WISCONSIN LEGISLATIVE AUDIT BUREAU
AUDIT SUMMARY

Report 01-18

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State of Wisconsin Investment Board

The Investment Board manages the assets of the Wisconsin Retirement System, which funds the pensions of more than 470,000 current and former state and local government employees. It also manages the assets of the State Investment Fund and five other state insurance and trust funds. As of December 31, 2000, assets under its management totaled $67.0 billion. The Investment Board's nine-member Board of Trustees is responsible for establishing long-term investment strategies and policies and has delegated day-to-day investment management responsibilities to a professional staff that includes the Executive Director and staff who research, select, buy, and sell domestic and international stocks, bonds, and other investment vehicles that they expect to perform according to the strategies and policies established by the trustees.

At the end of 2000, 81.8 percent of assets under the Investment Board's management were assets of the Wisconsin Retirement System's Fixed Retirement Trust Fund. To evaluate the Investment Board's performance in managing this fund, we compared its returns to the performance benchmarks established by the Investment Board and to the performance of other public pension funds. We focused our analysis on the Investment Board's Opportunity Portfolio in the Fixed Retirement Trust Fund, which is a higher-risk portfolio that has assets of approximately $1 billion.

The Fixed Retirement Trust Fund Has Exceeded Performance Benchmarks

The Fixed Retirement Trust Fund earned double-digit returns for five consecutive years in the late 1990s, but a market downturn in the second half of 2000 had a negative effect that resulted in a loss of 0.8 percent in 2000. The Investment Board continues to exceed its minimum performance goal for the fund, which is an annual average return of 8.0 percent over the long term.

Despite recent losses, the Investment Board also exceeded one-, five-, and ten-year performance bench-mark for the fund in 2000. However, long-term returns continue to lag those of other public pension funds. As of June 30, 2000, the Investment Board's five-year returns ranked last among ten funds we surveyed. Its return was 14.7 percent, compared to a median of 15.9 percent for the funds we surveyed.

The Opportunity Portfolio Is Not Meeting Expectations of Higher Returns

The Opportunity Portfolio was established in 1995 to capitalize on domestic and international investment opportunities that offer the prospect of greater returns but also involve increased risk. Performance has been mixed since the portfolio's inception. The largest dollar gain was realized from a relatively recent investment: shares of Philip Morris stock that were purchased in October 1999 for $45.2 million and sold in April 2001 for $89.9 million, a gain of almost 100 percent. The two largest losses involved Korean investments made in 1999 and 2000 and sold in 2001, including a $91.9 million loss on an investment in a South Korean computer chip maker.

Currently, the Opportunity Portfolio is falling short of its one- and five-year performance bench-mark. Its annualized average return from inception in 1995 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 also significantly lagged its benchmark. In 2000, the portfolio's management costs were approximately $6 million, making it the Investment Board's third most costly internally managed portfolio.

South Korean Investments Have Been Troubled

In the Opportunity Portfolio, the Investment Board has developed strategic partnering relationships that allow it to achieve more direct involvement and ownership in some investments at reduced costs. In 1999, it began a strategic partnering relationship with an investment management company that is currently known as iRegent, 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. A number of problems have plagued these companies since they were acquired, and based on these events, the Investment Board estimates the value of its investments in KOL was $15.9 million as of June 30, 2001. 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. The Investment Board has recently hired a New York law firm and forensic auditors to review the KOL investments.

Increased Oversight Is Needed to Prevent Potential Conflicts of Interest

A controversial investment of the Opportunity Portfolio has been the Investment Board's purchase of $8.3 million of distressed bonds from the Wisconsin-based Heartland Advisors, Inc., two weeks before Heartland repriced many of its bonds significantly lower than prices that had been carried on its books. Concerns have been raised about the relationship between Heartland and the chair of the Investment Board's Board of Trustees, who is also a member of a related Heartland board, and about his role in the transaction. Whether the trustee influenced the investment 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 did not affect their decision on the investment.

Three current trustees and two former trustees have owned public stock in iRegent, the Investment Board's strategic partner in KOL. In most cases, 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 vote to invest $80.0 million in the joint venture with KOL. Whether this instance represents a conflict of interest under the State Ethics Code is debatable. However the vote, at a minimum, presents an appearance of a conflict that the trustees should have taken steps to avoid.

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