oppaga

Program Review

June 2002 **Report No. 02-37**

While State Board of Administration Investments Perform Relatively Well, the SBA Should Reassess Planned Expansion of Alternative Investments

at a glance

The Florida State Board of Administration's (SBA) overall performance in investing Florida Retirement System assets exceeded its objective over long-term periods covering the last 20 years. However, it did not meet its investment objective in Fiscal Year 2000-01, primarily as a result of declines in the domestic and international stock markets. Its allocation of assets to various asset classes was within the ranges established in its long-term investment plan.

The investment returns for most of the SBA's asset classes (domestic and international equities, fixed income, cash equivalents) exceeded or were close to their performance benchmarks. However, the alternative investment asset class, which consists of private equity portfolios and a venture capital portfolio, significantly under-performed its benchmark. Due to concerns regarding lower than expected performance and high management costs, the SBA should reassess its plan to expand the use of alternative investments in the future.

The SBA experienced a realized loss of $281 million due to investments in Enron stock by one external active style domestic equity investment manager, Alliance Capital. It recently selected law firms to represent it in litigation against this company. The Florida Attorney General's Office is also investigating Alliance Capital and its investment decisions relating to investing in Enron stock. It is OPPAGA's general policy to not directly comment on or make recommendations regarding matters that are subject to civil litigation or active criminal investigations. However, we will report on the outcome of these actions in future reports.

Purpose

Florida law requires a performance audit be made of the Florida State Board of Administration's (SBA) management of investments every two years. [1,2] This review examines the SBA's performance in achieving overall and asset class return rate objectives for investing Florida Retirement System assets in Fiscal Years 1999-00 and 2000-01.

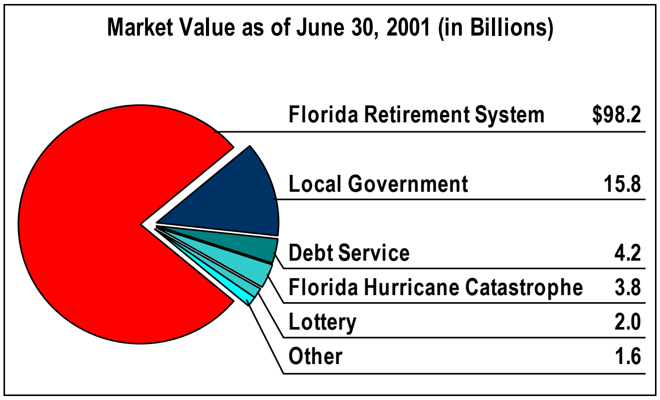
Background

The SBA is a constitutional board charged by law with investing certain assets of both the state and local governments. As shown in Exhibit 1, one of the SBA's major responsibilities is investing Florida Retirement System assets, which had a market value of $98.2 billion as of June 30, 2001, and a market value of $94.2 billion as of January 31, 2002.

[1] Section 215.44(6), *Florida Statutes*.

[2] In accordance with state law, OPPAGA informs the Legislature of actions taken in response to earlier reports on state programs. This report includes our assessment of the extent to which the findings and recommendations included in our 2000 report, *Investment of Florida Retirement System Assets Meets Goals, But Earnings Could Be Increased*, OPPAGA Report No. 99-52, May 2000, have been addressed by the State Board of Administration.

Exhibit 1
The SBA Invested $ 125.6 Billion in Florida State and Local Government Funds as of June 30, 2001



Source: State Board of Administration's data.

The SBA does not receive legislative appropriations of general revenue or trust funds to support its activities. Instead, the board funds its operations by charging fees for its investment management services. The SBA's administrative expenses are paid from these fees. In Fiscal Year 2000-01, the SBA's internal administrative expenses totaled $20.1 million. It also paid external investment managers $139.4 million during this year. The SBA's operating budget for Fiscal Year 2001-02 was $23 million.

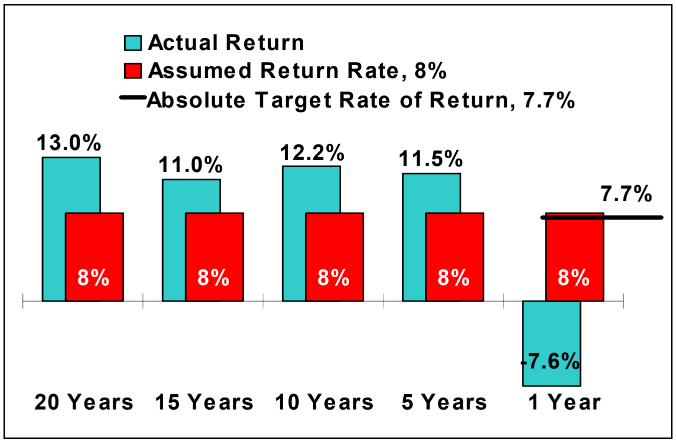
Findings

The SBA has generally performed well in investing FRS assets over the long term

The SBA has generally performed well in investing FRS assets over the long-term.

- As shown in Exhibit 2, the SBA's return rate for investing FRS assets exceeded its rate of return objective over 20-, 15-, 10-, and 5-year periods. [3] However, it under-performed its investment objective in Fiscal Year 2000-01, primarily as a result of declines in the domestic and international equity markets.[4] The SBA had approximately 55% of the system's assets invested in domestic equities and 11% in international equities as of June 30, 2001, respectively.
- As shown in Exhibit 3, other comparable large public pension plans experienced losses of a similar magnitude during the year ending June 30, 2001. These losses were also primarily due to these funds investing a large percentage of their assets in domestic and international equities. [5]
- The SBA's investment returns for certain asset classes (domestic and international equities, fixed income, cash equivalents) exceeded or were close to performance targets over one-year to five-year periods.

Exhibit 2
SBA Performance Exceeded Its Objective for Long-Term Periods up to 20 Years, But Not for Fiscal Year 2000-01



Source: SBA 2000-2001 Investment Report, State Street Analytics data, and OPPAGA analyses.

[3] Prior to April 2000, the SBA's objective in investing Florida Retirement System (FRS) assets was to achieve the actuarial assumed return rate on a long-term basis. The assumed rate of return used by the Department of Management Services' consulting actuary in valuing the system's pension liabilities is 8.0%. The SBA needed to meet this return rate over the long term in order to generate sufficient funds to pay future pension liabilities when due. In April 2000, the SBA changed the long-term investment objective from achieving the actuarial rate of return to an absolute real target rate of return of 4.3% over the rate of inflation. The SBA used the U. S. Department of Labor Consumer Price Index of 3.2% compounded to represent the inflation rate for Fiscal Year 2000-01, which, when added to 4.3%, resulted in an investment objective of 7.7%.

[4] During the period from July 1, 2000, to June 30, 2001, the return rate for the Wilshire 2500 Index (excluding tobacco stocks) was -15.6% and the return rate for the MSCI All Country World Ex-U.S. Free Index was -24.1%. The Wilshire 2500 Stock Index 2500 Universe consists of the 2,500 largest common stocks by market capitalization in the Wilshire 5000 Index. The SBA was prohibited from investing in the stocks of tobacco companies from June 1997 through June 2001. The MSCI All Country World Free index represents both developed and emerging markets around the world and reflects investable opportunities and takes into account local market restrictions on share ownership by foreigners. The SBA has used this index to evaluate the performance of its international equity investments since November 1999.

[5] Caution should be exercised in comparing the SBA's performance and asset allocation to other public funds of comparable size. Other public funds have different asset mixes, asset classes allocations, investment styles, risk levels, and restrictions on allowable investments.

Exhibit 3
Other Large Public Pension Plans Experienced Negative Investment Returns in Fiscal Year 2000-01[1]

Fund	Overall Rate of Return				Market Value of Assets
	10 Years	5 Years	3 Years	1 Year	(in $ Billions) June 30, 2001
California Public Employees Retirement System	11.4%	10.6%	4.9%	-7.2%	$156.100
California State Teachers Retirement System	10.6%	9.8%	5.1%	-9.1%	102.808
New York State Teachers Retirement System	12.2%	11.2%	4.7%	-5.7%	81.013
Teacher Retirement System of Texas	11.8%	11%	4.7%	-5.0%	78.731[2]
Florida State Board of Administration	**12.2%**	**11.5%**	**5.2%**	**-7.6%**	**98.207**

[1] The exhibit does not include the New York State Common Retirement System. We did not include this fund because investment performance data as of June 30, 2001, was not readily available. The market value of assets for the New York State Common Retirement System was $112.535 billion as of March 31, 2001.

[2] For years ending June 30, except Teacher Retirement System of Texas whose fiscal year ends as of August 31.

Source: Annual Investment reports and documents published by the California Public Employees Retirement System, California State Teachers Retirement System, New York State Teachers Retirement System, Teacher Retirement System of Texas, and the Florida State Board of Administration.

Exhibit 4
SBA Investment Returns for Most Asset Classes Were Slightly Higher or Close to Target Indexes Over the Last Five Years

Asset Class Performance and Current Target	Annualized Rates of Return		
	5 Years (1996-01)	3 Years (1998-01)	1 Year (2000-01)
Domestic Equities Actual	*13.8%*	*4.1%*	*-14.2%*
Target: Wilshire 2500 (excluding tobacco stocks) [1]	13.5 %	3.6%	-15.6 %
International Equities Actual	*4.1%*	*1.6%*	*-20.7%*
Target: MSCI All Country World Ex – U.S. Free Index [2]	2.1%	-0.4%	-24.1%
Fixed Income Actual	*7.6%*	*5.4%*	*10.9%*
Target: Lehman Brothers U. S. Aggregate Bond Index [3]	7.6%	5.5%	10.8%
Cash and Central Custody Actual	*5.9%*	*6.0%*	*6.1%*
Target: 90-Day Treasury Bill Rate	5.3%	5.4%	5.6 %

[1] The Domestic Equities target was the Wilshire 2500 from October 1994 to May 1997 and from June 1997 to June 2001, it is the Wilshire 2500 excluding tobacco stocks.

[2] The International Equities target was a mix of 85% EAFE and 15% IFCI (50% weighted in Malaysia) from April 1995 to October 1999 and MSCI All Country World Ex-U.S. Free Index.

[3] The Fixed Income target was the Florida Extended Duration Index (FEDEX) until August 1997, and from August 1997 to June 1999 it was the Florida High Yield Extended Duration Index (HYFEX), which equals 95% FEDEX and 5% Merrill Lynch B- and BB-Rated Bond Index. From July 1999 to the present the target is the Fixed Income Management Aggregate (FIMA), a market-weighted representation of the broad investment grade market and the upper tiers of the high yield market. The two main components are Lehman Bros. Aggregate Bond Index and the Merrill Lynch B- and BB-Rated Bond Index.

Source: SBA's and State Street Analytics data, and OPPAGA analyses.

Alternative Investments Under-Perform Benchmarks

The SBA's alternative investments primarily consist of private equity investments in domestic and international companies through limited partnerships that are externally managed by general partners. As of June 30, 2001, the SBA's alternative investments consisted of 23 portfolios and a cash account with a total estimated market value of $3.514 billion. The SBA current objective for these investments is to achieve a long-term return equal to the return for the broad domestic equity market index plus 600 basis points. The original benchmark for private equities portfolios was established on May 23, 1997, as the domestic equity asset class target plus 750 basis points, evaluated over a 10-year period.

One of the SBA's alternative investment portfolios, the Cypress Equity Fund, is a venture capital fund that was intended to facilitate initial venture capital investments by Florida private financial institutions and institutional investors, and provide a means to encourage national venture capital managers to consider investment opportunities in Florida. The fund's investments could be made in companies located anywhere in the United States and were not targeted to in-state companies. In a 1998 report, OPPAGA concluded that the Cypress Equity Fund achieved its limited goal of initiating venture capital investments by state institutional investors and banks. However, due to the fund's design, it had not contributed to the achievement of its more important goal of improving Florida businesses' access to venture capital. [6]

We have concerns about SBA's alternative investments.

- SBA reports indicate that the portfolios in the asset class collectively under-performed their benchmarks since their inception (13.1% versus 16.5%, respectively). The SBA does not report returns for shorter periods because it believes that alternative investment strategies are long-term in nature.

  It should be noted that the SBA's reported performance for alternative investments internal rates of return based on unverified information and estimates of market values provided by the external portfolio managers. [7] The use of an internal rate of return to assess the performance of such investments is an accepted investment management practice. However, the SBA will not know the actual returns for such investments until the investments are closed out in the future.

  To date, only one of the SBA's alternative investment portfolios, Corporate Advisors, L.P., has been closed out and its actual return was significantly lower than its benchmark. The SBA entered into a contract with Corporate Advisors, L.P., in January 1989 and the portfolio closed in June 2000. Corporate Advisors' investment strategy was to seek returns by engaging in friendly takeovers of companies and leveraged buy-outs. The internal rate of return for this closed-out portfolio for the period from its inception to its closeout was 12.2%, which was significantly below its benchmark of 22.7%.

- Alternative investments have high management fees compared to other types of investments.

  In Fiscal Year 2000-01, the SBA paid alternative investment managers $43.9 million to invest $3.5 billion in assets. In comparison, it paid its active style domestic equity managers $46.7 million to invest $19.1 billion in assets. [8]

- The SBA does not have current plans and policies and procedures in place to guide the use of alternative investments. A report by the Florida Auditor General issued in September 2001 noted that the SBA planning documents and policies and procedures relating to alternative investments were either out-of-date or under development more that a year and a half after the creation of the asset class. [9] The SBA needs to have such plans and policies and procedures to effectively manage the use of such investments and assess their performance. The SBA indicates that it expects to complete developing a strategic plan, annual plan, and policies and procedures for alternative investments by October 2002.

Because of these concerns, we believe the SBA should reassess its plans to expand the use of alternative investments. The SBA amended its long-term investment plan in March 2001 to increase the percentage of Florida Retirement System assets that could be invested in the alternative investment asset class from 4% to 6%. The SBA needs to consider whether the expected returns from these investments are sufficient to compensate for their risks and high management costs.

The SBA also needs to review its practice of only reporting the performance of alternative investments since their inception against a benchmark rather than on a shorter-term basis. Like the SBA, the California Public Employees' Retirement System (CALPERS) assesses the long-term performance of its alternative investments against a benchmark for a long–term period consistent with the anticipated average term of the investments and the expected average holding period for direct investments. [10] However, CALPERS also compares its short-term performance against a

[6] Review of The Enterprise Florida, Inc., Capital Development Board's Cypress Equity Fund, OPPAGA Report No. 98-33, December 1998.

[7] The internal rate of return is defined, as the rate of return that would make the present value of future cash flows from an investment plus the final market value of the investment equal the investment's current market price.

[8] Active style managers select stocks based on various strategies with the goal of exceeding the performance of a market index.

[9] *External Manager Selection and Alternative Investments Management, Florida State Board of Administration Operational Audit.* Auditor General Report No. 02-043, September 2001.

[10] CALPERS evaluates the long-term performance of its alternative investments based on a 10-year rolling average for the total return of the CALPERS Wilshire 2500 Index plus a 500-basis point risk premium

benchmark appropriate to immature partnership investments. It also reports an overall return rate for its alternative investments for 10-, 5-, 3-, and 1-year periods. The SBA does not report its Alternative Investment performance against a benchmark for these time periods. In our opinion, the SBA should report such data to provide decision makers with more ongoing information regarding the performance of alternative investments and to help provide early warnings on potential performance problems.

Long-term trend of passive style domestic equity managers outperforming active style managers reversed in Fiscal Years 1999-00 and 2000-01

The SBA uses a combination of passive and active style managers to invest its domestic equities funds. Passive style managers typically buy and hold selected securities with the goal of achieving rather than exceeding the performance of a group or sector of stocks. In contrast, active style managers select stocks based on various strategies with the goal of exceeding the performance of a market index.

Passive style managers engage in minimal trading activity and incur lower transaction costs and charge lower management fees than active style investment managers. Research has shown that it is difficult for active style managers to achieve higher rates of returns than passive style managers over long periods of time.

Prior OPPAGA reports concluded that the SBA would achieved higher returns at less cost if it made more extensive use of passive style managers to invest its domestic equity assets. For example, we estimated the SBA could have earned an additional $612 million after deduction of management fees during Fiscal Year 1996-97 if it had used passive style managers to invest 100% of its domestic equity funds instead of its actual allocation of 59.8%.[11] We also estimated that the SBA would have earned an additional $400.2 million after deduction of management fees in Fiscal Year 1998-99 if it had used passive style managers to invest 80% of its domestic equity funds instead of its actual allocation of 59%.[12]

However, in Fiscal Years 1999-00 and 2000-01, active managers outperformed passive managers (see Exhibit 6).

Exhibit 6
Performance of Domestic Equities Managers Grouped by Style

Investment Style	Fiscal Year 1999-00	Fiscal Year 2000-01
All Active	12.00%	-12.70%
All Passive	9.60%	-15.00%

Source: SBA's 1999-01 Investment Reports.

SBA actions may have affected the change.

- During the period from July to November 1999, the SBA terminated its contracts with several external active domestic equity managers that had under-performed their benchmarks for five-year periods. This action was consistent with comments in an OPPAGA report issued in May 2000 that noted the SBA had seven external active style managers and one internal active style manager that had not met their respective performance benchmarks on an annualized basis over the past five fiscal years. As of June 30, 1999, these eight managers were responsible for investing assets with a June 30, 1999, market value of $9.165 billion, or 38.7% of the SBA's domestic equity assets under active management. The SBA terminated contracts for six of the seven external managers we identified as having performance problems over a five-year period. It also eliminated the internally managed portfolio we identified as having under-performed its benchmarks for a five-year period.
- The SBA improved its systems for monitoring the performance of domestic equity portfolio manager's performance. SBA staff develops monthly reports that assess each managers' performance using various investment returns and risk measures to determine if a manager is adding value from its active management style.
- In November 1999, the SBA transferred 14 external actively managed private equity portfolios and a private equity cash account from the Domestic Equity Asset Class to the newly created Alternative Investment Asset Class. These portfolios, which had a total estimated market value of $2.7 billion at the time of their transfer,

[11] *Oversight Report on the State Board of Administration's 1996-97 Investment Report,* OPPAGA Report No. 98-10, August 1998.

[12] *Investment of Florida Retirement System Assets Meets Goals, But Earnings Could Be Increased,* OPPAGA Report No. 99-52, May 2000.

> had a lower estimated return rate than the remaining domestic equity portfolios. We estimate that transferring the private equity portfolios increased the return rate for domestic equities from 7 to 92 basis points per year for the five-year period, July 1994 to June 1999, with an average increase of 37 basis points for the period.

The SBA should monitor the mix of its domestic equities internal and external investment managers to determine if active managers continue to add value in terms of returns relative to risk and if the results of the last two years continue in the future.

The SBA realized a loss of $281 million due to investments in Enron stock by one external active style domestic equity investment manager. The SBA recently selected law firms to represent it in litigation against this company.

The SBA reported it experienced a $321 million realized loss in market value due to investments in the publicly traded stock of Enron, which filed for bankruptcy on December 2, 2001. This loss was primarily due to investments made by one active style domestic equity manager, Alliance Capital, which accounted for $281 million of the total loss. The SBA initially contracted with Alliance Capital in 1984. Alliance Capital purchased Enron stocks from November 2000 through November 2001.

The SBA terminated its contract with Alliance Capital on December 13, 2001. At that time, the market value of SBA assets invested with Alliance Capital was $3.569 billion.

On May 7, 2002, the Governor, the Treasurer, and the Comptroller sitting as the trustees of the SBA approved a lawsuit against Alliance Capital. The Florida Attorney General's Office has also been investigating Alliance Capital and its decisions to invest in Enron stock. In January 2002, the Attorney General's Office issued subpoenas under the Racketeer Influenced and Corrupt Organization Act demanding that Alliance Capital provide it with information on its investment decisions.

It is OPPAGA's general policy to not directly comment on or make recommendations regarding matters that are subject to active criminal investigations or civil litigation. However, we will report on the outcome of these actions in future reports.

Conclusions and Recommendations

The SBA has generally performed well in investing Florida Retirement System assets over the long-term. Return rates for stocks, bonds, and cash equivalents exceeded or were close to performance benchmarks over the last 20 years.

However, we are concerned about the SBA's alternative investment asset class. The alternative investment asset class is significantly under-performing its benchmark and these types of investments have relatively high management fees. The SBA has also not completed developing policies and procedures to guide the use of such investments. Given these concerns, we recommend the SBA reassess its plans to expand the use of alternative investments in the future. The SBA needs to consider whether the returns from these investments are sufficient to compensate for their risks and high management costs.

We also recommend that the SBA modify its practice of only reporting the performance of alternative investments against a benchmark since inception. Instead, the SBA should adopt practices similar to those used by the California Public Employees' Retirement System in which alternative investment performance is assessed and reported against a benchmark for both long- and short-term periods.

Prior OPPAGA reports concluded that the SBA could achieve additional earnings, reduce external management fees, and reduce brokerage commissions by increasing the percentage of its domestic equity assets invested by passive style managers. However, active managers outperformed passive managers over the last two fiscal years. We recommend that the SBA monitor its mix of internal and external passive and active style investment managers to determine if active managers continue to add value in terms of returns relative to risk and if the results of the last two years continues in the future.

STATE BOARD OF ADMINISTRATION OF FLORIDA

Post Office Box 13300
32317-3300
1801 Hermitage Boulevard-Suite 100
Tallahassee, Florida 32308
(850) 488-4406

June 14, 2002

Mr. John Turcotte, Director
Office of Program Policy Analysis and
Governmental Accountability
111 West Madison Street
Claude Pepper Building, Room 312
Tallahassee, FL 32301

Dear Mr. Turcotte:

In accordance with Section 11.45(7)(d), Florida Statutes, the State Board of Administration (SBA) submits the following written response to the preliminary findings and recommendations contained in the Program Review of the 1999-00 and 2000-01 Investment of Florida Retirement System assets:

Recommendation #1: The SBA reassess its plan to expand the use of alternative investments in the future. The SBA needs to consider whether the returns from these investments are sufficient to compensate for their risks and high management costs.

Response: The SBA continually reviews all its asset classes with regards to their appropriateness to the overall board investment plan and the private equity program is deemed a valuable long-term component of the total fund. Certain factors specific to private equity investments make the program's interim performance difficult to properly evaluate. A large number of investments in the portfolio are held at cost and potentially undervalued. This conservative valuation methodology, coupled with private equity investment's unique cash flow characteristics, artificially depresses returns in a young program. Additionally, the SBA' s private equity program was largely established in 1998, at the peak of the private equity pricing market. Consistent with the SBA's bias against attempting to time market movements, the SBA intends to continue to properly develop and diversify the private equity program and to take advance of the current more favorable pricing environment to lower its average cost of investment. As the program matures, the SBA' s consultants are confident that it will contribute significant value to the total fund performance and provide a return that adequately compensates for the risk and fees associated with the program. Next year, the SBA intends to conduct a total fund asset allocation study at which time the SBA will evaluate, among other things, the role of the Alternative Investment asset class. The SBA does not intend to expand the asset class prior to this review from its current target asset allocation.

Recommendation #2: The SBA modify its practice of only reporting the performance of alternative investments against a benchmark since inception.

Response: The SBA is pleased to expand its reporting on investment performance for the Alternative Investments Asset Class. In future editions of the Annual Investment Report we will include the full performance record for closed buy-out portfolios. In addition, we will provide vintage-based performance comparisons for all of open alternative investment portfolios to provide reasonable indications of performance over shorter periods.

Recommendation #3: The SBA monitor its mix of internal and external passive and active style investment managers to determine if active managers continue to add value in terms of returns relative to risk and if the results of the last two years continue in the future.

Response: We will continue the practice of monitoring our internal and external passive and active style domestic equity investment managers. In addition, we are instituting a risk budgeting process which is designed to minimize the likelihood that actively managed portfolios fail to provide an adequate long-term return.

Please feel free to contact Gwenn Thomas, Chief Financial Officer, at 488-4406 if you have any questions or require further information. As always, we appreciate your diligence and assistance.

Sincerely,

/s/
Tom Herndon

ks/TH

OPPAGA provides objective, independent, professional analyses of state policies and services to assist the Florida Legislature in decision making, to ensure government accountability, and to recommend the best use of public resources. This project was conducted in accordance with applicable evaluation standards. Copies of this report in print or alternate accessible format may be obtained by telephone (850/488-0021 or 800/531-2477), by FAX (850/487-3804), in person, or by mail (OPPAGA Report Production, Claude Pepper Building, Room 312, 111 W. Madison St., Tallahassee, FL 32399-1475).

Florida Monitor: http://www.oppaga.state.fl.us/

Project supervised by Tom Roth (850/488-1024)
Project conducted by A.B. Verhine (850/487-9276)
John W. Turcotte, OPPAGA Director