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Office of Program Policy Analysis And Government Accountability

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Director

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OVERSIGHT REPORT ON THE STATE BOARD OF ADMINISTRATION'S 1994-95 INVESTMENT PERFORMANCE

REPORT ABSTRACT

- The State Board of Administration's (SBA) allocation of Florida Retirement System assets was within ranges established in its long-term investment plan.
- The SBA's overall return on investing Florida Retirement System assets exceeded its investment objective of 8%.
- Investment returns for most asset classes were close to their performance objectives over periods of three and five years. However, the domestic equity asset class under-performed its objectives in 1994-95. If the return rate on domestic equities in 1994-95 was as high as relevant market indexes, the SBA would have earned additional returns ranging from $356 million to $566 million.
- Performance data in the SBA's 1994-95 Investment Report is reasonably accurate.

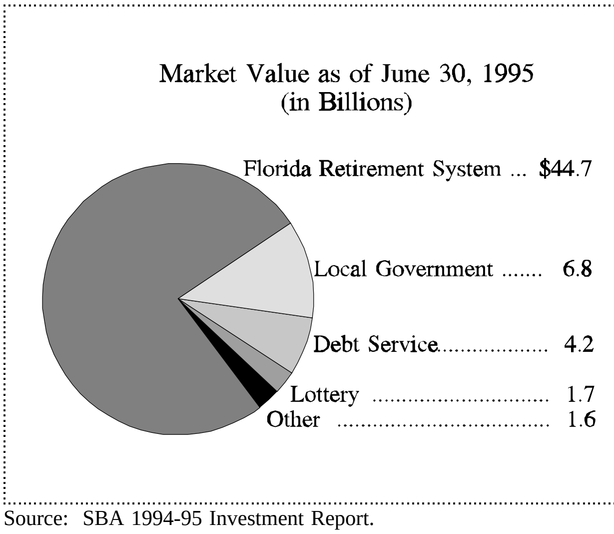
PURPOSE AND SCOPE

Florida law requires an annual performance audit be made of the State Board of Administration's (SBA) management of investments, including an independent verification of the data included in the SBA's annual investment report to the Legislature. This review evaluates the SBA's performance in meeting overall and asset class objectives for investing Florida Retirement System assets in fiscal year 1994-95. It also assesses whether the SBA provided the Legislature with reasonably accurate information in its 1994-95 Investment Report.

BACKGROUND

The SBA is a constitutional board charged with investing certain assets. Exhibit 1 shows the SBA's major investment responsibilities and the amount of assets it manages.

Exhibit 1
SBA Responsible for Investing $59 Billion



Source: SBA 1994-95 Investment Report.

One of the SBA's major responsibilities is investing Florida Retirement System assets. The Florida Retirement System has the fourth largest pension fund among state retirement plans (market value $44.7 billion as of June 30, 1995).

FINDINGS

The allocation of Florida Retirement System funds to various asset classes is within the ranges established in the SBA's long-term investment plan.

Asset allocation is the process of diversifying an investment portfolio among asset classes (i.e., stocks, bonds, real estate, cash, etc.). Asset allocation is the most important factor affecting an investment program's long-term performance. Studies indicate that more than one-half of a portfolio's long-term results are due to asset allocation decisions.

Given this, it is critically important for the SBA to have a long-term asset allocation plan. The SBA initially adopted such a plan, the Florida Retirement System (FRS) Total Fund Investment Plan, in November 1988 and most recently amended it in April 1995. Exhibit 2 indicates that the SBA's actual asset allocation as of July 1, 1994, and June 30, 1995, was within the Total Fund Investment Plan's ranges for allocating investments.

As Exhibit 2 indicates, the SBA's allocation to the cash asset class was on the high side and domestic equities was on the low side of their policy ranges for most of fiscal year 1994-95. The SBA maintained a high cash position and a low domestic equity position based on its own research and financial consultants' advice. SBA and its consultants believed the domestic equity market was soft and expected a market correction in which stock prices would decline. By increasing its cash allocation the SBA protected itself against the expected market correction. However, it also lost out on possible additional earnings when stock prices continued to rise.

The SBA's performance exceeded its overall FRS investment objective.

The FRS Total Fund Investment Plan establishes an overall investment objective for SBA to achieve the actuarial assumed return rate (8%). The SBA needs to meet the actuarial assumed return rate on a long-term basis in order to generate sufficient funds to pay future pension liabilities when due.

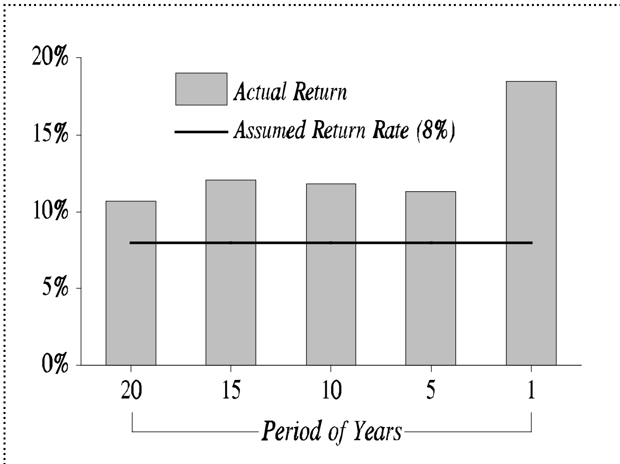
Exhibit 2
Asset Allocation Within Investment Plan Ranges

	Policy Range		Actual Allocation	
Asset Class	**July 1, 1994**	**June 30, 1995**	**July 1, 1994**	**June 30, 1995**
Domestic Equities	54% - 64%	55% - 67%	62%	56%
Foreign Equities	2% - 6%	5% - 10%	4%	7%
Fixed Income	25% - 40%	20% - 35%	31%	27%
Real Estate	2% - 10%	2% - 6%	2%	3%
Cash	0% - 10%	0% - 10%	1%	7%

Source: SBA 1994-95 Investment Report.

The SBA's return rate (18.5%) on FRS assets exceeded this objective not only for fiscal year 1994-95, but also for longer periods covering the last 20 years. (See Exhibit 3.)

Exhibit 3
SBA Investment Performance Exceeds Long-Term Objective



Source: SBA 1994-95 Investment Report, SEI data, and Office of Program Policy Analysis and Government Accountability analyses.

The SBA's investment performance for the domestic equity and foreign equity asset classes presented in the Annual Report was not compared to newly adopted broad market indexes.

According to the FRS Total Fund Investment Plan, each asset class return is evaluated against a performance objective or expectation based on a broad market index appropriate to that class. Asset class investment outcomes should be evaluated over a period of several years corresponding to a typical business cycle (three to five years). Returns for shorter periods should be reviewed primarily to identify potential trends and causes for under-performance.

The SBA's Investment Report indicates that the FRS Investment Plan was modified during fiscal year 1994-95 to change the broad market indexes for the domestic equity and foreign equity asset classes. However, asset classes return rates presented in the Report were compared to the prior year's broad market indexes and not to the newly adopted indexes.

The broad market index for the domestic equity asset class was changed in October 1994 from the S&P 500 Index to the Wilshire 2500 Index. SBA staff stated that the Wilshire 2500 more accurately represents the universe of stocks in which most of the larger corporate and public plan sponsors invest and includes smaller capitalization companies than the S&P 500. They also stated that in recent times returns provided by stocks of companies with smaller capitalizations have been greater than those with larger capitalizations.

The broad market index for the foreign equity asset class was changed in April 1995 from the Europe, Australia & Far East Index (EAFE) to a mix of (85%) EAFE and (15%) International Finance Corporation Investable (IFCI) Index. SBA staff stated that the index was changed based on a decision to dedicate 15% of foreign equity investments to emerging markets. This 15% weighting is reflected by the addition of the IFCI Index.

Investment returns for most asset classes were close to their objectives over periods of three and five years. However, the domestic equity asset class under-performed its objective in 1994-95 and needs to be closely monitored.

The SBA's domestic equity, fixed income, and cash asset class return rates were close to or over market indexes' asset class return rates over three- and five-year periods. (See Exhibit 4.)

Exhibit 4
SBA Investment Returns for Most Asset Classes Were Close to Market Indexes Over the Last Five Years

Asset Class /Performance Objective	Annualized Rates of Return Five Years 1990-95	Three Years 1992-95	One Year 1994-95
Domestic Equities	12.2%	12.9%	23.4%
S&P 500 [1]	12.1%	13.2%	26.1%
Wilshire 2500			25.1%
Foreign Equities	--- [2]	--- [2]	1.4%
EAFE Index	4.6%	12.6%	1.6%
Fixed Income	10.7%	9.0%	15.2%
Florida Extended Duration Index	10.5%	8.8%	15.6%
Real Estate	-1.1%	0.6%	8.0%
Russell-NCREIF Property Index	-0.1%	2.7%	7.9%
Cash and Central Custody	6.0%	5.5%	5.8%
91-Day Treasury Bill Rate	4.4%	3.7%	5.0%

[1]SBA's domestic equity objective was changed to the Wilshire 2500 effective October 1, 1994; however, in its Annual Report, SBA reported its performance against the S&P 500.

[2]The SBA began to invest in foreign equities in October 1992.

Source: SBA 1994-95 Investment Report.

As Exhibit 5 indicates, the SBA is above the average of other states in allocating assets to domestic equities. The SBA has emphasized domestic equities as they have historically had a higher return than other asset classes. Because the SBA has such a large percentage of the FRSTF assets invested in domestic equities (56%), it needs to closely monitor this asset class.

Our review identified several concerns regarding the domestic equity asset class. The SBA's return rate on domestic equities was below the asset class's market indexes in 1994-95 (2.7 percentage points or 270 basis points compared to the S&P 500 or 1.70 percentage points or 170 basis points compared to the Wilshire 2500). This level of under-performance is a concern, even if it occurred in only one fiscal year. To illustrate, if the domestic equity asset class's 1994-95 return rate was as high as the S&P 500 Index, the SBA would have earned an additional $565.9 million, if it was as high as the Wilshire 2500 Index, the SBA would have earned an additional $356.3 million.

Exhibit 5
SBA More Aggressive in Investing in Equities

Asset Class	Asset Allocation: Other States Average Allocation[1]	Florida as of June 30, 1995
Domestic Equities	37%	56%
International Equities	6%	7%
Domestic Bonds	45%	27%
International Bonds	2%	---
Real Estate	3%	3%
Cash	5%	7%
Alternative Investments	2%	---
Total	**100%**	**100%**

[1]Average based on 83 retirement systems in 49 other states and the District of Columbia.

Source: 1994 Wilshire Report on State Retirement Systems and SBA 1994-95 Investment Report.

Several factors contributed to the SBA's domestic equity investments under-performing the asset class market index in 1994-95:

- **Thirteen of the SBA's domestic equity portfolio managers had individual, customized objectives below either of the overall asset class objectives (Wilshire 2500 Index or the S&P 500 Index) addressed in the 1994-95 Investment Report. This makes it unlikely that the overall return rate on domestic equities would reach the asset class objective.**

The SBA uses a computer program to develop customized objectives for each portfolio manager. The customized objectives are designed to take into account a manager's specific investment style. The SBA believes the customized objectives are more appropriate for evaluating an individual manager's performance than a broad market index like the Wilshire 2500 or the S&P 500. However the SBA's approach for developing customized objectives did not maximize its likelihood of meeting either of the overall asset class objectives.

In fiscal year 1994-95, the SBA had 27 domestic equity portfolio managers (6 internal and 21 external) responsible for investing a total of $24.4 billion in assets.[1] Thirteen of the 27 managers (48%) had customized objectives below the Wilshire 2500 Index. (See Exhibit 6.) These 13 managers were responsible for managing 20% ($5 billion) of the SBA's domestic equity investments. Even if each of the SBA's managers had a return rate as high as its customized objective, the total return on the domestic equity asset class would still be lower than either the Wilshire 2500 Index or the S&P 500 Index (24.7% compared to either 25.1% or 26.1%, respectively). By comparison, in 1993-94, 7 of 19 domestic equity managers (37%) had customized objectives below the S&P 500 Index.

Exhibit 6
Most Domestic Equity Portfolio Managers Have Individual Objectives Below the Asset Class Broad Market Index

	Individual Managers Objectives			
	Higher Than Wilshire 2500[1]	**Same as Wilshire 2500[1]**	**Lower Than Wilshire 2500[1]**	**No Objective**
Number of Managers	13	1	13	2
Domestic Equity Funds Under Management June 30, 1995 (billions) [2]	$13.2	$6.2	$5.0	$0.5
Percent of Domestic Equity Funds Under Management	53.1%	24.9%	20.1%	2.0%

[1] The Wilshire 2500 Index was selected for comparison purposes because stocks comprising this index have a wider range of capitalization than the stocks comprising the S&P 500 and it better reflects the stocks in which the SBA invests.

[2] Does not include the $116 million invested by 7 new external active style managers.

Source: SBA 1994-95 Investment Report.

[1] This does not include seven new managers that the SBA contracted with in fiscal year 1994-95 and two managers that did not have specific performance benchmarks.

In establishing objectives for individual portfolio managers, consideration should be given to the overall asset class objective and to the return rate that could be obtained by investing in index funds.

- **The majority of the SBA's domestic equity portfolio managers had return rates below their customized objectives.**

During fiscal year 1994-95, 18 of the SBA's 27 domestic equity portfolio managers (67%) had actual return rates below their customized objectives. (See Exhibit 7.) If these managers' return rates had met their objectives, the SBA would have earned an additional $296 million in fiscal year 1994-95. By contrast, in fiscal year 1993-94, only 5 of 19 domestic equity managers (26%) had return rates below their customized objectives.

SBA administrators believe the major reasons for so many of these managers under-performing their customized objectives was that market conditions in that year did not favor the managers' investment strategies.

Performance data in SBA's 1994-95 Investment Report is reasonably accurate.

It is imperative for an entity administering an investment program to provide its stakeholders with accurate performance information. While the SBA did not compare its performance to its newly adopted indexes, we determined the SBA developed and implemented internal controls to help ensure that its Investment Report to the Legislature included reasonably accurate performance data.

Exhibit 7
Most Domestic Equity Portfolio Managers
Did Not Meet or Exceed Their Individual Objectives [1]

Managers	1993-94	1994-95
Exceeded Objectives	11 (58%)	7 (26%)
Met Objectives	3 (16%)	2 (7%)
Did Not Meet Objectives	5 (26%)	18 (67%)
Total	**19**	**27**

[1] 1993-94 returns compared to S&P 500 and 1994-95 returns compared to Wilshire 2500.

Source: SBA's 1994-95 Investment Report and records.

RECOMMENDATIONS

We recommend that the SBA closely monitor the performance of individual domestic equity managers and the asset class as a whole. The SBA should:

- Ensure it reports investment results against applicable market indexes specified in its Investment Plan.
- Assess whether investment problems encountered in 1994-95 were short-term in nature resulting from factors such as unfavorable market conditions or longer-term resulting from the asset class's structure or the SBA's method for establishing customized objectives for individual managers.
- Ensure that if the managers' meet their customized objectives, their combined returns would meet or exceed the overall asset class market index as established in the SBA's investment guidelines.

AGENCY RESPONSE

September 9, 1996

Mr. John W. Turcotte, Director
Office of Program Policy Analysis and
Government Accountability
111 West Madison Street, Room 312
Tallahassee, Florida 32302

Dear Mr. Turcotte:

We concur with your recommendation that the SBA closely monitor the performance of individual domestic equity managers and the asset class as a whole. We also believe, as you noted in your report, the major reasons for so many of the equity managers under-performing their customized objectives for this one year period was that market conditions in that year did not favor the manager's investment strategies.

The audit was conducted in a very professional manner.

Sincerely,

/s/ Barbara L. Jarriel
Acting Executive Director

BJ/Vtb

This project was conducted in accordance with applicable evaluation standards. Copies of this report may be obtained by telephone (904/488-1023 or 800/531-2477), by FAX (904/487-3804), in person (Claude Pepper Building, Room 312, 111 W. Madison St.), or by mail (OPPAGA Report Production, P.O. Box 1735, Tallahassee, FL 32302).

Web site: http://www.state.fl.us/oppaga/

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THE FLORIDA LEGISLATURE
OFFICE OF PROGRAM POLICY ANALYSIS AND GOVERNMENT ACCOUNTABILITY

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