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John W. Turcotte, Director — January 1998

Oversight Report on the State Board of Administration's 1995-96 Investment Report

Abstract

- **The State Board of Administration's (SBA) performance in investing Florida Retirement System assets not only exceeded its overall investment objective in 1995-96 but also for longer periods covering the last 20 years.**
- **The SBA's allocation of Florida Retirement System assets was within ranges established in its long-term investment plan.**
- **Investment returns for various asset classes were higher than or close to performance targets over three- and five-year periods.**
- **The SBA's 1995-96 Investment Report contains reasonably accurate and reliable performance data. However, the SBA has some weaknesses in its management controls for ensuring data accuracy and reliability.**
- **The 1995-96 Investment Report does not provide performance information on individual accounts in the real estate asset class.**
- **The SBA has not developed a system for reporting on whether its managers are adhering to Investment Plan guidelines.**

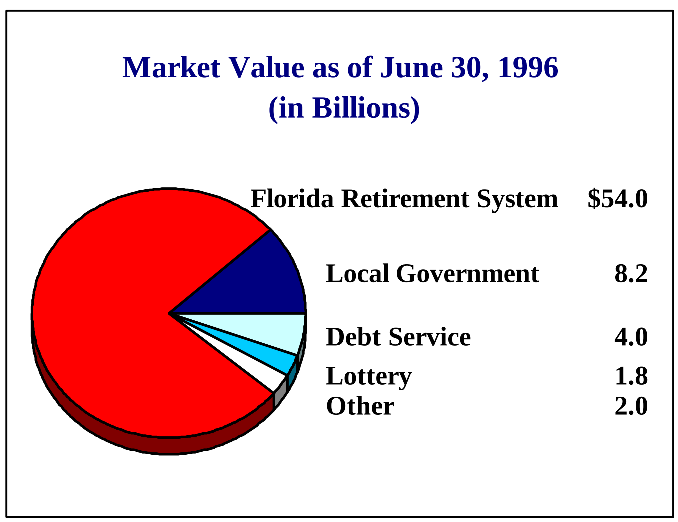
Purpose

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 1995-96. It also assesses whether the SBA provided the Legislature with reasonably accurate information in its 1995-96 Investment Report.

Background

The SBA is a constitutional board charged with investing certain assets of both the state and local governments. Exhibit 1 shows the SBA's major investment responsibilities and the amount of assets it manages. One of the SBA's major responsibilities is investing Florida Retirement System assets (market value of $54 billion as of June 30, 1996).

Exhibit 1
SBA Responsible for Investing $70 Billion State and Local Government Funds



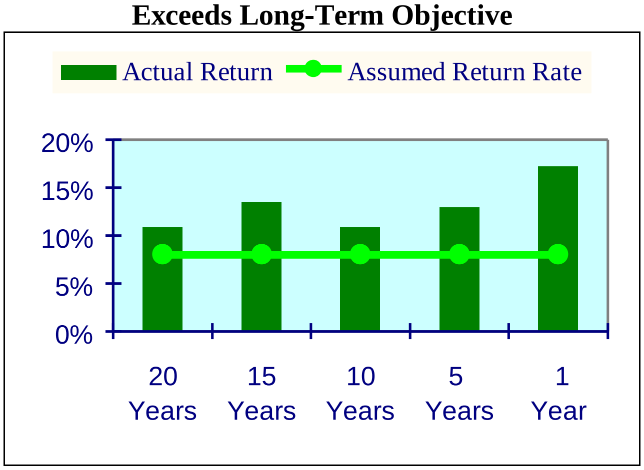
Findings

The State Board of Administration's performance in investing Florida Retirement System assets not only exceeded its overall investment objective in 1996-97, but also for longer periods covering the last 20 years.

The Florida Retirement System (FRS) Total Fund Investment Plan establishes an overall investment objective for the 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.

The SBA's return rate (17.2%) on FRS assets exceeded this objective for fiscal year 1995-96. The SBA also exceeded this objective for longer periods covering the last 20 years. (See Exhibit 2.)

Exhibit 2
SBA Retirement Fund Investment Performance Exceeds Long-Term Objective



Source: SBA 1995-96 Investment Report, SEI and State Street data, and OPPAGA analysis.

The SBA's allocation of Florida Retirement System funds to various asset classes was within the ranges established in its 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. The SBA's Investment Report states that more than 90% 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 and adhere to its provisions. The SBA initially adopted a long-term plan, the Florida Retirement System Trust Fund Total Fund Investment Plan, in November 1988 and most recently amended it in April 1995. Exhibit 3 indicates that the SBA's actual asset allocation as of July 1, 1995, and June 30, 1996, were within the Total Fund Investment Plan's ranges for allocating investments.

Exhibit 3
Asset Allocation Within Investment Plan Ranges

	Policy Range	Asset Allocation	
Asset Class	July 1, 1995, to June 30, 1996	July 1, 1995	June 30, 1996
Domestic Equities	55% - 67%	56%	55%
International Equities	5% - 10%	7%	8%
Fixed Income	20% - 35%	27%	27%
Real Estate	2% - 6%	3%	3%
Cash	0% - 10%	7%	7%

Source: SBA 1995-96 Investment Report and SBA records.

As Exhibit 3 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 again for most of fiscal year 1995-96. The SBA maintained a high cash position and a low domestic equity position based on its own research and financial consultants' advice. The SBA and its consultants believed the domestic equity market was overvalued 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.

Investment returns for various asset classes were higher than or close to performance targets over three- and five-year periods.

The SBA's investment return rates for various asset classes (domestic equities, international equities, fixed income, real estate, and cash) exceeded or were close to performance targets over periods of three and five years. For example, the SBA's five-year annualized rate of return for domestic equities was 15.9% compared to 15.4% for the SBA's performance target, the Wilshire 2500 Index. Over the five-year period from July 1, 1991, to June 30, 1996, the SBA earned an additional $676 million as a result of asset class performance exceeding targets.

However, the SBA's return rate for the real estate asset class was under its target for fiscal year 1995-96. If the real estate asset class's 1995-96 return rate was as high as the Russell-NCREIF Index, the SBA would have earned an additional $7 million. (See Exhibit 4.)

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

Asset Class /Performance/Target	Annualized Rates of Return		
	5 Years 1991-96	3 Years 1993-96	1 Year 1995-96
Domestic Equities	15.9%	16.6%	26.4%
Wilshire 2500	**15.4%**	**16.7%**	**26.1%**
International Equities	---*	11.4%	14.6%
85% EAFE & 15% IFCI	**---**	**10.8%**	**12.9%**
Fixed Income	9.5%	5.6%	4.7%
Florida Extended Duration Index	**9.3%**	**5.6%**	**4.7%**
Real Estate	2.3%	6.7%	8.9%
Russell-NCREIF Property Index	**2.0%**	**7.2%**	**9.5%**
Cash and Central Custody	5.5%	5.9%	5.9%
90-Day Treasury Bill Rate	**4.6%**	**4.9%**	**5.7%**

*The SBA began to invest in foreign equities in October 1992.

Source: SBA 1995-96 Investment Report, SBA records and OPPAGA analyses.

The SBA's 1995-96 Investment Report contains reasonably accurate and reliable performance data. However, the SBA has some weaknesses in its management controls for ensuring data accuracy and reliability.

The SBA's annual Investment Report is the State Board's primary means of communicating its investment performance to the Legislature and other policy-makers. Therefore, it is imperative that the Report includes accurate, reliable, and verifiable performance data.

Based on our tests, we concluded that the rates of return and market values for the overall Florida Retirement System Trust Fund, asset classes, and individual portfolios included in the Investment Report were reasonably accurate and reliable. However, we identified several weaknesses in the State Board's management controls for ensuring data accuracy and reliability:

- The SBA did not request its investment performance consultant, State Street Analytics to provide copies of source documents for all performance data presented in the Report. Without such source documents, the SBA cannot readily verify the accuracy of the Report's performance data. SBA managers attributed this problem to several factors including changes in the organizational unit and personnel assigned responsibility for preparing the Investment Report.
- The 1995-96 Investment Report also included some errors (see Exhibit 5). The presence of these errors indicates the SBA needs to improve its quality control procedures for preparing the Investment Report and ensuring data accuracy and reliability.

Exhibit 5
Some Errors Were Included in the 1995-96 Investment Report

	Per Investment Report	Actual
Real Estate Asset Class		
Target, one year, 1996	7.9%	9.5%
Managed return, one year, 1996	8.6%	8.9%
Managed return, two years, 1995-96	7.7%	7.8%
Managed return, three years, 1994-96	6.6%	6.7%
Domestic Equity Accounts		
Carl Domino Associates June 30, 1996, Market Value $43.3 million	Performance not reported	Exceeds benchmark
Active Core June 30, 1996, Market Value $2.4 billion	Meets or exceeds benchmark	Did not meet benchmark
Pivot portfolio June 30, 1996, Market Value $7.7 billion	Actively managed	Passively managed

Source: OPPAGA analyses and review of SBA records and interviews with SBA staff.

The SBA's Investment Report does not provide performance information on individual accounts in the real estate asset class.

The SBA's 1995-96 Investment Report provides performance information on individual accounts in all asset classes except for the real estate asset class. As of June 30, 1996, the SBA's Real Estate asset class included 18 accounts with a total market value of $1.4 billion. These 17 accounts included 1 real estate stock account, 1 real estate cash account, 4 diversified participation accounts and 11 directly owned investment accounts. The Investment Report only presents an overall return rate for the asset class as a whole compared to the asset class target, the Russell-NCREIF index. No information is presented to help the Legislature and other interested readers review the performance of individual real estate accounts.

The SBA could provide more useful information in the Investment Report by presenting information on the performance of the real estate accounts. For example, it could compare the performance of each individual account against the target index. It could also compare performance against an expected rate of return for each account. According to the SBA's investment guidelines, the SBA's internal real estate managers are required to develop expected rates of return for each investment as part of their due diligence process.

The SBA has not developed a system for reporting on whether its managers are adhering to Investment Plan guidelines.

Written investment guidelines are essential to ensure that investment managers' activities are consistent with an organization's goals and objectives. They provide guidance to staff on the specific constraints under which they will operate, such as the types of investments to be made and the level of tolerable risk.

The SBA developed or is in the process of developing written investment guidelines for various asset classes. For example, investment guidelines were developed for the equity, fixed income, real estate, and cash asset classes in May 1990. SBA managers are also in the process of developing written guidelines for the international equities asset class. The SBA began treating international equities as a separate asset class subsequent to the development of its original guidelines. The international equities asset class had a market value of $4.3 billion as of June 30, 1996.

Although the SBA produces internal reports on asset class and investment manager performance, it has not developed a system for reporting on whether asset class investments complied with established guidelines. SBA staff indicated that it was up to each asset class manager to monitor investments for compliance with relevant guidelines. We were also told that no written reports were prepared on whether investments were being made in compliance with guidelines.

Recommendations

We recommend that the SBA maintain source documents for use in verifying the accuracy and validity of information published in its annual investment reports.

We recommend that the SBA improve its quality control procedures for ensuring the accuracy of performance data included in its annual investment reports.

We recommend the SBA provide performance information on all real estate accounts.

We also recommend the SBA establish a system for periodically reviewing its investments to determine if they comply with established guidelines and report the results of these reviews to the Executive Director.

Agency Response

The Executive Director of the State Board of Administration, in his written response, indicated the following:

- *For FY 1996-97, the SBA had moved to a system of maintaining source documents for return information published in the annual investment report in electronic format only. For the future, we will resume maintenance of paper copy documents as well.*

- *The performance measurement errors detailed in Exhibit 5 were noted and corrected in internal records in early 1997. We have improved our quality control procedures to ensure the accuracy of performance data to be included in future annual investment reports.*

- *The SBA will provide the performance information on all real estate accounts in future annual investment reports.*

- *We have monitored our investments to determine compliance with established guidelines; however, we have not established a documented system to date. We will establish a documented system of these reviews. Additionally, we will establish a reporting system for notifying the Executive Director of manager compliance with established guidelines.*

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Project Supervised by: Thomas S. Roth (488-1024) Project Conducted by: A.B. Verhine, C.P.A. (487-9276)