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OFFICE OF PROGRAM POLICY ANALYSIS & GOVERNMENT ACCOUNTABILITY

November 2006 **Report No. 06-68**

Use of Investment Returns Has Increased; Plan for Addressing Associated Risks Should Be Documented

at a glance

The SBA has generally performed well in achieving its investment objective for FRS pension plan assets. However, as the system has matured, it would be beneficial for the SBA to provide the Legislature with more information to assist in budget planning. We recommend that the

- **state's long-range financial outlook include projections of contributions to the pension plan;**
- **SBA better document its approach to control short-term volatility of investment returns; and**
- **SBA report the results of 2006 statutory changes increasing its flexibility in making alternative investments.**

Scope

Florida law requires a performance audit be made of the State Board of Administration's management of investment every two years. [1, 2] This review examines the SBA's activities in Fiscal Years 2003-04 and 2004-05.

Background

The State Board of Administration (SBA) is a constitutional board charged by law with investing certain assets of both the state and local governments. [3] The SBA is responsible for managing 25 funds that had a total net asset value of approximately $140 billion at the end of Fiscal Year 2004-05. The board's operational and administrative expenses are entirely funded through fees for its investment management services, which in Fiscal Year 2004-05 totaled $23 million. The SBA also paid external investment managers approximately $197 million for management services and brokerage commissions during this period.

The Florida Retirement System (FRS) is the largest fund managed by the SBA. At the end of Fiscal Year 2004-05, the FRS pension plan had a net asset value of almost $110 billion, and served 598,063 active members and 236,681 annuitants. [4]

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[1] As specified in s. 215.44(6), *F.S.*

[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 SBA has addressed the findings and recommendations included in our 2004 report, *Multi-Year Projections of Retirement System Funding Should Be Provided to the Legislature*, Report No. 04-70, October 2004.

[3] The SBA is composed of the Governor, the Chief Financial Officer, and the Attorney General.

[4] Florida Retirement System members may join one of two retirement benefit options—the pension plan or the investment plan. The FRS pension plan is a defined benefit plan, meaning that employer contributions to employees' retirement benefits are invested by the employer. The employer guarantees a certain level of benefit payment and bears the risk that investment returns will not support that level of benefits. Participants' retirement benefits are based upon a formula taking into account factors such as their salary levels, years of service, compensation, and FRS membership class.

The SBA provides investment management of available assets on behalf of the FRS, while the Division of Retirement, as the administrative agency for the FRS, is responsible for administering pension benefits and contributions, commissioning actuarial studies, and proposing rules and regulations for the FRS. The Legislature has the responsibility of setting contribution and benefit levels and providing statutory guidance for FRS.

The investment objective of the FRS is to provide investment returns sufficient for the pension plan to be maintained in a manner that ensures the timely payment of promised benefits to current and future participants and keeps the plan cost at a reasonable level. The SBA establishes investment guidelines such as target allocation of various asset classes for utilization in the management of the fund's available assets. [5] These investment guidelines are outlined in the current FRS Defined Benefit Investment Policy Statement, which was last modified on August 12, 2003.

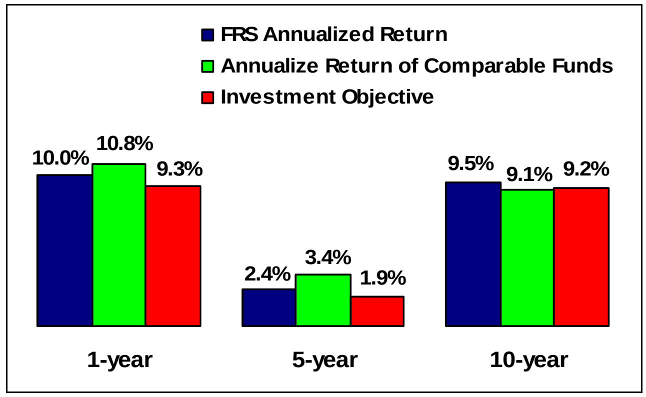
Findings

The SBA continues generally to perform well in achieving its investment objective

The SBA generally has performed well in achieving its investment objective for FRS pension plan assets. The primary objective for the plan is to ensure that the system has adequate funds to cover payment of retirement benefits over the life of the plan. To achieve this goal, the SBA has established a long-term investment objective of achieving a rate of annual return of 4% over the rate of inflation. [6]

As shown in Exhibit 1, the SBA's return rate for investing FRS pension plan assets exceeded its 1-, 5-, and 10-year rate of return objective for the period ending June 30, 2005. The exhibit also shows that the investments of FRS pension plan assets exceeded the median return of comparable funds over the 10-year period, but trailed over the 1- and 5-year period ending June 30, 2005. [7]

Exhibit 1
The SBA's 10-Year Returns Exceeded Its Investment Objective and Outperformed Comparable Funds [1]



[1] The Investment Objective is equal to the contemporaneous rate of inflation plus 4%. Annualized returns are for periods ending June 30, 2005.

Source: *Ennis Knupp Second Quarter 2005 Investment Review of the Florida Retirement System* and OPPAGA analysis.

The SBA's performance is primarily attributable to its asset allocation strategy. As shown in Exhibit 2, the current SBA investment guidelines allocate a greater percentage of assets to equities and real estate and a lower percentage to fixed income assets, such as bonds and money markets, than the average allocation of comparable pension funds. Consequently, during periods when equity markets are performing well, the FRS investment performance exceeds it objectives and the investment performance of comparable funds with lower allocations of equities.

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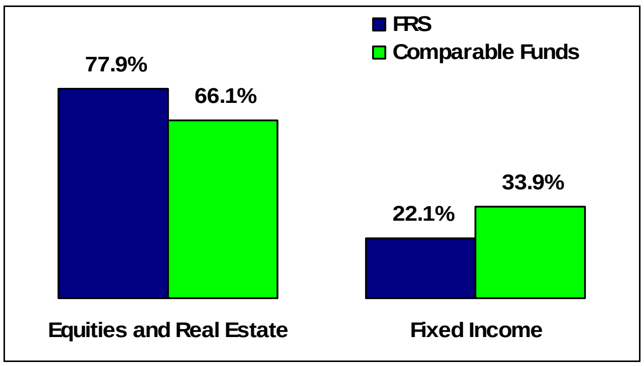
[5] Asset classes represent groups of individual securities that have common economic and legal characteristics.

[6] Prior to April 2000, the SBA's objective in investing Florida Retirement System 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%. The SBA determined it 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. In August 2003, the SBA reduced its target rate of return to 4% (compounded and net of investment expenses) over the rate of inflation.

[7] The investment returns of comparable funds are based on the median return of the Trust Universe Comparison Service of Large Funds. These funds consist of 39 fund sponsors with an average fund size of $39.9 billion.

While an increased allocation of assets to equities and real estate increases the expected long-term rate of return of the fund, it also serves to increase the short-term risk of significant investment losses. For example, the SBA reported that there was a 10% probability that under the current allocation of assets, the fund would lose more than 11% of its value in the next year.

Exhibit 2
FRS Asset Allocation Is Expected to Produce a Higher Return, But Has More Risk Than Comparable Funds



Source: *Ennis Knupp 4th Quarter 2003 Investment Review of the Florida Retirement System* and OPPAGA analysis. Information is as of June 30, 2005.

Status of Prior Findings

Our 2004 report noted that the FRS pension plan has matured to the point where annual benefit payments exceed employer contributions. Under the plan, retiree benefit payments and management expenses are funded through a combination of employer contributions and returns from investments. However, in recent years the pension plan has matured as the number of retirees has increased, and employer contributions no longer exceed annual retiree benefits. This trend is expected to continue. As a result, the pension plan will have to rely more heavily on investment returns to fund benefit payments in the future.

We recommended several options to help ensure that the plan continues to have sufficient funds available to pay benefits and to address concerns about the returns of the SBA's alternative investment asset class.

- The Florida Retirement System Actuarial Assumption Conference should provide an analysis of the plan's future funding requirements for the next three to five years.
- The State Board of Administration should better describe its approach for controlling short-term volatility in investment returns in its FRS Investment Plan.
- The SBA should consider whether returns from the alternative investment asset class are sufficient to compensate for their risk.

Although steps have been taken to address each of these options, none has been fully implemented.

Long-range financial outlooks can be used to provide the Legislature information about the sufficiency of pension plan funds

Our 2004 report recommended that the Florida Retirement System Actuarial Assumption Conference provide an analysis of the plan's future funding requirements for the next three to five years. This would assist the Legislature in its budget planning and help ensure that the FRS pension plan continues to have sufficient funds to cover benefit payments.

While this recommendation has not been implemented, it is consistent with the requirements of the recently passed constitutional amendment that directs the state to strengthen its long-term financial planning. In November 2006, voters approved an amendment to the constitution that requires the state to develop long-range financial outlooks. [8] These long-range financial outlooks are intended to provide an overview of the state's fiscal position that integrates funding projections of major programs with estimates of revenue collections. The financial outlooks, as developed by the Joint Legislative Budget Commission, will also include fiscal strategies that each state agency is required

[8] Amendment to Section 19 of Article III of the constitution as specified in Committee Substitute for Senate Joint Resolution 2144.

to use in the development of its annual legislative budget request.

To help ensure that the Legislature is provided the information necessary for budget planning and that the FRS pension plan continues to have sufficient funds to cover benefit payments, we recommend that the long-range financial outlook include projections of contributions to the pension plan. This information will enhance budgetary planning for the state and participating local governments by providing greater certainty regarding the FRS pension plan's funding requirements. The SBA may also find this information useful in developing its investment strategies.

Approach for controlling short-term volatility in investment returns has not been documented

Our 2004 report noted that the SBA's investment strategy emphasizes maximizing long-term returns to minimize long-term funding needs and risks. With increasing reliance on investment returns to fund pension benefit obligations, the board's ability to achieve its objective is more likely to be affected by short-term investment volatility. However, the SBA has not yet implemented our recommendation to update its investment plan to document its approach to control the short-term volatility risks associated with the increased use of investment returns.

In Fiscal Year 2004-05, transfers out of the pension plan exceeded employer contributions by nearly $3 billion. Of this amount, approximately $731 million was transferred to investment plan accounts due to employees exercising their one-time option to transfer plans. [9] Use of investment returns to fund benefit payments and payouts associated with the employee transfers from the pension plan to the investment plan increases risks associated with the short-term volatility of investment returns.

The SBA reported that its current investment strategy emphasizes maximizing long-term returns to minimize long-term funding needs and risks. Current requirements to fund benefits and transfers to the investment plan with investment returns are managed through incidental income flows and asset liquidations.

We continue to believe that the SBA should update its FRS Defined Benefit Investment Policy Statement to describe more fully its approach to controlling the increased short-term volatility risks associated with the use of investment returns to fund pension plan benefits and transfers to investment plan accounts. Increased disclosure within the plan document would better inform the Legislature and other state policymakers about the SBA's strategies for balancing short- and long-term investment risks.

Alternative investments continue to fail to achieve objectives, performance should continue to be monitored

Our previous reviews noted that SBA's alternative investments have not met their investment objective. [10] This issue becomes more salient given recent legislation that will allow SBA to access better investment opportunities in this asset class.

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. [11] As of June 30, 2005, the SBA's alternative investments had a total estimated market value of $3.5 billion, representing 3.2% of the total pension plan assets. Private equities are illiquid investments because they generally require a 7- to 10-year commitment of funds to realize the expected investment return. In addition, the reported returns are based primarily on valuations by the SBA and are difficult to verify because the

[9] As specified in s. 121.4501, *F.S.*

[10] *While State Board of Administration Investments Perform Relatively Well, the SBA Should Reassess Planned Expansion of Alternative Investments*, Report No. 02-37, June 2002 and *Multi-Year Projections of Retirement System Funding Should Be Provided to the Legislature*, Report No. 04-70, October 2004.

[11] Private equity is non-debt capital raised by companies not listed on securities exchanges for starting a business, restructuring an existing business, or financing a buyout or acquisition. These private equity investments are typically in the form of leveraged buyouts.

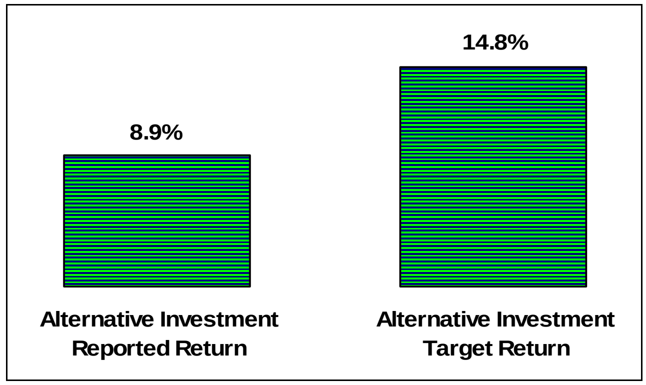
majority of the investments are not publicly traded.

In Fiscal Year 2004-05, the alternative investment asset class continued to underperform its investment objective. [12] As shown in Exhibit 3, the reported 10-year annualized return for alternative investments has been significantly lower than its investment return objective. The SBA reported that it is being very selective in its use of alternative investments, as evidenced by its current allocation, which is well below the target allocation of 5% for this asset class. [13]

In response to an SBA initiative, the 2006 Legislature authorized an exemption from the public records law for certain sensitive and proprietary information relating to alternative investment strategies and operations. [14] The SBA believes that this exemption will allow for greater access to private equity managers, thus allowing for consideration and selection of managers with the best performance history.

Given the underperformance of alternative investments, we recommend that the SBA report the results of 2006 statutory changes to the Legislature. Our future reports will continue to monitor this investment class to determine whether the recent statutory changes help produce returns that meet investment objectives.

Exhibit 3
The Reported 10-Year Annualized Returns for the Alternative Investment Class Has Not Achieved Its Investment Objective [1]



[1] The alternative investment target return is the domestic equity 10-year target rate of return plus 450 basis points. A basis point represents 0.01% interest rate.

Source: *Ennis Knupp 4th Quarter 2003 Investment Review of the Florida Retirement System* and OPPAGA analysis. Information is as of June 30, 2005.

Agency Response

In accordance with the provisions of s. 11.51(6), *Florida Statutes,* a draft of our report was submitted to the executive director of the State Board of Administration for review and response. The executive director's written response is included in Appendix A.

[12] The alternative investment target return is the domestic equity 10-year target rate of return plus 450 basis points. A basis point represents 0.01% interest rate.

[13] As detailed in the SBA's FRS Defined Benefit Investment Policy Statement.

[14] Chapter 2006-163, *Laws of Florida.*

OPPAGA supports the Florida Legislature by providing evaluative research and objective analyses to promote government accountability and the efficient and effective 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). Cover photo by Mark Foley.

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

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Gary R. VanLandingham, OPPAGA Director

Appendix A

STATE BOARD OF ADMINISTRATION

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AS SECRETARY

COLEMAN STIPANOVICH
EXECUTIVE DIRECTOR

November 15, 2006

Gary R. VanLandingham
Director
OPPAGA
Claude Pepper Building, Room 312
111 West Madison Street
Tallahassee, FL 32399

Dear Mr. VanLandingham:

Please find attached the State Board of Administration's response to OPPAGA's preliminary findings and recommendations contained in the report entitled "Use of Investment Returns Has Increased; Plan for Addressing Associated Risks Should Be Documented."

We welcome OPPAGA's efforts to offer recommendations intended to improve the quality and effectiveness of the SBA's investment programs.

Please let us know if you have any questions or would like additional information. As always, we appreciate your diligence and assistance.

Sincerely,

Coleman Stipanovich
Executive Director

cc: Kara Collins-Gomez, Staff Director, OPPAGA
Flerida Rivera-Alsing, Chief of Internal Audit, SBA

SBA Response to OPPAGA's Preliminary Findings and Recommendations in Report Entitled "Use of Investment Returns Has Increased; Plan for Addressing Associated Risks Should Be Documented" December 2006, Report No. 06-xx

The State Board of Administration (SBA) has been asked to respond in writing to OPPAGA's draft report titled above. We are gratified that the report finds "the SBA has generally performed well in achieving its investment objective for FRS pension plan assets."

The report contains three recommendations, all related to prior findings. We respond in order of presentation in the OPPAGA report.

1. OPPAGA recommends that:
   "the state's long-range financial outlook include projections of contributions to the pension plan."

   Response:
   We respectfully suggest that OPPAGA make this recommendation directly to the parties who prepare the state's long-range financial outlook. They are not a part of the SBA and we are not in a position to cause them to include any particular information in their reports and plans.

   The FRS actuary, Milliman USA, has for sometime provided multi-year projections of total retirement system costs in their annual FRS Actuarial Valuation Report. Milliman USA could presumably use this information as a basis for preparing projections of the State of Florida's contributions to the FRS Pension Plan. Notably, the FRS Actuarial Valuation Report is widely available to the staff members responsible for preparing the State of Florida financial outlook reports and plans.

   As stated in our response to this issue in OPPAGA's last report[1], we also annually produce such projections and stand willing to share the results with the legislature and executive branch, as well as any other interested parties. We have made this offer known to the Legislative and executive branch members of the Florida Retirement System Actuarial Assumption Conference, who are also the staff members responsible for preparing financial outlook reports and plans. To date, we have not received a response to this offer.

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[1] SBA's previous response to this issue was as follows:
"SBA agrees that such information may be useful to the Legislature. SBA finds such information to be essential in developing appropriate investment policies for the FRS portfolio. OPPAGA is apparently unaware that the SBA conducts an annual asset-liability study in which year-by-year projections are made of FRS benefit payments, contribution rates, plan liabilities, plan assets and funded ratios over a fifteen year horizon under 500 different economic and market scenarios. We would be pleased to share this information with the Legislature, the Florida Retirement System Actuarial Assumption Conference and local governments."

2. OPPAGA recommends that:
"the SBA better document its approach to control short-term volatility of investment returns."

Response:
While SBA's approach is laid out in a number of public documents, we have no objection to including a brief description of it in our Investment Policy Statement (IPS). Note, however, that the IPS is not updated annually. It was last revised in 2003; current plans call for a revision to be presented to the Trustees in April 2007.

3. OPPAGA recommends that:
"the SBA report the results of 2006 statutory changes increasing its flexibility in making alternative investments."

Response:
The life cycle of a private equity limited partnership vehicle is typically 10 to 12 years. It is, therefore, too early for performance data to reflect an impact from the 2006 statutory changes.

Nonetheless, we believe the 2006 statutory changes will improve our ability, over time, to access the best private equity investment managers. To that end, we can document the performance impact of earlier SBA initiatives that systematized the conduct and monitoring of our private market investments. Prior to November 1999, SBA's private equity investments were the responsibility of certain employees within SBA's Domestic Equities asset class. Subsequently, the SBA created a specific asset class with a dedicated staff to focus exclusively on private market investments. Additionally, strategic planning within the asset class has been emphasized, with ongoing support from a specialist consultant. The table below compares the performance of private equity portfolios associated with pre-November 1999 decisions and commitments (legacy portfolios) with those of the post-1999 era. Although we cannot predict the ultimate performance of our ongoing private equity limited partnership vehicles, notable performance differences exist at this time between the legacy and post-1999 portfolios.

Alternative Investment Portfolios

Since-Inception Internal Rates of Return through June 30, 2006

	Managed Return	Primary Benchmark Return	Value-Added Return
Legacy Portfolios	6.55%	11.60%	-5.04%
Post-1999 Portfolios	21.64%	13.23%	8.41%
Total Alternative Investments	8.46%	11.83%	-3.37%