the investments and related strategies made it difficult for other investment staff to readily assume responsibility for the Opportunity Portfolio, even temporarily. Therefore, the Investment Board began, in the summer of 1998, to liquidate portions of the Opportunity Portfolio.

Large holdings in domestic equities and some of the emerging market equity investments were sold. Investment Board staff stated that their goal at that time was to retain only investments in which the Investment Board had long-term commitments that could not be readily sold, such as private equity investments. The Investment Board paid \$60,000 in consulting fees to the former portfolio manager to assist with this process. Holdings in the Opportunity Portfolio changed significantly throughout the liquidation period. Domestic equities declined to less than 10 percent of the portfolio by December 31, 1998, and the cash balance grew to 44 percent of total assets as the Investment Board considered the future of the portfolio.

In January 1999 the Investment Board rehired the former portfolio manager to take the position of investment director, and in June 1999 an entry-level analyst was also hired for the Opportunity Portfolio. In February 2001 the Investment Board added an assistant portfolio manager to assist the investment director and provide additional support. The current investment director has developed and is in the process of implementing new strategies for the portfolio that are focused on private equity investments in emerging markets. Earlier investments that do not fit these strategies are being liquidated.

## Portfolio Performance

Although the Investment Board expects higher returns from the Opportunity Portfolio than from its more traditional investments over the long term, the portfolio's performance has been mixed since its inception. While several successes were realized, especially on investments that had been made in earlier years, the portfolio has also experienced significant investment losses. Currently, it is falling short of its one- and five-year benchmarks.

### Overall Performance

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**The Opportunity Portfolio is currently expected to realize a net return of 15.0 percent.**

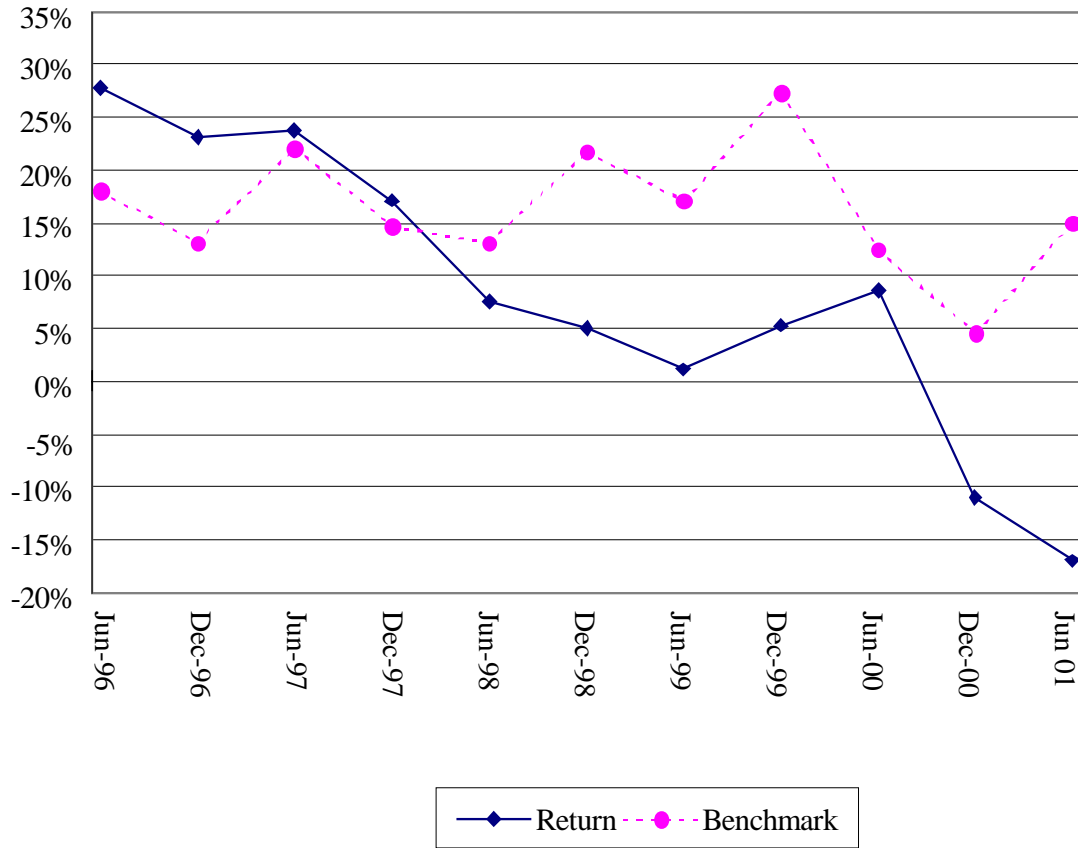
Because of the Opportunity Portfolio's unique structure, the Investment Board has had some difficulty establishing a relevant benchmark against which to compare performance. Although a different benchmark was chosen at inception, the Morgan Stanley Capital International (MSCI) All Country Index was primarily used as the portfolio's benchmark until July 1, 2000, to reflect the relatively large portion of the portfolio in publicly traded equities. At that time, the benchmark was changed to a return of 15.0 percent after deducting investment management fees.

The change to the 15.0 percent benchmark reflected a change in the portfolio's focus from publicly traded securities to private equity vehicles. Because no available benchmarks target these markets, the absolute return benchmark was determined by the Investment Board to be the preferred alternative. However, this benchmark does not recognize that private equity investments may have little or no earnings during their first three to five years. Investment Board staff suggest, therefore, that they may need to modify the benchmark to account for the portfolio's return patterns.

As shown in Figure 3, the Opportunity Portfolio exceeded its one-year performance goals for 1996 and 1997 but has not met its benchmarks in subsequent years. The portfolio's annualized average return from inception through June 30, 2001 was 7.7 percent, compared to a benchmark of 16.3 percent. Its one-year return of negative (-)17.0 percent and its five-year annualized average return of 4.0 percent also significantly lagged benchmarks of 15.0 percent and 15.9 percent, respectively.

Figure 3

**Comparison of Opportunity Portfolio's One-Year Returns to Benchmarks**



One of the difficulties in evaluating the performance of the Opportunity Portfolio is that its returns are, to a large degree, based on subjective information. Although interest earnings can be easily calculated, as can realized gains and losses on investments sold, the portfolio's returns include a component related to changes in its investments' estimated values over time. Because the investments are not publicly traded and do not have a ready trading market, determining their values can be difficult. The Investment Board's valuation policy maintains the value of a private equity investment at cost or the amount invested until an event occurs that indicates a change in value.

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**The Opportunity Portfolio is the third most costly internally managed portfolio.**

Another factor to consider in evaluating performance is portfolio management costs. The Opportunity Portfolio's management costs are high relative to those of other internally managed portfolios. The Investment Board determined that in 2000, the costs for managing the Opportunity Portfolio, including all direct and indirect expenses, were approximately \$6.0 million for each \$1.0 billion managed. Only two other internally managed portfolios had higher costs: the Private Equity Portfolio, for which management costs were \$14.8 million per \$1.0 billion, and the Real Estate Portfolio, for which management costs were \$9.4 million per \$1.0 billion managed. In contrast, the costs for managing portfolios containing domestic public securities ranged from \$297,400 per \$1.0 billion for the domestic public bond portfolios to \$556,200 per \$1.0 billion for the domestic stock portfolios.

Overall, the Opportunity Portfolio has not yet met its objective of achieving higher returns than more traditional investment vehicles. At this time, similar returns could have been achieved with less risk and lower costs through a domestic bond index fund. Further, the average annualized five year-return of 14.4 percent in the Investment Board's S&P 500 Index Fund, which is a domestic equities index fund, was more than three times greater than the Opportunity Portfolio's five-year return of 4.0 percent as of June 30, 2001.

### **Investment Gains**

Although the Opportunity Portfolio's overall returns have fallen short of benchmarks and expectations, the portfolio has, as noted, had several successful investments. Its early emphasis on domestic equities, and specifically large cap stocks, contributed to its early success during a period in which domestic equities performed well. Additionally, a number of investments made during the portfolio's first years were subsequently sold at a significant gain. As shown in Table 7, eight of the ten largest dollar gains were realized from sales of investments that had been made during the first three years. Notably, six of the ten investments were publicly traded equities and could have been made through other Investment Board portfolios. Three were investments in investment funds, and one was an option based on the movement of the U.S. dollar against the Japanese yen.

Table 7

**Ten Largest Realized Gains on Investments Sold  
from the Opportunity Portfolio Since Its Inception**  
(in millions)

<u>Investment Name and Description</u>	<u>Period Held</u>	<u>Cost</u>	<u>Sale Proceeds</u>	<u>Gain</u>	<u>Percentage Gain</u>
Philip Morris— <i>consumer products and tobacco manufacturer</i>	10/99-4/01	\$45.2	\$89.9	\$44.7	98.9%
ING Bank— <i>a major world bank and insurance enterprise headquartered in the Netherlands that had a presence in emerging markets</i>	4/95-4/98	20.6	63.8	43.2	209.7
LENS II— <i>leading corporate governance fund</i>	8/96-11/00	20.0	50.9	30.9	154.5
Corning Glass— <i>optical fiber producer and medical lab operator</i>	9/95-6/97	22.3	51.9	29.6	132.7
YPF— <i>Argentina's former state oil company, which was privatized</i>	2/95-9/97	24.9	51.2	26.3	105.6
U.S. dollar/Japanese yen option	2/95-2/00	11.9	37.6	25.7	216.0
JP Morgan Commodity Index Fund	2/99-7/99	50.0	71.8	21.8	43.6
SmithKline— <i>major world drug company</i>	5/96-6/97	20.0	39.5	19.5	97.5
Kelso— <i>single-purpose fund to invest solely in American Standard Companies</i>	6/96-2/97	20.1	39.2	19.1	95.0
Unilever— <i>large producer of household products</i>	10/95-7/97	26.1	40.3	14.2	54.4

**The Opportunity Portfolio realized a \$44.7 million gain on Philip Morris stock.**

The largest dollar gain was realized from a relatively recent investment: shares of Philip Morris stock were purchased in October 1999 for \$45.2 million and sold in April 2001 for \$89.9 million, a gain of \$44.7 million or almost 100 percent. The investment director's view at purchase was that tobacco lawsuits had temporarily decreased Philip Morris's stock value and that its price would increase.



## Investment Losses

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**The portfolio realized losses of \$54.9 million when the Investment Board liquidated some of its assets in 1998.**

The decline in the Opportunity Portfolio's performance in recent years is, in part, attributable to the staffing changes and portfolio liquidation that began in 1998. As noted, the portfolio's cash balance grew during the liquidation process. Because of the uncertainty of the portfolio's future, the Investment Board chose to continue investing the cash balance in the State Investment Fund, where it earned a short-term return, rather than to attempt investing the excess cash in higher-yielding investments. The liquidation of the portfolio's assets also came at a time when the domestic stock market experienced a short-term decline, and emerging markets were continuing a decline that had begun in 1997. From July 1, 1998 through December 31, 1998, when a large portion of the liquidation took place, the portfolio realized losses of \$54.9 million.

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**The portfolio realized losses of \$45.6 million on early Asian investments.**

The Investment Board also made several early investments that ultimately resulted in losses. As shown in Table 8, six of the ten largest dollar losses in the Opportunity Portfolio were realized from sales of investments that had been made during its first three years. In addition, an earlier investment focus on investments in Asian markets resulted in losses. From 1996 through mid-1998, the Investment Board made 41 investments in Asian funds and companies at a total cost of \$183.3 million, including investments in South Korea, Thailand, Malaysia, and the Philippines. The investments were in a variety of industries, including real estate, airlines, banking, cement, electricity, telecommunications, seafood exports, steel mills, paper, and waste treatment. As of June 30, 2001, the Investment Board had sold 34 of the 41 investments. The 34 investments had cost \$134.3 million but sold for \$88.7 million, or a loss of \$45.6 million. The seven remaining investments, which had cost \$49.0 million, experienced a 46 percent loss in value as of June 30, 2001, when their reported value was \$26.7 million.

Table 8

**Ten Largest Realized Losses on Investments Sold  
from the Opportunity Portfolio Since Its Inception**  
(in millions)

<u>Investment Name and Description</u>	<u>Period Held</u>	<u>Cost</u>	<u>Sale Proceeds</u>	<u>Loss</u>	<u>Percentage Loss</u>
Hyundai Electronics— <i>Korean computer chip maker</i>	6/00-6/01	\$106.5	\$14.6	\$91.9	86.3%
Hanvit Bank— <i>Korean bank</i>	8/99-3/01	50.7	3.8	46.9	92.5
Inchscape— <i>United Kingdom distributor of Japanese autos and other products</i>	3/96-9/99	36.5	9.8	26.7	73.2
S&P Index put option	8/96-7/99	20.5	0	20.5	100.0
BGI MSCI Equity Index Fund	12/99-2/01	153.5	133.7	19.8	12.9
Union Pacific Resources— <i>U.S. oil and gas exploration company</i>	8/97-9/98	24.9	16.1	8.8	35.3
Russian Bond— <i>short-term bond payable in \$US at an interest rate of 9.25%</i>	5/98-10/98	9.5	2.9	6.6	69.5
Industria Bachoco SA— <i>Mexico's leading chicken producer</i>	9/97-11/99	10.0	4.4	5.6	56.0
Andrew Corp.— <i>leading U.S. cellular infrastructure supplier</i>	4/97-1/99	18.8	13.9	4.9	26.1
LTV— <i>U.S. manufacturer with interests in steel and steel-related businesses</i>	8/95-1/98	22.6	17.7	4.9	21.7

**The portfolio realized a \$91.9 million loss on an investment in a South Korean computer chip maker.**

The portfolio has also realized significant losses from more recent investments. The two largest dollar losses were realized from South Korean investments that were made in 1999 and 2000 and sold in 2001. The largest loss, which totaled \$91.9 million, greatly exceeds the losses realized during the portfolio's earlier years: in June 2000, the investment director purchased stock in Hyundai Electronics after its value had already decreased significantly, because he anticipated a turnaround. Instead, the price of the stock declined sharply soon after the investment was made; the decline corresponded with significant declines in other technology companies. The stock was sold in June 2001.

## Current Portfolio Strategies

The Opportunity Portfolio has been undergoing a period of transition as the Investment Board implements new strategies and liquidates earlier investments that do not fit the current structure. Since late 1999, the Investment Board has been focusing the portfolio's investments in an attempt to simplify both management and monitoring. The Investment Board is also developing strategic partnering relationships in an attempt to have more control over Opportunity Portfolio investment decisions and to reduce investment fees. It should be noted that having larger, more concentrated holdings increases both the risks and the potential rewards associated with pursuing a single investment theme or view and that under some forms of strategic partnering agreements, safeguards against losses may be diminished.

### Investment Themes

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**The current Opportunity Portfolio strategy includes fewer and larger investments.**

In contrast to an earlier approach that involved multiple smaller investments, the Opportunity Portfolio's current approach is to make a smaller number of larger investments. For example, only 7 percent of individual investments made under the first investment director exceeded \$25.0 million, compared to 36 percent under the current investment director, who believes that premiums can be earned if an investor is willing to commit substantial amounts to "situations out of the mainstream," particularly in emerging market countries with developing capital markets.

The current investment director also has stated that the effort and resources needed to research and monitor the increased risks associated with emerging markets make it necessary to limit the number of investments held in the Opportunity Portfolio. As of June 30, 2001, the portfolio consisted of 49 individual investments, compared to 111 at the end of 1997. Furthermore, the investment director plans to liquidate 26 investments that do not fit current portfolio strategies and themes as opportunities become available. These investments are valued at \$216.0 million.

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**The Opportunity Portfolio had estimated net unrealized losses of \$100.1 million on June 30, 2001.**

In addition to reducing the number of investments in the portfolio, the investment director is attempting to focus on investment themes or industries. As shown in Table 9, the current portfolio is focused primarily in financial services, energy, and cement industries, with a primary emphasis in emerging markets in Asia and Eastern Europe. As of June 30, 2001, it had estimated net unrealized losses of \$100.1 million. Appendix 3 provides a complete listing of all investments in the portfolio as of June 30, 2001.

Table 9

**Opportunity Portfolio Investments**  
**as of June 30, 2001**  
(in millions)

<u>Strategy</u>	<u>Investment Name</u>	<u>Country or Region</u>	<u>Cost</u>	<u>Value 6/30/01</u>	<u>Unrealized Gain (Loss)</u>
FINANCIAL SERVICES	iRegent—Korea				
	Korea OnLine Limited (KOL)	Korea	\$110.0	\$15.9	\$(94.1)
	Regent Securities	Korea	9.5	4.1	(5.4)
	Illeun Securities	Korea	5.0	3.7	(1.3)
	iRegent.com LTD	Hong Kong	15.6	2.8	(12.8)
	iRegent.com LTD Warrants	Hong Kong	1.6	0.1	(1.5)
	iRegent—Europe				
	SWR Inc.	Eastern Europe	18.7	18.7	0.0
	Charlemagne Capital LTD	Eastern Europe	2.1	2.1	0.0
	WL Ross				
	Asia Recovery Co-Investment Fund	Asia	15.1	15.8	0.7
	Asia Recovery Fund	Asia	28.8	29.5	0.7
	WL Ross Recovery Fund	Global	19.8	17.7	(2.1)
	Nippon Investment Partners	Japan	75.0	75.0	0.0
	Financial Services—Other				
	GS Special Opportunity Asia Fund	Asia	25.1	32.7	7.6
	Kookmin Bank	Korea	11.2	14.8	3.6
Seoul Securities	Korea	4.8	3.7	(1.1)	
Total Financial Services			342.3	236.6	(105.7)
ENERGY	Lukoil	Russia	95.0	132.0	37.0
	Yukos	Russia	53.3	93.8	40.5
	Vulcan Partners	U.S.	25.0	23.6	(1.4)
	Total Energy			173.3	249.4
CEMENT	LaFarge/Halla Cement Corp.	Korea	86.0	86.0	0.0
	LaFarge India	India	62.7	62.6	(0.1)
	Total Cement			148.7	148.6
OTHER	Bear Stearns Merchant Bank II LP	Global	4.3	4.3	0.0
	Heartland	Wisconsin	8.3	8.5	0.2
	Crompton Corp.	U.S.	26.2	28.9	2.7
	Hynix Semiconductor	Korea	14.6	15.0	0.4
	TOTAL CURRENT STRATEGIES			717.7	691.3
PLANNED FOR LIQUIDATION			289.7	216.0	(73.7)
<b>TOTAL PORTFOLIO</b>			<b>\$1,007.4</b>	<b>\$907.3</b>	<b>\$(100.1)</b>

Source: Investment Board Records

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**The portfolio's largest investment theme is financial services in Asia and Eastern Europe.**

Financial Services - The Opportunity Portfolio has made significant investments in financial services in Asia and Eastern Europe, with an emphasis on South Korea. Investment Board staff identified opportunities in Asia in the wake of an economic crisis there during the late 1990s, and they especially targeted South Korea because of restructuring in its financial services industry that was undertaken to avoid a similar economic crisis in the future. They believe that Korean assets had been undervalued and that the opening of markets that had previously been closed to foreign investment makes it possible to purchase financial services firms below their value, restructure them to include a full range of services, and combine them into larger entities that can eventually be sold.

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**The portfolio lost \$46.9 million on a Korean bank liquidated by the South Korean government.**

The Opportunity Portfolio has had limited success with financial services investments to date, as was shown in Table 9. Investments in South Korea that were undertaken with an investment management firm established as the Regent Pacific Group, and later renamed iRegent Group Limited, have experienced significant losses in value. In addition, the Opportunity Portfolio realized a significant loss on an investment in a Korean bank, Hanvit Bank, which was the second-largest realized loss shown in Table 8. A \$50.7 million investment in Hanvit in August 1999 was involuntarily liquidated for \$3.8 million in March 2001, when the South Korean government delisted and repurchased the bank's stock after recurring losses caused the bank's financial ratios to fall below required levels.

The Opportunity Portfolio has also acquired equity stakes in two banks in Bulgaria and Croatia in anticipation of the convergence of Western and Eastern European financial services. The investment director believes that these banks can be purchased at "pre-convergence" prices, introduced to a more complete range of western-style services, developed into a larger package of banks, and finally sold to Western European banks looking for a presence in the Eastern European markets. As of June 30, 2001, the Investment Board had invested \$18.7 million and committed an additional \$51.3 million to the Eastern European financial services venture.

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**The portfolio has been successful in its investments in Russian oil companies.**

Energy - The Opportunity Portfolio has also invested in the energy sectors in Russia and the United States, which to date have been successful. The portfolio has investments in Russia's two largest oil companies, Lukoil and Yukos, and in a U.S. partnership investing in domestic coal. Investment Board staff believe the Russian oil companies had been undervalued. As of June 30, 2001, the value of the two Russian investments had increased \$77.5 million, or 52.3 percent. The investment in domestic coal was made in anticipation of consolidation following recent deregulation in the utility industry. The investment director has also been considering large energy investment opportunities in Wisconsin.

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**The portfolio has investments in South Korean, Indian, and Japanese cement companies.**

Cement - The Opportunity Portfolio is participating in a consolidation of the cement industry in Asia through a strategic partnering relationship with LaFarge SA of France, the largest cement company in the world. LaFarge is in the process of acquiring cement companies in Asia, and the Investment Board is providing capital with the understanding that LaFarge will manage the companies and buy the Investment Board's equity share within three to five years at favorable terms. As of June 30, 2001, the Investment Board had invested \$86.0 million in a South Korean cement company and \$62.7 million in an Indian cement company. Subsequently, it invested \$27.0 million in a cement plant in Japan. Investments in other Asian countries, including Bangladesh, are being considered.

### **Strategic Partners**

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**The portfolio uses strategic partnering relationships to achieve more direct involvement and ownership of some investments.**

Strategic partnering relationships allow the Opportunity Portfolio to participate more directly in private equity investments by acquiring majority or large minority equity stakes in companies with a partner that acts as manager. The Investment Board considers strategic partnering a tactic for making direct private equity investments by relying on the resources and investment activities of a managing strategic partner to supplement staff resources at the Investment Board.

Previously, the Opportunity Portfolio had participated indirectly in private equity investments, primarily through limited partnerships or private equity funds that were managed by investment firms. That is the strategy institutional investors typically use to enter private emerging markets. In contrast to strategic partnering relationships, limited partnerships and private equity funds typically limit the investors' influence over the specific investments being made and do not give them direct ownership of the entities in which they have invested.

The Investment Board believes that developing strategic partnering relationships provides a number of advantages over limited partnerships and private equity funds. One of the primary advantages cited is reduced management fees. In limited partnerships and funds, the general partner or fund manager typically charges an annual management fee that ranges between 1 and 2 percent of the amount invested, plus 20 percent of any earnings. In its strategic partnering relationships, the Investment Board typically does not pay management fees. In addition, returns are not reduced for taxes, as is the case for many limited partnerships and funds. Another perceived advantage is that the investment director has more direct involvement in investment decisions.

As noted, however, some of the advantages and safeguards that are available through limited partnerships and private equity funds may be diminished in some forms of strategic partnering relationships. In limited partnerships and private equity funds, the general partner or fund

manager is contractually responsible for all investment activities of the partnership or fund, including initial assessment or due diligence, negotiations, and investment monitoring. The partnership or fund agreement typically binds the general partner or fund manager to a fiduciary standard of care, which affords the investors a measure of legal protection from losses and potential liability arising out of the general partner's or fund manager's negligence or misconduct. In contrast, the standard of care the manager owes the Investment Board becomes a negotiable item in contractual agreements for strategic partnering relationships.

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**The Investment Board has established three partnering relationships in the Opportunity Portfolio.**

The Investment Board has established three major partnering relationships in the Opportunity Portfolio, which have varying terms and complexities. The relationship with what appears to be relatively favorable terms is the partnering relationship with LaFarge SA of France to purchase cement companies in South Korea, India, and Japan. The agreements with LaFarge either pledge a high standard of fiduciary care in managing the investments or provide favorable exit terms that limit the potential for loss.

A partnering relationship with the investment firm WL Ross and Company LLC, which specializes in acquiring and rehabilitating distressed companies, represents a more typical limited partnership arrangement. The Investment Board first established its relationship by investing in two funds managed by WL Ross: the Asia Recovery Fund, and the WL Ross Recovery Fund. In addition, the Investment Board has invested \$15.1 million in a third fund, the Asia Recovery Co-Investment Fund, which was created to allow fund participants to "co-invest" in investments alongside the Asia Recovery Fund on a no-fee basis. Most recently, the Investment Board invested \$75.0 million to acquire a 36.8 percent stake in Nippon Investment Partners LP, a partnership with WL Ross to acquire assets of a failed regional Japanese bank. The three other WL Ross funds in which the Investment Board has invested are also invested in Nippon Partnership, which indirectly gives the Investment Board an additional 9.5 percent stake in Nippon. As general partner of the Nippon Partnership, WL Ross has a fiduciary duty to the partnership.

The most extensive and complex partnering relationship, and the one that appears to offer the Investment Board the least protection, has been the relationship with an investment management company to invest in financial services in South Korea. At the time the relationship was established the company was known as Regent Pacific Group, but it is currently known as iRegent Group Limited. This complex partnership, which was the first established in the Opportunity Portfolio, has directly exposed the Investment Board to the complexities and risks that can be encountered in entering emerging markets.

## **Korean Investments with iRegent**

The Investment Board began investing with iRegent in 1998, when it invested in private equity funds in Asia managed by the company and also purchased the company's public stock. Building upon this experience, the Investment Board began a strategic partnering relationship with iRegent in 1999 to invest in South Korea's financial services sector. The partnership has provided for a complex relationship of investments in a number of South Korean financial services companies. Problems that have plagued these various Korean entities have required the Investment Board's attention, have increased the risk of adverse results in the Investment Board's related investments, and have resulted in expenditures on contracts with outside auditors and consultants to review the investments. Furthermore, the Investment Board had limited documentation of the steps it took to ensure the soundness of its partnering relationship and the resulting investments.

### **Description of Problematic South Korean Investments**

In July 1999, iRegent formed a holding company in partnership with the Investment Board and a minority Korean investor—Midas Consolidated Investment Limited (MCI)—for the purposes of acquiring financial services companies in Korea and forming an integrated financial services company that would provide securities trading, banking, and insurance services. The name of the holding company currently is Korea OnLine Limited (KOL).

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**The Opportunity Portfolio has invested \$110.0 million in a holding company to acquire financial services companies in Korea.**

Between 1999 and 2000, KOL acquired controlling interests in a bank, an insurance company, an asset management company, and two securities companies in South Korea. In addition, the Investment Board also purchased public stock of the two securities companies acquired by KOL. The Investment Board invested \$110.0 million in KOL and another \$14.4 million directly in the two securities companies. As of May 2001, the Investment Board held 26.7 percent of the shares of outstanding stock in KOL. In comparison, a group of more than 15 investors also invested in KOL and, in total, held approximately 20 percent of the outstanding shares.



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**The South Korean government suspended operations of a bank affiliated with KOL after a run on its deposits.**

The Korean venture has been adversely affected by a number of problems affecting the affiliated financial services companies. For example, in May 2000, KOL management reported to the South Korean government that the controlling shareholder in MCI had obtained unauthorized loans from two of the financial services companies acquired by KOL: the bank and one of the securities companies. According to the Investment Board, the failure in November 2000 of an unrelated financial services company that was also controlled by the controlling shareholder in MCI caused a run on deposits in the KOL bank because of its connection with MCI. The South Korean government suspended operations of the bank, which subsequently merged with another South Korean bank. The controlling shareholder in MCI surrendered to South Korean authorities in December 2000, and his trial related to the unauthorized loans and to charges involving companies that are unrelated to KOL is ongoing. Recent financial statements report that KOL recognized \$40.8 million in losses on its investment in the bank for the period ending March 31, 2001.

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**An insurance company affiliated with KOL was liquidated by the South Korean government.**

KOL has also been affected by the liquidation of its insurance company, which was the last company acquired by KOL. It was acquired in March 2000 and, less than one year later, a due-diligence audit performed by the South Korean government found that liabilities exceeded assets, and the company was unable to meet the government's solvency requirements. Recent financial statements report that the insurance company became insolvent primarily because of policy losses carried forward from periods prior to its acquisition by KOL, and the deterioration of business conditions after acquisition. In addition, KOL recognized in its financial statements \$89.5 million in losses related to its investment in the insurance company for the period ending March 31, 2001. In May 2001, the South Korean government took control of the insurance company. The asset management company is also being liquidated because a decision by the South Korean government to defer proposed deregulation of that country's funds market apparently left it with no viable product line.

**Effect on the Investment Board**

The KOL investments illustrate the risks and difficulties involved in investing in emerging markets. They also illustrate the increased risks and involvement that can be associated with a strategic partnering relationship. Being a major shareholder in KOL has required the Investment Board to become more directly exposed to the operations and problems of KOL and its affiliated companies than it would have been under a less-direct investment vehicle, such as a private equity fund.

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**The Investment Board has hired outside firms to review the KOL investments and related transactions.**

Although iRegent serves as the managing partner that is directly involved in the management of KOL and the affiliated companies, Investment Board staff have devoted considerable time, effort, and costs to monitoring the companies' actions and ensuring that the Investment Board's investments are protected. For example, in 2001 the Investment Board has paid \$60,000 to an accounting and consulting firm with staff in South Korea for help in further assessing the current risks associated with KOL and the affiliated companies. In addition, the Investment Board's legal counsel recently hired a New York law firm and forensic auditors to further review the KOL investments and to determine whether the Investment Board's investment proceeds were directed to the appropriate entities and applied in compliance with terms of investment agreements. The total costs for legal and forensic auditing services are not known at this time.

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**The Investment Board reports that the value of its \$110.0 million investment in KOL had declined to \$15.9 million as of June 30, 2001.**

The recent events surrounding KOL and the affiliated companies also have affected the current value of the Investment Board's investments in the South Korean venture. The Investment Board's valuation policy is to maintain private equity investments at cost until an event occurs that indicates a change in value. Based on recent events, the Investment Board's valuation committee determined that the KOL investments were impaired and estimated their value as of June 30, 2001 at \$15.9 million, which represents an 85.5 percent decrease from the amount invested, which totaled \$110.0 million. In addition, the Investment Board's direct investments in public stock of the two securities firms, which were purchased at \$14.5 million, were valued by the Investment Board at \$7.8 million as of June 30, 2001.

The investment director continues to believe that the investments will eventually break even, if not provide a positive return, and he does not believe that current reported values fully represent the underlying value of KOL and the two securities companies. As a long-term investor, the Investment Board has the ability to wait for a turnaround in these investments. Therefore, their ultimate profitability will be known only at the time the Investment Board sells or otherwise exits the investments.

### **Due-Diligence Efforts**

In its strategic partnering relationships, the Investment Board relies on the due-diligence process completed by the managing partner, such as iRegent, to assess the risks of investments and related entities. Such reliance is important in the Investment Board's partnering relationships because it does not itself have the resources to adequately assess the risks and potential merits of these investments.

At the same time, the Investment Board also needs to perform its own due diligence to ensure that its reliance on chosen business partners is merited. Such a process could include steps similar to those taken for a direct investment, such as reviewing performance, financial information, staffing capabilities, and the reputation of the potential partner. In addition, it would be reasonable to expect the Investment Board would be confident that the partner's due-diligence process for evaluating and pursuing investment opportunities was comprehensive. Finally, as a direct partner without some of the legal protections that may be available to investors in funds, the Investment Board could be expected to evaluate the adequacy of specific due-diligence work completed by its managing partner.

The Investment Board indicates that the due-diligence steps it took before entering into the partnering relationship with iRegent included:

- reviewing press accounts of iRegent;
- meeting with other investors or knowledgeable industry sources; and
- meeting with iRegent management and management of companies being considered for investment.

The Investment Board indicates that its ability to ascertain the reputation and credibility of iRegent through discussions with other pension fund representatives and investors investing with iRegent was key in its decision to partner with iRegent.

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**The Investment Board provided limited documentation of its review of iRegent's due-diligence efforts.**

However, limited documentation was made available to us to support these or other steps the Investment Board took to ensure its reliance on iRegent and iRegent's due-diligence efforts were merited. Therefore, we cannot assess whether adequate due diligence was performed or whether the Investment Board made a sound decision in partnering with iRegent. While the Investment Board strongly asserts that adequate due diligence was performed, more complete documentation of its analytical process would help to better support the soundness of its investment decisions. In addition, improved documentation would increase the likelihood that the Investment Board will succeed in any actions it decides to pursue relating to its investments.

## Heartland Investment

Another Opportunity Portfolio investment that has become controversial is the Investment Board's September 2000 decision to purchase \$8.3 million of distressed bonds from the Wisconsin-based Heartland Advisors, Inc. Concerns have been raised about the soundness and appropriateness of the investments, as well as the involvement of a member of the Board of Trustees in bringing the proposal to the Investment Board's attention.

### Investment Description

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**On September 29, 2000, the Investment Board purchased a package of municipal bonds from Heartland for \$8.3 million.**

On September 29, 2000, the Investment Board purchased a package of municipal bonds from Heartland Advisors, Inc., for \$8.3 million. Specific information about the bonds, including the identity of the Heartland funds and clients that previously owned the securities, the issuers of the securities, and the projects representing the collateral that secure the obligations represented by the securities, is protected under the terms of a confidentiality agreement signed by the Investment Board as a condition of the purchase in September 2000. However, according to press accounts, a Heartland spokesman disclosed that all the bonds purchased by the Investment Board were either in technical default, meaning one or more conditions of the original borrowing had been violated, or in monetary default, meaning the bondholders were not being repaid.

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**The Investment Board has the right to sell the bonds it purchased back to Heartland for the purchase price plus a 20 percent annual return.**

Heartland continues to manage the bonds and has an incentive to maximize recovery on the bonds because of a "put option" negotiated as part of the investment agreement. A put option gives the holder the right to sell specified securities to the writer of the option at a specified price up to a specified date. The put option included in the Heartland agreement is complicated, but essentially it allows the Investment Board, as the holder of the option, to sell the bonds back to Heartland's parent company, Heartland Holdings, at the end of two years for the purchase price plus a 20 percent annual rate of return, which would total approximately \$12.0 million. In addition, the put option is personally guaranteed by Heartland's founder and president. The investment agreement also includes provisions that require Heartland to have certain amounts of liquid assets on hand at specified points during the two-year period.

The Investment Board required the put option and the personal guarantee before agreeing to the investment transaction. Although the investment does not fit any of the Opportunity Portfolio's general themes or strategies, the Investment Board defends its decision as appropriate and attractive for the portfolio because of the portfolio's opportunistic nature. In addition, the investment is relatively smaller than others currently being made in the Opportunity Portfolio, so Investment Board staff argue that the Board's risk is minimized.

## Concerns with the Investment

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**Two weeks after the investment, Heartland repriced its municipal bonds significantly lower.**

While the Investment Board believes it has entered into a sound investment transaction, the soundness and appropriateness of the Heartland investment have been questioned. One day before the transaction between the Investment Board and Heartland was finalized, Heartland repriced the bonds in the Heartland High-Yield Municipal Bond Fund and the Heartland Short Duration High-Yield Fund significantly lower than the prices that had been carried on its books, which caused the Heartland funds' share prices to drop 8.2 percent and 2.1 percent, respectively. On October 13, 2000—two weeks after the Investment Board transaction—Heartland again repriced the bonds in these two Heartland funds to further factor in liquidity and credit quality concerns, which had the effect of significantly lowering the bonds' prices.

The repricing of the securities caused a one-day decline in the combined assets of the Heartland High-Yield Municipal Bond Fund and the Heartland Short Duration High-Yield Fund from \$120 million to \$58 million, with related declines in share prices of 70 percent and 44 percent, respectively. Soon after Heartland repriced its securities, investors began filing suits seeking damages for losses, which have subsequently been consolidated into a class-action suit. The Securities and Exchange Commission (SEC) obtained a court order to freeze the assets of Heartland's three high-yield bond funds, and the SEC and the Wisconsin Department of Financial Institutions are both investigating the pricing of Heartland's municipal bond funds.

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**Concerns have been raised about a potential conflict of interest with the Heartland investment.**

In connection with questions about the overall soundness of the Investment Board's Heartland investment, concerns have also been raised about the relationship between Heartland and the chair of the Investment Board's Board of Trustees, and about his role in the transaction. Concerns about a potential conflict of interest have been raised because the trustee is also a member of the board of directors of Heartland Group, Inc., which contracts with Heartland Advisors to manage the Heartland series of mutual funds. In addition, Heartland Advisors is a major tenant of an office building in Milwaukee developed and managed by the trustee's investment and real estate company. As Heartland's landlord, the trustee would appear to have an interest in Heartland remaining viable and in providing an incentive to assist Heartland.

Both the trustee and Investment Board staff have indicated the trustee's role was limited to facilitating the initial contact between Heartland and the Investment Board. The trustee indicated that the only communication he had with Heartland regarding a potential deal with the Investment Board was to provide the names of the Investment Board's Executive Director and the investment director for the Opportunity Portfolio, in response to a request for the appropriate

contacts at the Investment Board. Investment Board staff confirm that the trustee's contact with them was limited: the Opportunity Portfolio's investment director reported that, one day before he was contacted by Heartland, the trustee inquired as to whether the investment was large enough to warrant consideration.

The Board's minutes indicate that the trustee recused himself from discussion and from votes on the proposed transaction that were taken by the trustee committee that ultimately approved the investment on September 27, 2000. In addition, the Investment Board's legal staff told us they had verified that the trustee's company was not involved in the development of the facilities financed by the bonds under consideration, and they concluded that the trustee's recusal sufficiently distanced him from any potential conflicts of interest posed by serving on both organizations' boards.

The Investment Board's policies do allow trustees to refer investment opportunities to investment staff, who are then required to evaluate referred opportunities using the same process and criteria that apply to other investments. Whether the trustee influenced the investment beyond his referral, either directly or indirectly, because of his role as chair of the Investment Board's Board of Trustees, is difficult to determine from the limited documentation maintained by the Investment Board. However, we found no evidence that direct influence had been exerted, and Investment Board staff told us the trustee's referral did not affect their decision on the investment.

### **Consideration of the Heartland Investment**

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**The Investment Board has maintained limited documentation of its assessment of the Heartland transaction.**

The investment director for the Opportunity Portfolio indicated that his recommendation to purchase the Heartland bonds was based primarily on his familiarity with Heartland, which he considered a solid business risk. He indicated that he had evaluated the transaction as a "credit" that carried the backing of the corporation, rather than as a purchase of securities, because of the questionable quality and value of the securities. However, the investment director's analysis was relatively informal and, as noted, limited documentation is available to demonstrate its extent.

The investment director obtained copies of Heartland's and its president's financial statements, although documentation was not available to show what analysis was performed on either set of financial statements before entering into the transaction. The investment director reviewed Heartland's audited financial statements for 1999 and unaudited financial statements for the first nine months of 2000 to obtain an understanding of its profitability and liquidity. Based on that review, the investment director requested the personal guarantee from the president and obtained his unaudited personal financial statements

as of June 30, 2000. While the financial statements provide overall information about the president's financial position, they provide limited detail on individual assets and liabilities. For example, the financial statements do not provide a listing of specific investments. Without more detailed information, it would appear difficult to fully assess the president's ability to make good on the guarantee if Heartland were unable to honor the put option.

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**The Investment Board performed a limited valuation three months after the investment was made.**

In response to questions being raised about the Heartland investment, Investment Board staff completed a more formal valuation in December 2000 to provide documentation of the informal evaluation they assert had been performed before the investment was made. In the December valuation, staff used a model based on 1999 earnings to project that Heartland's future value would exceed the amount it owed the Investment Board and would provide a sufficient source of recovery in the event the put option was not honored. However, we note the model was based on one year of earnings, which the Investment Board analyst noted in his valuation documentation "should be considered inadequate information for accurate financial modeling." Further, the valuation did not appear to fully factor in a decrease in Heartland's assets under management that had occurred from September through December 2000 or consider the potential effect that ongoing federal investigations and lawsuits could have on Heartland's future value. We note, however, that the Investment Board asserts the analyst conferred appropriately with its legal counsel on these developments.

The informal approach to assessing and documenting the analysis of the Heartland investment is not inconsistent with the level of documented review done for other investments in the Opportunity Portfolio. The investment director suggests that the structure of the Heartland investment and many of the other investments in the Opportunity Portfolio do not lend themselves to the formal analyses that are more commonly completed for other portfolios and investments.

However, we believe that the unique nature and higher risks of investments in the Opportunity Portfolio increase the need for comprehensive analysis and documentation of the Investment Board's consideration. For example, we question why the Investment Board did not perform as comprehensive an analysis for the Heartland investment as it performs for investments in the Private Placements Portfolio, which include direct, intermediate-term loans to companies. In evaluating a potential investment, Private Placements staff typically review five years of audited financial statements and the company's business plan, and they compare the company's financial position and performance to others in the industry. In addition, the typical debt instrument in the Private Placements Portfolio requires the company to provide ongoing financial information and certification of compliance with covenants.

As noted, investment staff for the Opportunity Portfolio reviewed less than two years of financial information. They did not have access to Heartland's business plan and were not aware of its intentions regarding its troubled funds. Further, under the terms of agreements between the parties, Heartland is not required to provide any ongoing information regarding its financial position and activities. Although Heartland is required to have certain amounts of liquid assets at specified dates during the term of the investment, the agreement does not specify how compliance is to be certified or monitored.

Investment Board staff state that the analyses and requirements for Private Placements Portfolio investments are not applicable in this case because the structure of the Heartland transaction is different from that of typical debt instruments evaluated by Private Placements staff. While we agree that the Heartland transaction is not structured as a debt instrument, it does appear to encompass characteristics similar to a debt transaction, including a guaranteed rate of return, reliance on Heartland's put option rather than the value of the purchased bonds, and Heartland's ongoing management responsibilities. Therefore, it would appear to have been prudent to at least have performed the same level of analysis and follow-up performed for the typical debt instrument in the Private Placements Portfolio, especially considering the subsequent events surrounding Heartland that could affect its profitability and potential viability. The referral of the investment by a trustee increased the importance of documenting that appropriate and consistent consideration had been given to evaluating the investment.

### **Current Status of the Heartland Investment**

According to an account summary provided by Heartland, the bonds were worth \$2.3 million as of June 30, 2001. Regardless of the value of the underlying bonds, the Investment Board is confident that Heartland will fulfill its obligations if the Investment Board ultimately needs to invoke the put option. Factoring in the put option and the credit-worthiness of Heartland, the Investment Board valued the Heartland Investment at \$8.5 million as of June 30, 2001. However, without access to current financial information or activities, Heartland's ability to fulfill its obligations under the put option cannot be independently assessed. In addition, the effects of the SEC's actions or the class-action lawsuit on Heartland's ability to honor the put option are not known. Likewise, the Investment Board's legal status with other creditors and vested parties would need to be defined before any legal proceedings against Heartland or the president's guarantee could be pursued.

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Mixed investment returns and risks such as those associated with the iRegent Korean investments and the Heartland investment raise questions about the future of the Opportunity Portfolio for the Fixed Retirement Trust Fund. The Board of Trustees' support for the portfolio is divided and may further diminish if returns do not improve. The Investment Board is making procedural changes relating to the portfolio and is intensively reviewing its operations, but we believe additional steps are needed to increase management oversight and prevent potential conflicts of interest involving the Board of Trustees.

### **Trustee Support for the Opportunity Portfolio**

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**Trustee support for the Opportunity Portfolio is divided.**

In a vote of confidence taken on May 16, 2001, the Board of Trustees voted 5-3 (with 1 trustee absent) to support continuation of the Opportunity Portfolio. The majority, who are primarily trustees with extensive investment backgrounds, believe that the portfolio provides diversification in the Fixed Retirement Trust Fund and that it has the potential to increase overall returns, although it may require some time to do so. These supporters point to statistical models projecting that elimination of the Opportunity Portfolio would reduce the Fixed Retirement Trust Fund's overall expected returns. They also contend that because the Opportunity Portfolio represents a relatively small portion of the Fixed Trust Fund—2.0 percent—the effect on the Fixed Fund of the risk undertaken by the portfolio is minimal. Finally, they believe the Investment Board should be a leader in undertaking new investment strategies and markets and that it needs to aggressively seek ways to outperform the market. The Opportunity Portfolio, they argue, is an important means to do so.

The three trustees who did not support the Opportunity Portfolio in the May 16 vote believe that its returns to date have not been commensurate with the risk undertaken. These trustees, who are representatives of the Wisconsin Retirement System and local governments, base their assessments on statistical models that show actual (rather than projected) performance and that indicate elimination of the Opportunity Portfolio would have improved the Fixed Retirement Trust Fund's overall returns. At least one of these trustees has also expressed concern about the potential effects that investments such as Heartland and iRegent can have on overall credibility and trust in the Investment Board and the Wisconsin Retirement System as such investments are publicly disclosed.

We note that although six of the other pension funds we surveyed had investments in international private equity and limited partnerships similar to those found in the Opportunity Portfolio, none of these funds had established a separate portfolio with a similar opportunistic focus. Based on our survey results, only the largest public pension fund, the California Public Employees Retirement System, appears to partner with investment managers to participate directly in international private equity investments as the Investment Board has done with the Opportunity Portfolio. The other funds involved in international and private equity investments invest in fund-type vehicles that are managed externally.

Although a majority of Investment Board trustees voted in May to continue the Opportunity Portfolio, some supporters have indicated their support may decrease if the portfolio does not begin realizing higher returns in the next two to three years. Therefore, the long-term future of the Opportunity Portfolio remains uncertain and will require continued assessment.

In October 2001, the Investment Board hired a management consulting firm to:

- refine its strategy for all alternative and real estate investment classes;
- build a consensus among Investment Board staff and trustees around the rationale for the investment strategy; and
- identify key organizational and governance mechanisms critical for success of the investment strategy.

The cost of the consultant's investment strategy work, which is expected to be completed in December 2001, is \$500,000, plus expenses.

Because of the unique nature of the Opportunity Portfolio and the divided support for it among the trustees, we believe increased oversight is warranted. Therefore, *we recommend the State of Wisconsin Investment Board, in its annual reports to the Legislature, specifically report on the strategies and performance of the Opportunity Portfolio.*

## Oversight of the Opportunity Portfolio

Since early 2001, trustees and staff have been evaluating and instituting changes in Investment Board policies and procedures for the Opportunity Portfolio, including changes in the roles and responsibilities of trustees and investment staff. While these changes are expected to help address concerns that have arisen about trustee involvement in investment transactions, we believe additional steps are needed to ensure that investment activities and decisions are supported and monitored.

### Changes in Roles and Responsibilities

To properly serve as fiduciaries and protect those with vested interests in the sound operation of the funds under the Investment Board's management, the trustees need both to ensure that their own interests are not in conflict with those of the funds and to ensure that they serve in a governing role, rather than that of investment manager or staff. The Opportunity Portfolio has posed challenges for the trustees in meeting these responsibilities: during our audit, we found the appearance of potential conflicts, as well as instances in which trustees may have become directly involved in portfolio management.

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**Some trustees have been involved with investments in the Opportunity Portfolio.**

As a governing body, the Board of Trustees is responsible for employing the Executive Director, establishing policy and direction for the Investment Board, and ensuring that adequate monitoring mechanisms are in place. Industry professionals suggest that to effectively serve in this role, trustees need to limit their role in specific investment decisions to ensure that they can maintain an unbiased perspective and devote sufficient time to their broader policymaking and oversight responsibilities. For the traditional investment portfolios, the trustees have limited involvement with individual investments; however, for portfolios with less-traditional investments, such as the Opportunity Portfolio, their involvement in specific investments has, at times, been substantial.

Before March 2001, Opportunity Portfolio investments in securities that were not publicly traded required prior approval of either the full Board of Trustees or a committee of trustees. An alternative investment committee was established in 1999 to review and approve private investments in the Opportunity Portfolio and in the Investment Board's other private investment portfolios, as set forth in the investment guidelines. In February 2000, the alternative investment committee and a real estate committee, which was responsible for approving selected real estate transactions, were combined into the Board of Trustees' Alternative and Real Estate Investment (AREI) Committee. Most private investments were voted on by committee members, although some required approval of the full Board of Trustees because they fell

outside parameters established through investment guidelines. The number of Opportunity Portfolio transactions requiring approval of the committee increased as that portfolio's focus changed from public to private securities. As a result, selected trustees began spending increased amounts of time on individual investments.

For example, one trustee who was especially interested in the strategies being undertaken in the Opportunity Portfolio appears to have taken on a mentoring role to the investment director and became involved in activities that are typically performed by senior investment staff. The trustee, who was a member of the AREI Committee, has participated in meetings with representatives of companies in which the Investment Board invested or was considering investing. Based on available documentation and our interviews, we found reference to at least three occasions in which the trustee participated in such meetings, including a visit to KOL, the holding company formed by iRegent; a visit to a steel mill in Thailand in which the Opportunity Portfolio invested; and discussions with local energy representatives regarding energy investment opportunities in Wisconsin.

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**Outside fiduciary advisors have advised the trustees to limit their involvement in individual investment decisions.**

In response to recent events and questions being raised about the Opportunity Portfolio, and on advice from outside fiduciary advisors who spoke to the trustees in November 2000, the Investment Board has been reevaluating and instituting changes to its procedures and oversight activities. Outside fiduciary advisors advised trustees to spend less time performing functions that could be prudently delegated so that they could more effectively perform their broader policymaking and monitoring functions. The fiduciary advisors also informed the trustees that Wisconsin Statutes place fiduciary responsibilities with the entire Board of Trustees as a collective entity and that no explicit authority is provided to allow the Board to delegate its powers to committees.

In February and March 2001, the Board of Trustees approved changes to policies and procedures that more clearly delineated management and governing roles between Investment Board staff and the trustees, especially as they pertained to the Opportunity Portfolio. Membership on the AREI Committee has been broadened to include all trustees. In addition, investments being considered for the Opportunity Portfolio are first reviewed by a risk management committee that is staffed only by senior Investment Board staff, with no trustee involvement. Committee members include the Executive Director; the assistant executive director; the chief investment officers for public fixed-income and public equities; the chief legal officer; the chief operating officer; the quantitative analytics director; and the director of internal audit, as an ex-officio member.

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**A staff risk management committee has been given responsibility to review potential investments for the Opportunity Portfolio.**

The risk management committee, which was originally established in response to the 1995 derivatives loss in the State Investment Fund, is responsible for reviewing derivative investments, but before March 2001 it had no explicit responsibility for reviewing investments in the Opportunity Portfolio or other non-public portfolios. The committee is intended to provide peer review analysis, rather than to serve as an approval process, although it can suspend an investment director's authority to finalize an investment without Board of Trustee approval if members have concerns that the investment is not prudent or in compliance with the portfolio's objectives and investment guidelines.

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**In March 2001, investment guidelines were changed to broaden investment staff's authority.**

The trustees also broadened the authority delegated to investment staff through investment guidelines for the non-public portfolios, and thereby reduced the number of transactions requiring trustee approval. Under the new investment guidelines for the Opportunity Portfolio, trustee approval is required for individual investments exceeding \$100.0 million or for investments that create an ownership position in excess of 50 percent in any one company. In addition, trustee approval is required for any investment that would bring exposure in emerging markets to over 75 percent of the portfolio. The new investment guidelines also require that each portfolio manager report to the Board of Trustees on any referrals or contacts by trustees with staff on private investments. Before March 2001 the AREI Committee typically met monthly, and during 2000 it reviewed approximately 32 investments. Since the March 2001 changes in the investment guidelines, the AREI Committee has met only once to discuss and vote on an investment opportunity for the Biotech Venture Capital Portfolio.

As a balance for less trustee involvement in individual investment decisions, recent changes provide for increased reporting and discussion between investment staff and trustees on investment strategies and performance in the different portfolios. In the past, portfolio managers had reported to the trustees on an annual basis. Under the current structure, they will update trustees on portfolio strategies, potential investments under consideration, portfolio developments, and problematic investments at least three times per year.

### **Management Oversight**

As trustees decrease their involvement in specific investment decisions, we believe the Investment Board should ensure adequate management oversight of the Opportunity Portfolio, especially before entering into investment transactions that may be difficult to sell or otherwise exit. From the available documentation, we could not determine either the level of management involvement or the level of oversight that was

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**The investment directors for private investments report directly to the Executive Director.**

provided for the Opportunity Portfolio's investments. In the case of the South Korean investments involving iRegent, the Executive Director indicated that she had inquired into iRegent's reputation while traveling in Europe in February 2000. However, these inquiries were made after \$30.0 million had been disbursed for the investments.

Since the 1995 derivatives loss in the State Investment Fund, the Investment Board has taken a number of recommended steps to increase management oversight. A major step has been to establish chief investment officer positions to provide oversight and supervision of public fixed-income investments and public equities. Investment directors for the various portfolios with public investments report to these chief investment officers. However, as shown in Appendix 4, investment directors for private investments continue to report directly to the Executive Director. The Investment Board is considering establishing another chief investment officer position that would oversee the private market portfolios, including the Opportunity Portfolio, although it believes it may be difficult to fill that type of position.

As the Investment Board pursues the feasibility of establishing a chief investment officer position to more closely oversee the Opportunity Portfolio, it should also take steps to develop policies and procedures that establish parameters for a due-diligence process in the Opportunity Portfolio. The Investment Board does not have clear policies and procedures regarding either the due-diligence process that staff should perform before entering into investments for the Opportunity Portfolio or the type and level of documentation that should be maintained to support investment decisions for the portfolio. As a result, the soundness and appropriateness of investments are more susceptible to questions like those that surround the South Korean investments with iRegent and the Heartland investment.

Investment Board staff maintain that it is difficult to establish a standard due-diligence process or requirements that would be applicable to all the different types of investments permitted for the Opportunity Portfolio. However, we believe there are basic considerations and criteria that could apply to most investments, including partnering relationships and investment funds. Such considerations, which could be amended to accommodate various types of investments, include:

- quantitative information, including financial and performance information over a number of years;
- experience, operational characteristics, and reputation of the firm;
- experience, education, and depth of key personnel;

- business or investment philosophy and strategies;
- controls, risk-management policies and procedures, and due-diligence process; and
- market conditions.

Since the risk management committee is currently responsible for reviewing investments being made for the Opportunity Portfolio, it may be the appropriate group to help establish a due-diligence process for the portfolio and to use it in assessing whether appropriate consideration is being given to the merits, soundness, and risks of proposed investments. The management consulting firm the Investment Board hired in October 2001 to help refine its investment strategy for alternative investments has also proposed a due-diligence project for \$100,000 per week, plus expenses, in which it would help the Investment Board to define key evaluation criteria and assist in performing a due-diligence review of a potential strategic partner. To ensure that investment opportunities are properly evaluated and supported in the Opportunity Portfolio, *we recommend the State of Wisconsin Investment Board establish policies and procedures that define the level of analysis and documentation standards that should be met before entering into investment transactions and relationships in the Opportunity Portfolio.*

### **Potential Conflicts of Interest**

Adding to concerns about trustees' involvement in specific investments has been the fact that some trustees also have economic interests in some entities associated with the Opportunity Portfolio. For example, we found that three current trustees and two former trustees have owned public stock in iRegent, the Investment Board's strategic partner in KOL.

The State Ethics Code, which is contained in subchapter III of chapter 19, Wis. Stats., establishes standards of conduct under which public officials, including the Investment Board's trustees, must operate in performing their official state duties and responsibilities. The Ethics Code prohibits public officials from taking any official action substantially affecting a matter in which they have a financial interest and from using their public positions to obtain personal financial gain. However, the Ethics Code also recognizes that public officials cannot rid themselves of all personal and economic interests in performing their duties and that there is a need to distinguish between those minor and inconsequential conflicts that are unavoidable in a free society and those conflicts that are substantial and material.

With the extensive investment background that many of the Investment Board's trustees possess, it is not surprising that they regularly encounter situations in which questions about potential conflicts of interest could arise. As a result, trustees need to regularly make judgments about how their personal and economic interests may affect the performance of their public duties as trustees. They often look to the Investment Board's legal staff for further guidance in making these judgments. In addition, the Investment Board provides guidance in its trustee manual. For example, the manual indicates that trustees may refer investment opportunities to staff, but it also encourages trustees to avoid even the appearance of a conflict of interest. The Investment Board also periodically provides training for trustees on the ethics provisions.

Situations with potential for conflicts of interest appeared regularly in decisions involving the Opportunity Portfolio. Minutes from Investment Board meetings reflect instances in which trustees who owned public stock in iRegent appropriately recused themselves from consideration of related investments. In fact, on more than one occasion, the AREI Committee did not have a quorum after one or more of its members recused themselves based on ownership of public stock in a related entity or on participation in the partnership under consideration. At those times, either a temporary committee member was assigned or the item was brought before the full Board of Trustees.

However, we found one instance in which two trustees who reported they owned public stock in iRegent, the Investment Board's strategic partner in KOL, did not recuse themselves from a July 2000 vote to invest \$80.0 million in a joint venture with KOL. As provided for under s. 19.55(2)(c), Wis. Stats., we receive and review quarterly and annual ethics statements filed by the trustees with the Ethics Board, which provide summary information on investment transactions and holdings. Unlike the ethics statements of other public officials, those of the Investment Board's staff and trustees are not available for public inspection. According to these ethics statements, the two trustees owned public stock in iRegent during the period that the vote was taken to invest the \$80.0 million, and the Board's minutes indicate that the trustees voted on the investment.

Whether this instance represents a conflict of interest is debatable, because we cannot determine whether the trustees' votes on the KOL transaction would have substantially affected their financial interests in iRegent. However, the votes, at a minimum, present an appearance of a conflict that the trustees should have taken steps to avoid.



With the recent changes in policies and procedures that limit the level of involvement trustees will have in individual investment decisions for the Opportunity Portfolio, potential conflicts could be reduced. However, the Investment Board should continually assess whether further guidance is needed to ensure that conflicts are avoided. Specifically, we suggest the Investment Board revisit its policies on:

- trustee actions on investments in which trustees may have a personal or economic interest. The Investment Board may want to consider expanding its current guidance in the trustee manual to include specific examples of situations that the trustees may encounter, particularly in the Opportunity Portfolio.
- trustee referral of investment opportunities, especially when a trustee has personal or economic interests related to the investment. As previously discussed, one trustee properly recused himself from voting on the Heartland investment, and we did not find any indications that he had improperly influenced decisions regarding the Heartland investment. However, even the appearance that such influence could have been exerted reduces the confidence of interested parties that investment decisions are fairly and properly made.
- trustee participation in company visits and negotiations. Trustee participation in conferences designed for fiduciary or high-level investment education is beneficial and appropriate for the trustees in fulfilling their fiduciary responsibilities. However, as noted, trustee participation in visits and discussions with companies in which the Investment Board has invested or is interested in investing may reduce the ability of trustees to effectively serve in their broader policymaking and oversight role.

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Appendix 1

Comparison of Fixed Retirement Trust Fund Performance to Benchmarks

		Period Ending 12/31/00			Period Ending 12/31/99			Period Ending 12/31/98		
		<u>1-Year</u>	<u>5-Year</u>	<u>10-Year</u>	<u>1-Year</u>	<u>5-Year</u>	<u>10-Year</u>	<u>1-Year</u>	<u>5-Year</u>	<u>10-Year</u>
<b>Fixed Retirement Trust Fund</b>	<b>Actual</b>	-0.8%	12.0%	12.6%	15.7%	17.0%	12.5%	14.6%	13.4%	12.9%
	<b>Benchmark</b>	-1.4%	11.4%	12.0%	14.2%	16.8%	12.0%	15.5%	13.7%	12.6%
<b>Equities—All</b>	<b>Actual</b>	-7.4%	15.7%	15.9%	28.1%	22.9%	15.4%	17.8%	17.3%	15.0%
	<b>Benchmark</b>	-9.6%	13.9%	15.2%	23.5%	22.4%	15.3%	17.4%	17.8%	15.7%
<b>Domestic</b>	<b>Actual</b>	-4.6%	17.0%	16.6%	26.0%	24.1%	15.7%	18.7%	18.6%	15.5%
	<b>Benchmark</b>	-7.0%	15.8%	16.6%	21.1%	25.0%	16.4%	18.1%	20.5%	16.9%
<b>International</b>	<b>Actual</b>	-11.6%	13.5%	14.0%	34.1%	19.9%	14.4%	16.0%	12.8%	n/a
	<b>Benchmark</b>	-13.4%	10.4%	11.0%	28.2%	16.7%	11.0%	15.9%	10.6%	n/a
<b>Emerging Market</b>	<b>Actual</b>	-29.7%	0.8%	n/a	62.8%	6.7%	n/a	-25.3%	-3.2%	n/a
	<b>Benchmark</b>	-30.6%	-3.8%	n/a	65.2%	2.4%	n/a	-25.7%	-8.5%	n/a
<b>Fixed-Income—All</b>	<b>Actual</b>	10.0%	6.7%	8.8%	-1.6%	8.9%	8.6%	9.8%	8.1%	10.6%
	<b>Benchmark</b>	9.4%	6.5%	8.6%	-1.0%	8.7%	8.3%	9.4%	8.0%	9.9%
<b>Domestic</b>	<b>Actual</b>	12.2%	6.5%	9.0%	-2.3%	8.5%	8.6%	9.9%	8.0%	10.7%
	<b>Benchmark</b>	11.2%	6.3%	8.6%	-2.0%	8.2%	8.2%	9.4%	7.7%	9.9%
<b>International</b>	<b>Actual</b>	2.8%	7.3%	7.7%	0.9%	10.2%	8.1%	9.8%	8.2%	n/a
	<b>Benchmark</b>	1.6%	7.9%	8.4%	4.0%	11.1%	8.6%	9.7%	9.3%	n/a
<b>Emerging Market</b>	<b>Actual</b>	17.7%	15.7%	n/a	28.1%	18.9%	n/a	-17.6%	n/a	n/a
	<b>Benchmark</b>	15.7%	14.0%	n/a	26.0%	16.3%	n/a	-14.4%	n/a	n/a
<b>Real Estate</b>	<b>Actual</b>	12.5%	11.2%	7.7%	8.3%	10.8%	7.1%	15.3%	10.4%	7.1%
	<b>Benchmark</b>	11.7%	11.7%	5.2%	11.9%	10.8%	4.4%	16.6%	8.9%	3.9%
<b>Alternatives*</b>	<b>Actual</b>	-6.0%	13.8%	13.5%	5.3%	n/a	n/a	5.0%	n/a	n/a
	<b>Benchmark</b>	15.0%	15.0%	15.0%	27.3%	n/a	n/a	21.7%	n/a	n/a
<b>Cash</b>	<b>Actual</b>	6.3%	5.4%	5.3%	4.9%	5.3%	5.6%	5.3%	5.2%	6.0%
	<b>Benchmark</b>	6.0%	5.3%	4.9%	4.8%	5.2%	5.1%	5.1%	5.1%	5.4%

n/a = not available

\*Some returns on alternative investments are reflected in equity and fixed-income returns prior to 12/31/99.



Appendix 2

**Comparison of Fixed Retirement Trust Fund to Other Public Pension Funds**  
(as of June 30, 2000)

<b>Retirement System</b>	<b>Total Assets</b>	<b>Internally Managed</b>	<b>Externally Managed</b>	<b>Asset Class</b>	<b>Actual Asset Allocation</b>	<b>5-Year Returns by Asset Class</b>
CALIFORNIA PUBLIC EMPLOYEES RETIREMENT SYSTEM	\$171.5 billion	58.4%	41.6%	Equities		
				Domestic	44.4%	22.7%
				International	18.9%	13.9%
				Fixed-Income		
				Domestic	22.5%	6.8%
				International	3.9%	3.4%
				Private Equity	4.4%	18.5%
				Real Estate Equity	5.1%	11.0%
				Cash Equivalents	0.8%	5.8%
				Mortgages	0.0%	0.0%
Other	0.0%	0.0%				
FLORIDA RETIREMENT SYSTEM TRUST FUND	\$106.3 billion	38.6%	61.4%	Equities		
				Domestic	56.2%	23.0%
				International	11.2%	12.0%
				Fixed-Income		
				Domestic	16.9%	6.4%
				International	0.0%	0.0%
				Private Equity	3.2%	27.8%
				Real Estate Equity	3.5%	11.2%
				Cash Equivalents	0.9%	5.9%
				Mortgages	8.1%	(A)
Other	0.0%	0.0%				
MINNESOTA COMBINED FUNDS	\$43.8 billion	0.6%	99.4%	Equities		
				Domestic	50.1%	22.2%
				International	14.2%	12.3%
				Fixed-Income		
				Domestic	27.3%	6.6%
				International	0.0%	0.0%
				Private Equity	4.0%	30.9%
				Real Estate Equity	2.0%	12.9%
				Cash Equivalents	1.8%	5.9%
				Mortgages	0.0%	0.0%
Other	0.6%	na				

(A)= Included in fixed-income returns

(B)= Included in domestic equity returns

(C)= Included in domestic fixed-income returns

na= Not available

<b>Retirement System</b>	<b>Total Assets</b>	<b>Internally Managed</b>	<b>Externally Managed</b>	<b>Asset Class</b>	<b>Actual Asset Allocation</b>	<b>5-Year Returns by Asset Class</b>
NEW JERSEY DIVISION OF INVESTMENTS	\$82.1 billion	99.7%	0.3%	Equities		
				Domestic	50.0%	25.3%
				International	16.0%	16.2%
				Fixed-Income		
				Domestic	25.0%	6.6%
				International	2.0%	3.4%
				Private Equity	0.0%	0.0%
				Real Estate Equity	0.0%	0.0%
				Cash Equivalents	3.0%	5.7%
Mortgages	4.0%	6.7%				
Other	0.0%	0.0%				
NEW YORK STATE TEACHERS RETIREMENT SYSTEM	\$90.1 billion	82.1%	17.9%	Equities		
				Domestic	61.7%	21.6%
				International	9.3%	12.9%
				Fixed-Income		
				Domestic	17.4%	6.5%
				International	1.6%	3.9%
				Private Equity	0.5%	30.0%
				Real Estate Equity	3.9%	11.8%
				Cash Equivalents	1.8%	5.6%
Mortgages	3.8%	7.5%				
Other	0.0%	0.0%				
PENNSYLVANIA PUBLIC SCHOOL EMPLOYEES RETIREMENT SYSTEM	\$53.2 billion	33.3%	66.7%	Equities		
				Domestic	43.5%	21.6%
				International	19.2%	12.5%
				Fixed-Income		
				Domestic	11.8%	6.6%
				International	3.8%	3.8%
				Private Equity	3.3%	26.5%
				Real Estate Equity	5.5%	12.4%
				Cash Equivalents	1.5%	na
Mortgages	0.0%	0.0%				
Other	11.4%	na				
<b>STATE OF WISCONSIN INVESTMENT BOARD—FIXED RETIREMENT TRUST FUND</b>	<b>\$65.0 billion</b>	<b>41.7%</b>	<b>58.3%</b>	Equities		
				Domestic	<b>38.8%</b>	<b>20.1%</b>
				International	<b>17.8%</b>	<b>(B)</b>
				Fixed-Income		
				Domestic	<b>26.8%</b>	<b>7.0%</b>
				International	<b>6.2%</b>	<b>(C)</b>
				Private Equity	<b>2.5%</b>	<b>22.5%</b>
				Real Estate Equity	<b>3.6%</b>	<b>10.6%</b>
				Cash Equivalents	<b>1.4%</b>	<b>5.3%</b>
Mortgages	<b>0.7%</b>	<b>na</b>				
Other	<b>2.2%</b>	<b>13.5%</b>				

(A)= Included in fixed-income returns

(B)= Included in domestic equity returns

(C)= Included in domestic fixed-income returns

na= Not available

<b>Retirement System</b>	<b>Total Assets</b>	<b>Internally Managed</b>	<b>Externally Managed</b>	<b>Asset Class</b>	<b>Actual Asset Allocation</b>	<b>5-Year Returns by Asset Class</b>
TEACHERS RETIREMENT SYSTEM OF TEXAS	\$87.2 billion	100.0%	0.0%	Equities		
				Domestic	53.1%	21.3%
				International	10.6%	(B)
				Fixed-Income		
				Domestic	34.4%	6.7%
				International	0.0%	0.0%
				Private Equity	0.2%	na
				Real Estate Equity	0.0%	na
				Cash Equivalents	1.1%	na
				Mortgages	0.6%	na
Other	0.0%	0.0%				
VIRGINIA RETIREMENT SYSTEM	\$41.8 billion	16.9%	83.1%	Equities		
				Domestic	47.0%	21.4%
				International	14.0%	9.9%
				Fixed-Income		
				Domestic	25.0%	6.3%
				International	0.0%	0.0%
				Private Equity	9.0%	48.5%
				Real Estate Equity	3.0%	9.7%
				Cash Equivalents	0.0%	0.0%
				Mortgages	0.0%	0.0%
Other	2.0%	na				
WASHINGTON STATE INVESTMENT BOARD	\$49.0 billion	25.4%	74.6%	Equities		
				Domestic	38.5%	22.4%
				International	17.2%	10.8%
				Fixed-Income		
				Domestic	24.5%	6.3%
				International	0.0%	0.0%
				Private Equity	11.9%	27.6%
				Real Estate Equity	6.9%	18.7%
				Cash Equivalents	1.0%	5.7%
				Mortgages	0.0%	0.0%
Other	0.0%	0.0%				

(A)= Included in fixed-income returns

(B)= Included in domestic equity returns

(C)= Included in domestic fixed-income returns

na= Not available





## Appendix 3

**Opportunity Portfolio Inventory of Investments**

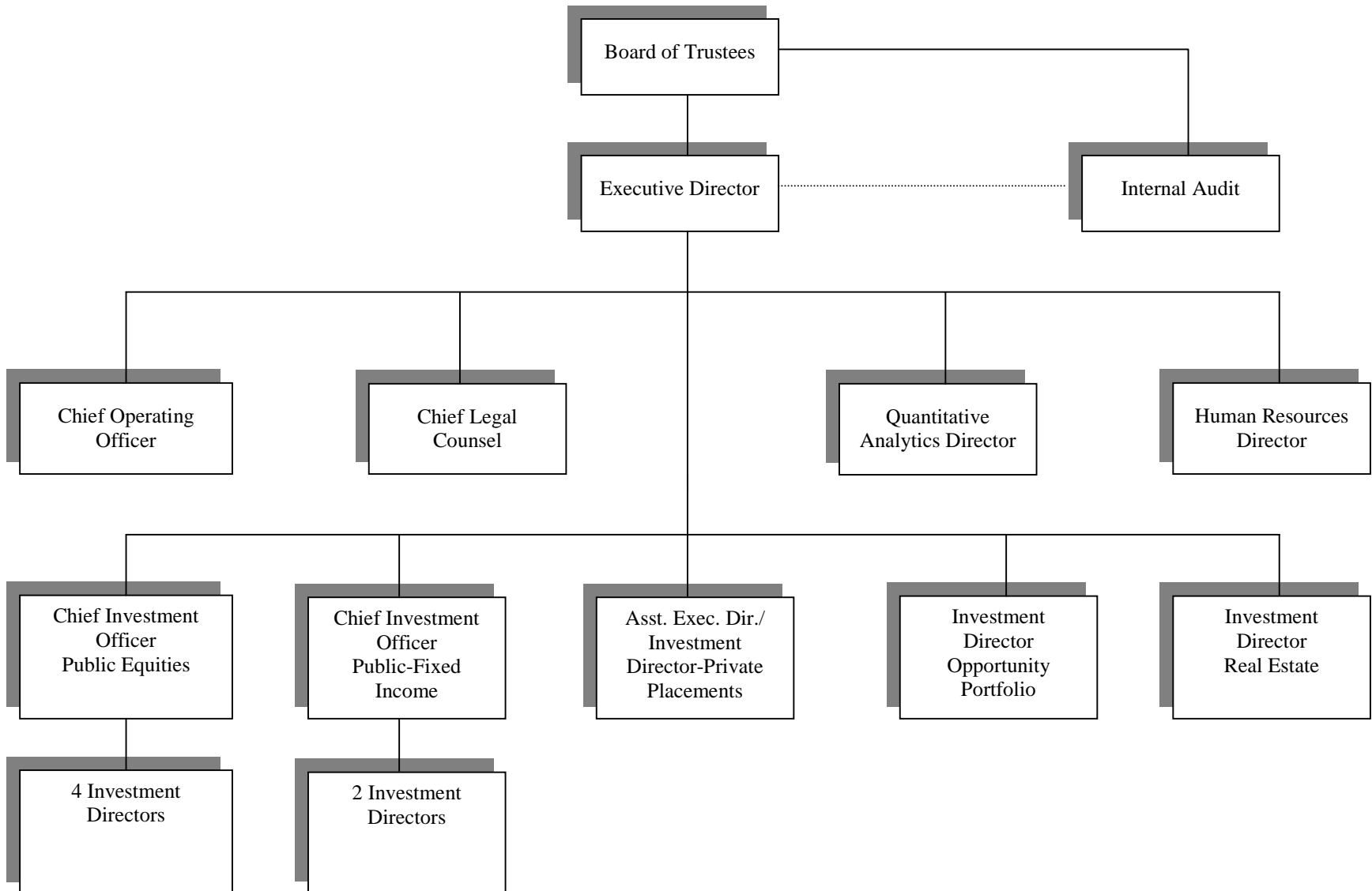
(as of June 30, 2001)

<u>Investment Type</u>	<u>Investment Name</u>	<u>Cost</u>	<u>Total Unrealized Gain (Loss)</u>	<u>Fair Value</u>
<i>Fixed-Income</i>	Heartland	\$ 8,347,085	\$ 110,766	\$ 8,457,851
	NSM Steel	7,866,083	(7,079,475)	786,608
<i>Subtotal, Fixed-Income</i>		<u>16,213,168</u>	<u>(6,968,709)</u>	<u>9,244,459</u>
<i>Equities</i>	APP Fin VI	19,198,560	(17,788,560)	1,410,000
	Asia Pulp & Paper	17,673,625	(17,383,573)	290,052
	Crompton Corp.	26,208,638	2,665,462	28,874,100
	Hynix Semiconductor	14,587,972	446,849	15,034,821
	Kookmin Bank	11,216,702	3,546,398	14,763,100
	Nakornthai Strip Mill	2,668,620	(2,308,462)	360,158
	Lukoil	95,026,760	36,952,395	131,979,155
	Pohang Iron & Steel ADR	10,563,750	4,522,050	15,085,800
	Pohang Iron & Steel	1,117,747	1,491,889	2,609,636
	Seoul Securities	4,827,093	(1,088,157)	3,738,936
	Yukos	53,280,000	40,487,999	93,767,999
<i>Subtotal, Equities</i>		<u>256,369,467</u>	<u>51,544,290</u>	<u>307,913,757</u>
<i>Funds and Limited Partnerships</i>	Ashmore Asian Opportunity Fund	20,000,000	(4,046,451)	15,953,549
	Asian Value Fund	20,000,000	498,600	20,498,600
	Bear Stearns Merchant Bank II LP	4,247,576	67,489	4,315,065
	Brunswick Russian Emerg	9,080,973	(6,996,055)	2,084,918
	Cap Int'l Emerging Eq LP	18,124,386	1,354,103	19,478,489
	Caryle Asia Ltd	11,454,582	(259,720)	11,194,862
	Central & Southern Asian Fd	3,000,000	(2,370,360)	629,640
	East Europe Frontiers Fund	10,250,000	(2,935,000)	7,315,000
	Energy Income Fund LP	14,668,795	7,221,626	21,890,421
	First NIS Regional Fund	6,982,963	(3,270,463)	3,712,500
	GS Special Oppty Asia Fund	25,075,419	7,667,418	32,742,837
	Icebreaker Ltd Partnership	481,674	(174,026)	307,648
	Indian Smaller Companies	5,000,000	(3,072,921)	1,927,079
	Latin America Enterprise Fund	17,507,156	(3,078,677)	14,428,479
	Latin America Enterprise Fund II	5,034,445	(368,686)	4,665,759
	Lyonnais Asia Water	5,988,800	944,488	6,933,288
Northstar Cap Inv	20,000,000	(5,875,000)	14,125,000	
Pioneer Poland	9,999,730	(5,198,879)	4,800,851	
Sun Capital Partners LP	8,627,606	(5,417,295)	3,210,311	
Vulcan Partners	25,000,000	(1,392,330)	23,607,670	
Xylem Fund II LP	20,000,000	(10,129,546)	9,870,454	
<i>Subtotal, Funds and Limited Partnerships</i>		<u>260,524,105</u>	<u>(36,831,685)</u>	<u>223,692,420</u>

<u>Investment Type</u>	<u>Investment Name</u>	<u>Cost</u>	<u>Total Unrealized Gain (Loss)</u>	<u>Fair Value</u>
<i>Strategic Partnerships</i>				
<b>LaFarge</b>	LaFarge/Halla Cement Corp.	\$ 86,000,000	—	\$ 86,000,000
	LaFarge India	62,664,962	(79,929)	62,585,033
<i>Subtotal, LaFarge</i>		<i>148,664,962</i>	<i>(79,929)</i>	<i>148,585,033</i>
<b>WL Ross</b>	Asia Recovery Fund	28,802,710	686,835	29,489,545
	WL Ross Recovery Fund	19,800,000	(2,082,154)	17,717,846
	Asia Recovery Co-Investment Fund	15,102,970	741,477	15,844,447
	Nippon Investment Partners	75,000,000	—	75,000,000
<i>Subtotal, WL Ross</i>		<i>138,705,680</i>	<i>(653,842)</i>	<i>138,051,838</i>
<b>iRegent—Korea</b>	Asian Opportunity Fund	20,000,020	379,980	20,380,000
	Regent Pac Novy Fund	4,499,999	7,613,457	12,113,456
	iRegent.com LTD	15,567,383	(12,815,083)	2,752,300
	iRegent.com LTD Warrants	1,640,634	(1,579,237)	61,397
	Korea OnLine Limited (KOL)	110,000,000	(94,058,163)	15,941,837
	Regent Securities	9,479,524	(5,381,245)	4,098,279
	Illeun Securities	4,957,575	(1,267,156)	3,690,419
<i>Subtotal, iRegent—Korea</i>		<i>166,145,135</i>	<i>(107,107,447)</i>	<i>59,037,688</i>
<b>iRegent—Europe</b>	Charlemagne Capital LTD	2,119,953	(2,543)	2,117,410
	SWR Inc.	18,700,000	—	18,700,000
<i>Subtotal, iRegent—Europe</i>		<i>20,819,953</i>	<i>(2,543)</i>	<i>20,817,410</i>
<b>Total, Opportunity Portfolio</b>		<b>\$1,007,442,470</b>	<b>(\$100,099,865)</b>	<b>\$907,342,605</b>

Appendix 4

**Investment Board Organization Chart**  
(as of June 30, 2001)







## State of Wisconsin Investment Board

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MAILING ADDRESS  
PO BOX 7842  
MADISON, WI 53707-7842

121 EAST WILSON ST  
MADISON, WI 53702  
(608) 266-2381  
FAX: (608) 266-2436

October 31, 2001

Ms. Janice Mueller  
State Auditor  
Legislative Audit Bureau  
22 East Mifflin Suite 500  
Madison, WI 53703

Dear Ms. Mueller:

Thank you for the opportunity to review and respond to the management audit of the Investment Board. The following represents the staff response to the report.

### **Summary Comments**

#### **Fixed Retirement Fund Continues to Outperform Investment Goals**

- Despite the severe stock market downturn of the last two years and the economic aftershock of the September 11 terrorist attacks, long-term investment returns for the Fixed (or balanced) Retirement Fund continue to exceed the 8% average annual rate required to meet benefit obligations to fund participants.
- The audit confirms that the Fixed Fund is outperforming the markets on a one-, five- and ten-year basis. Over the five years ending June 30, 2001, SWIB added \$1.8 billion of cumulative investment return over the market rate of return.
- The audit's comparison of the Fixed Fund to nine other state pension funds shows most of those funds invested more heavily in domestic stocks. In an unprecedented bull market for domestic stocks, SWIB concluded that it was too risky to carry too large an exposure. Although the comparison funds had greater five- and ten-year returns than the Fixed Fund, most had more volatile returns. The Fixed Fund's ranking compared to other pension funds improved beginning in 2000 as the stock market began to correct for overvaluations. Recent returns place SWIB among the top performing funds LAB surveyed.
- As the audit acknowledges, its analysis of the Fixed Fund performance relative to nine other funds is not entirely an "apples to apples" comparison. The WRS is the only system offering participants the choice to invest more of their funds in the stock market than a balanced pension fund provides. With the reopening of the Variable Fund, many more WRS participants now have this choice. Applying a simple average of Fixed and Variable returns, participants in the Variable Fund had a 17.2% average annual return on their combined Fixed and Variable contributions during the five-year period covered in LAB's report. This five-year combined return ranked 3<sup>rd</sup> among the ten funds surveyed.

#### **No Undue Influence in Heartland Investment; 20% Return Expected**

- We are pleased that your report confirmed that our investment with Heartland Advisors followed policy guidelines. Your review found "no evidence that direct influence was exerted" in the investment process. We have not changed our view that this investment will prove to be successful.

**Opportunity Portfolio (2% of Fixed Fund): Seeks Higher Return by Taking Greater Risk**

- The objective of the Opportunity Portfolio is to seek out investments on a global basis with the potential for higher long-term returns than the broader asset mix of the Fixed Retirement Fund. To achieve this objective, the portfolio may include investments with higher risk. This portfolio represents only 2% of the assets of the Fixed Fund.
- SWIB uses a very deliberative process to build the Fixed Fund's allocation to various markets so that they fit together to provide the best risk-adjusted return over the long-term. The Opportunity Portfolio is one part of the Fixed Fund strategy and should not be viewed outside its role in the overall portfolio.
- Private equity investments often take three to five years to demonstrate a positive return. The slower recovery of emerging markets in Asia was not foreseen when the strategy to invest in those markets was initiated. However, the Fixed Fund's long-term investment horizon was a major consideration in establishing this portfolio. It is too early to evaluate its success.
- Through September 30, the Opportunity Portfolio's total return of -7.8% in 2001 exceeded the return for all SWIB equities (-20.5%) as the stock market downturn continued. One of the goals of the portfolio is to cushion downturns in other assets through diversification.
- As noted in your report, oversight of the portfolio has been strengthened: (1) The portfolio has been capped at its current size and to its current investment themes to evaluate how current strategies are performing; (2) Since March 2001, a Risk Committee of senior staff has had an expanded role in monitoring the portfolio; and (3) In January 2001 we initiated an independent audit by Deloitte Touche of a troubled Korean investment that has not performed as expected due to events outside SWIB's control.
- SWIB has retained a leading investment industry consulting firm to examine the strategies and organizational structure for alternative assets, defined as private equity (including the Opportunity Portfolio, leveraged buyouts and venture capital) and real estate. This work will consider the viability of the alternative asset class going forward. We expect to have this work completed by year-end.
- We agree with your observation that portfolio documentation can be improved. As recommended by your report, we will provide an updated discussion of the Opportunity Portfolio, including documentation of the due diligence process, in our next annual strategy and performance report to the Legislature.

**SWIB's Ethics Standards Approved by the Ethics Board; Prohibit Conflicts of Interest**

- Our policies incorporate the State Ethics Code as the Standard of Conduct for trustees and staff. As such, no trustee may take official action on a matter in which they have a personal financial interest. At SWIB's request, the Ethics Board reviewed and approved our policies when they were enhanced in 1991.
- Trustees are required to file quarterly and annual statements with the Ethics Board that include information on investment holdings and transactions. By law, these statements are open to inspection only by the Legislative Audit Bureau and the Ethics Board. SWIB staff cannot view Trustee filings with the Ethics Board and SWIB does not have enforcement authority.
- The Ethics Board is authorized to pursue any concerns about potential violations of these requirements. If additional reports regarding SWIB's investment portfolio would assist Ethics Board staff in enforcing ethics compliance, we would be happy to provide them. We will contact the Ethics Board in that regard.

With these summary comments in mind, SWIB staff have the following more specific observations regarding each of the major areas of the audit:

### **Fixed Retirement Fund Investment Performance**

- ***Long-term Investment Objectives: To Meet Actuarial Goals & Outperform the Markets***

The mix of assets in the Fixed Fund has been carefully chosen to meet or exceed the 8% average annual long-term return needed to fulfill obligations to current and future retirees. The mix is well diversified among stocks, bonds and other assets to maximize returns and minimize risks under a variety of economic scenarios. Annually, the Board reviews the asset allocation. We stress test the impact of “worst case” economic scenarios on the trust funds.

SWIB also monitors the performance of our portfolio managers against market benchmarks. A committee of the Board selects the benchmarks with the assistance of outside consultants. The benchmarks are reviewed on a regular basis to ensure they are rigorous without encouraging excessive risk taking. A previous report from the Legislative Audit Bureau (LAB) confirmed that our benchmarks met this objective.

This process is discussed in detail as part of our annual goals and performance report to the Legislature. We always welcome the opportunity to discuss any questions that legislators or others may have in regards to that report.

- ***Investment Results: Consistently Outperforming Long-Term Objectives***

Long-term investment performance continues to be well ahead of the 8% actuarial goal. Strong long-term performance was the primary factor that led to recent pension benefit and financing improvements as well as five consecutive years of reductions in employer contribution rates to the WRS.

Since the last LAB report in 1999, the Fixed Fund has outperformed its market benchmarks at each fiscal year and calendar year end-reporting period. Over the last ten years, the Fixed Fund has outperformed its five-year market benchmark 85% of the time and the ten-year-benchmark 95% of the time. Over the five years ending June 30, 2001, SWIB’s outperformance of the market benchmarks resulted in \$1.8 billion of cumulative added investment return.

- ***Private Loans, Small Company Stocks & International Stocks: Part of a Diversified Strategy***

As your report observes, two of the investment strategies that were questioned in the last management audit are performing well. Our small company stocks and loans to private companies beat their one-, five- and ten-year benchmarks. In 2000, the loan portfolio added \$130 million of value by outperforming its market benchmark and small company stocks added \$83 million. In addition, since mid-1999, small company stocks have outperformed large company stocks.

The audit notes that the five-year return for international stocks was less than domestic stocks. It should be emphasized that this period was an unprecedented bull market for domestic stocks. Even so, international stocks outperformed domestic stocks in four years during the 1990s, providing important diversification benefits and reducing the volatility of fund returns. Like all portfolios, the role of international stocks is reviewed and approved annually by the Board. In 2001, we did reduce the share of international stocks in the Variable Fund from 25% to 20% of the Fund’s assets to provide a more

appropriate level of total risk for participants in both funds. We will present the results of our January 2002 strategy review in our next strategies and performance report to the Legislature.

- ***Comparisons to Other Public Pension Funds***

Our asset allocation and investment decisions are not determined by what other public funds do. State pension funds have different actuarial requirements. They also operate under different legal restrictions and other constraints with regard to their investment activities. Some state funds are constrained in their use of outside management while others are not. Some state funds have complete control in setting their budgets; others do not.

It is difficult to determine the overall level of risk that each of the other state pension funds take in their investments. Other public pension funds reporting greater returns typically allocated a larger share of their assets to large company stocks, the best performing asset class for much of the 1990s. We believe those pension funds took a greater risk, and that a more diversified asset mix was preferable in order to better manage risk and ensure that the long-term 8% return goal is met for the Fixed Fund. We believe the wisdom of that approach has been confirmed by the performance of the stock market over the last two years.

The audit's comparison of the Fixed Fund to nine other state pension funds shows most of those funds invested more heavily in domestic stocks. In an unprecedented bull market for domestic stocks, SWIB concluded that it was too risky to carry too large an exposure. Although the comparison funds had greater five- and ten-year returns than the Fixed Fund, most had more volatile returns. The Fixed Fund's ranking compared to other pension funds improved beginning in 2000 as the stock market began to correct for overvaluations. Recent returns place SWIB among the top performing funds LAB surveyed.

As the audit acknowledges, its analysis of the Fixed Fund performance relative to nine other funds is not entirely an "apples to apples" comparison. The WRS is the only system offering participants the choice to invest more of their funds in the stock market than a balanced pension fund provides. With the reopening of the Variable Fund, many more WRS participants now have this choice. Applying a simple average of Fixed and Variable returns, participants in the Variable Fund had a 17.2% average annual return on their combined Fixed and Variable contributions during the five-year period covered in LAB's report. This five-year combined return ranked 3<sup>rd</sup> among the ten funds surveyed.

Broader pension fund return comparisons that we review show that the Fixed Fund performance ranks more favorably than in the LAB survey group, and that our relative performance has continued to improve. For example, as of June 30, 2001, the Fixed Fund is ahead of the median one-year and ten-year year returns for public funds with assets over \$10 billion. The Fixed Fund lagged the 10.65% five-year median return by just 0.33% <sup>1</sup>.

### **Investment with Heartland Advisors**

- ***Objective: Guaranteed Annual Return of 20%***

On September 29, 2000, SWIB entered into a "put agreement" with Heartland, a Milwaukee-based mutual fund manager. Under the agreement, SWIB bought \$8.3 million of bonds from Heartland at a significant

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<sup>1</sup> As reported by the Trust Universe Comparison Service (TUCS), a widely accepted performance benchmark in the investment industry



discount. Regardless of their market value, after two years SWIB can sell (or “put”) the bonds back to Heartland for a guaranteed annual return of 20%.

The Opportunity Portfolio made this investment in the Fixed Retirement Fund. By design, this portfolio considers investments with higher risk that offer opportunities for greater returns. The Heartland investment represents less than 0.02% of the assets of the Fixed Fund. It was made in accordance with our normal process for meeting our fiduciary responsibility to the Fixed Fund and its participants.

- ***Heartland Investment Process Followed Investment Guidelines and Ethics Rules***

The Chairman of the Investment Board suggested that Heartland contact the Opportunity Portfolio manager. Because he is also a member of a related, but different, Heartland Board, the Chairman recused himself and did not participate in Board actions on the Heartland investment. Our guidelines provide that:

*“Board members may refer or suggest potential investment opportunities for consideration and evaluation by staff and the Board. The same process and criteria shall be used by staff and the Board in reviewing Board member referrals as is used for other investment opportunities.”*

The portfolio manager recommended that the Heartland investment be made following his assessment of the potential risks and returns, as well as the guarantees that were provided. They include the personal guarantee of Heartland’s president, that was negotiated by the portfolio manager before approval of the deal. I approved this investment for presentation to the Alternative Investments and Real Estate Committee of the Board of Trustees. This committee unanimously approved the portfolio manager’s recommendation.

In response to questions in the media and the Legislature about this investment, on November 22, 2000, I wrote the Senate Co-Chair of the Joint Committee on Audit. I recommended that staff for the Joint Committee on Finance or Joint Committee on Audit conduct an independent review of the transaction, including confidential financial records. SWIB is pleased that your review found no evidence of improper influence in the making of this investment. Your review found “no evidence that direct influence was exerted” in the making of this investment.

- ***Heartland Investment Still Expected to Perform as Anticipated***

There are three levels of protection for SWIB’s investment: (1) the value of the bonds involved in the investment and the collateral underlying those bonds; (2) the total assets of Heartland, which must provide for the payment due SWIB on the “put”; and (3) the personal financial assets of the President of Heartland.

At the time this investment was made, the staff and Board of Trustees concluded that this was sufficient assurance that SWIB will receive the guaranteed 20% return. That continues to be our expectation and the investment is performing satisfactorily. As of June 30, 2001, Heartland Advisors reported \$1.6 billion in total assets under management. It is our judgement that actions that may be taken by the Securities and Exchange Commission and pending shareholder litigation regarding two Heartland bond funds will not impair SWIB’s investment.

## Opportunity Portfolio

- ***Highest Risk Portfolio in the Fixed Retirement Fund: Limited to 2% of the Fund's Assets***

The Opportunity Portfolio was created in 1995 to seek out investments on a global basis with higher longer-term returns than the broader asset mix of the Fixed Fund. To achieve this objective, the portfolio may include investments with higher risk.

SWIB uses a very deliberative process to build the Fixed Fund's allocations to various markets so that they fit together to provide the best risk-adjusted returns over the long-term. The Opportunity Portfolio is one part of a total strategy and should not be viewed outside of its role in the overall investment portfolio. At \$1.1 billion, the Opportunity Portfolio represents 2% of Fixed Retirement Fund assets.

- ***Strategy in Transition: Private Equity Investments Should be Evaluated Over 3 to 5 Years***

In 1999, the Opportunity Portfolio changed managers and adopted a new strategy, moving away from public markets already covered by other SWIB portfolios and toward more private equity investments. Work done by our asset allocation consultant confirmed that private equity is likely to outperform public markets in the future. However, private equity returns are more volatile and it often takes three to five years until a private equity investment shows positive returns.

The current manager's strategy was to concentrate the portfolio with strategic relationships with a small number of outside partners. These relationships should enable SWIB to execute its private equity strategy at much lower costs than other investors who rely more heavily on general partners who manage funds. Even though there would be some increase in internal costs for due diligence, on a \$1 billion private equity portfolio, the strategic partnership strategy could ultimately save over \$100 million over a five-year period in management fees. It is too early to judge the long-term success of this approach.

The portfolio currently has some large private equity investments through strategic partnership arrangements in emerging markets. The potential for economic growth in emerging countries is significant. A number of these markets were hard hit by the 1997 Asian economic crisis. The recovery has been slower than anticipated. However, the Fixed Fund's long-term horizon provides the ability for patient investors to realize longer-term gains. This is similar to the successful strategy we have taken with small company stocks. The opportunistic mandate of the portfolio will likely result in strategy changes as different market inefficiencies develop.

- ***Investments in Korea Hampered by Unexpected Events and Weakness of Korean Economy***

Following the Asian financial crisis of 1997, there were opportunities to acquire viable financial services companies at deep discounts. Korea OnLine (KOL) is a financial services holding company that has been in the process of acquiring and restructuring banks, insurance and securities companies in Korea, with the goal of selling the companies to Western buyers moving into Korea as Korean markets recovered.

SWIB's investment in KOL came about through an existing relationship in a related company (iRegent) in which SWIB purchased publicly traded stock in 1998. Our due diligence at the time indicated that the key investor in iRegent had nearly 20 years of investment management experience and was well-regarded by experts in the emerging market arena.

The Opportunity Portfolio's two investments in KOL total \$110 million. A number of other prominent investors—including Sir John Templeton, Citicorp, Equitable Life, Scudder and Harvard—also evaluated

the opportunity and participated side-by-side with SWIB in the KOL investment or other equity funds managed by the same group that managed KOL. This helped confirm the attractiveness of the investments and further solidified our confidence in the Regent Group.

In addition to our discussions with other experts about our principal partner in KOL, our due diligence on the KOL investments included:

- Two trips to Korea by the Opportunity Portfolio Manager before the first KOL investment was made, eight additional trips to Korea before the second investment was made and three trips since the second investment was made. These trips included meetings with KOL, or broader due diligence on the Korean economy and other Korean companies, and discussions with other investors.
- Six presentations made to the SWIB Trustees since June 1998 by our principal partner regarding KOL and other investment activities with his group.

Based on this work, the portfolio manager recommended, and the Trustees approved, these investments as fitting within the investment guidelines and strategic objectives of the portfolio.

Our KOL investment was valued at \$18.6 million as of September 30, 2001. To date, it has been impaired by: (1) continuing weakness in the Korean economy and surrounding Asian economies; (2) slower than expected reform in the country's regulatory and financial systems; and (3) public accusations of fraudulent conduct by another KOL shareholder, involving KOL and other Korean companies. None of these events were foreseen when SWIB and other prominent investors made their investments.

KOL completed a significant restructuring of its holdings following these events. Its core holdings are two securities companies. Both have new management and a significant retail presence, with 39 branches located in Seoul and around Korea. The Chairman of the Board of Directors of KOL has been in frequent contact with SWIB's portfolio manager regarding these events. Our portfolio manager and the KOL Chairman have made presentations to the Board of Trustees to update them on events and strategies going forward.

Because of the complexity and size of the KOL investment and issues that arose, SWIB took the following steps:

1. In March 2000, I directed our Chief Legal Counsel to determine whether there were any potential ethical conflicts within the reorganized Regent Group, including the KOL holding company. This review identified no such conflicts.
2. In November 2000, I directed that a full-scale audit be undertaken of KOL.
3. In December 2000, at the recommendation of the Director of Internal Audit, the Board's Audit Committee began the process of selecting an outside firm to review the status of the underlying companies within KOL and SWIB's ownership position in each. The final report from Deloitte Touche is expected next week. Our Director of Internal Audit is overseeing this work. Its ongoing progress has been reviewed with the Audit Committee of the Board.
4. In June 2001, we brought in an outside expert on the Korean markets to provide an update on the status of the Korean economy. His view is that progress is occurring and that governmental and financial systems will improve during the next five years.

5. In June 2001, SWIB retained legal counsel to oversee an investigation of any potential legal claims we may have against other parties regarding several of the problems that arose within KOL. This investigation is underway.

- ***Increased Oversight of the Portfolio***

The Board of Trustees annually approves the amount allocated to the Opportunity Portfolio. At least three times a year, the portfolio manager discusses the status of the portfolio with the Board. A number of actions have been taken to strengthen oversight of the portfolio:

1. The Trustees reexamined the role of the portfolio in May 2001. The Board has capped the portfolio at its current size and to its current investment themes to further evaluate how investments perform.
2. A Risk Committee, composed of senior SWIB staff, has had an expanded role in monitoring the status of the Opportunity Portfolio since March 2001. The Portfolio Manager must bring proposed investments to the Risk Committee for review and keep the Committee apprised of the status of existing investments.
3. In March 2001, an assistant portfolio manager with more than 15 years experience in the private equity markets joined the Opportunity Portfolio. This provides significant help in the execution of the portfolio's strategy. Because we have liquidated a number of smaller holdings, the portfolio's three staff members can focus more intensively on the management of fewer, but larger investments.
4. SWIB has retained a leading investment industry consulting firm to examine the strategies and organizational structure for alternative assets defined as private equity (including the Opportunity Portfolio, leveraged buyouts and venture capital) and real estate. This work will consider the viability of the alternative asset class going forward. We expect that this work will be completed by year-end, and we plan to discuss the results as part of our annual strategy and performance report to the Legislature.

### **Ethical Standards for Trustees**

- ***State Requirements***

Trustees of the Investment Board are subject to the requirements of the State Ethics Code under Chapter 19 of the Statutes. The Ethics Code prohibits public officials from taking any official action substantially affecting a matter in which they have a personal financial interest.

Trustees are required to file quarterly and annual ethics statements with the Ethics Board that include information on investment holdings and transactions. By law, these statements are open to inspection by the Legislative Audit Bureau and not to SWIB staff or the public. The Ethics Board is authorized to pursue any concerns about potential violations of these ethics standards.

- ***Additional Ethics Requirements Established by SWIB***

1. Our written procedures officially adopt the State Ethics Code as the standard of conduct. Accordingly, Trustees may not participate in or take any official action which would substantially affect a matter in which a Trustee, member of the Trustee's immediate family, associated organization or client has a substantial economic interest. Our written procedures further encourage Board members "to avoid even the appearance of a conflict or violation."

2. Trustees may refer potential investment opportunities to SWIB, but the same process and criteria must be used in evaluating these referrals as are used for other investment opportunities.
3. In each private transaction, we request written confirmation from SWIB's counterparty that no SWIB Trustee or employee has a personal interest in the transaction or is getting a kickback. This was received on all of the transactions referenced in the Legislative Audit Bureau's report.
4. In October 1999 the Board adopted a new Trustee Travel Policy requiring advance notice to and consent of the Board for any Trustee travel on SWIB business. This was done (in part) to ensure all Trustees were aware of, and could object to, any Trustee going on due diligence trips.
5. New investment guidelines, adopted in March 2001, require that each portfolio manager report to the Board on any referrals or contacts by Trustees with staff on privately negotiated investments (other than status requests).

- ***Potential Conflicts of Interest***

The audit raises a question about a possible conflict of interest that occurred in July 2000, when two Board members voted in favor of an investment in Korea OnLine. Based on its review of quarterly and annual statements that Board members file with the Ethics Board, the LAB concluded that two Board members owned publicly traded stock in a company with a financial interest in KOL. The audit states that whether this represented a conflict of interest or not "is debatable" but that it presents "an appearance of a conflict." SWIB staff has no access to these statements. The Ethics Board has enforcement authority.

Compliance with ethics requirements is of great importance to SWIB. If there are additional steps that SWIB could take to assist the Ethics Board in its enforcement role, such as providing copies of SWIB reports, action items or meeting minutes regarding fund investments, we would be happy to do so. We will contact the Ethics Board in that regard.

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Thank you for the opportunity to respond to your report. During the course of the audit, your staff made every effort to understand the objectives of areas that were the focus of this year's report. Their work was professional and considerate.

As recommended by the LAB, we will be including an updated discussion of these audit topics in our annual strategies and performance report to the Legislature.

Sincerely,

Patricia Lipton  
Executive Director