THE FLORIDA LEGISLATURE
Report No. 98-10

Office of Program Policy Analysis And Government Accountability

John W. Turcotte, Director
August 1998

Oversight Report on the State Board of Administration's 1996-97 Investment Report

Abstract

- **The State Board of Administration's (SBA) performance in investing Florida Retirement System assets has not only exceeded its overall investment objective in Fiscal Year 1996-97, 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 slightly higher or close to performance targets over one-, three- and five-year periods.**

- **The SBA would have earned an additional $612 million in Fiscal Year 1996-97 if its external domestic equity active investment style managers performed as well as external passive investment style managers. It also would have saved $49 million in management fees if all of its externally managed domestic equity assets were invested by passive investment style managers.**

- **The SBA's *1996-97 Investment Report* contains reasonably accurate and reliable performance data. However, some areas could have been improved with the disclosure of additional information.**

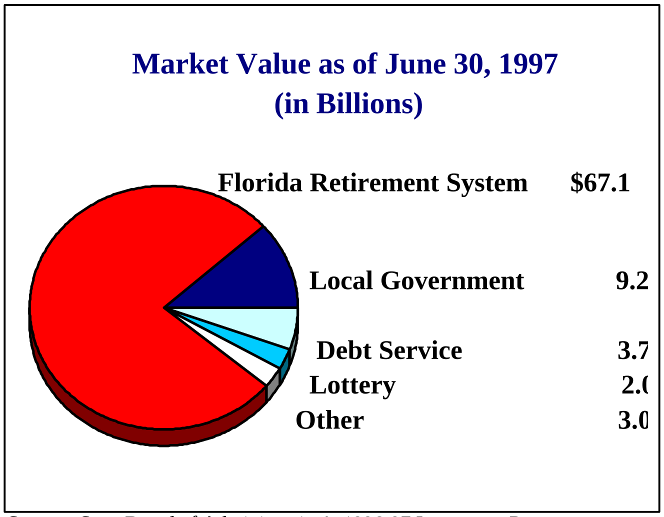
Purpose

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 1996-97. It also assesses whether the SBA provided the Legislature with reasonably accurate information in its *1996-97 Investment Report.*

Background

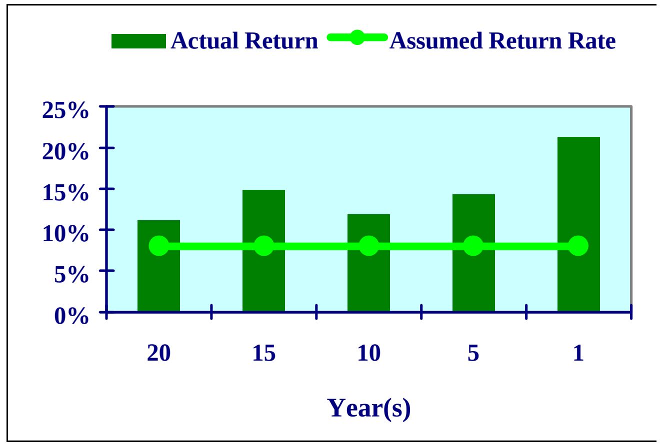
The SBA is a constitutional board charged with investing certain assets of both the state and local governments. Exhibit 1 shows the SBA's major investment responsibilities and the amount of assets it manages. One of the SBA's major responsibilities is investing Florida Retirement System assets, which had a market value of $67 billion as of June 30, 1997.

Exhibit 1
The SBA Is Responsible for Investing $85 Billion State and Local Government Funds



Source: State Board of Administration's *1996-97 Investment Report*

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



Source: SBA 1996-97 Investment Report, State Street data and OPPAGA analysis

Findings

The State Board of Administration's performance in investing Florida Retirement System assets has not only exceeded its overall investment objective in Fiscal Year 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 of 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 (21.3%) on FRS assets exceeded this objective for Fiscal Year 1996-97. The SBA also exceeded this objective for longer periods covering the last 20 years. (See Exhibit 2.)

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 *1996-97 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, 1996, and June 30, 1997, 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, 1996, to June 30, 1997	July 1, 1996	June 30, 1997
Domestic Equities	55% - 67%	55%	60%
International Equities	5% - 10%	8%	9%
Fixed Income	20% - 35%	27%	24%
Real Estate	2% - 6%	3%	3%
Cash	0% - 10%	7%	4%

Source: SBA *1996-97 Investment Report* and SBA records

The SBA's investment returns for most asset classes were close to performance targets over one-, three-, and five-year periods. However, the SBA would have achieved significantly higher returns if its external active investment style equity managers performed as well as external passive investment style managers.

As shown in Exhibit 4, the SBA's investment return rates for various asset classes were close to or exceeded performance targets over one-, three-, and five-year periods.

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

Asset Class /Performance/Target	Annualized Rates of Return 5 Years 1992-97	3 Years 1994-97	1 Year 1996-97
Domestic Equities	18.8%	26.5%	29.8%
Wilshire 2500	**18.7%**	**26.9%**	**30.3%**
International Equities	---*	10.5%	16.1%
85% EAFE & 15% IFCI	**---**	**9.7%**	**13.4%**
Fixed Income	8.2%	9.6%	9.0%
Florida Extended Duration Index	**8.0%**	**9.6%**	**8.9%**
Real Estate	5.6%	9.0%	11.6%
Russell-NCREIF Property Index	**5.8%**	**9.7%**	**11.4%**
Cash and Central Custody	5.6%	5.8%	5.7%
90-Day Treasury Bill Rate	**4.6%**	**5.4%**	**5.3%**

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

Source: SBA *1996-97 Investment Report*, SBA records and OPPAGA analyses

However, the SBA would have achieved significantly higher returns in Fiscal Year 1996-97 if its external active investment style domestic equity managers performed as well as its external passive investment style managers.[1] Passive investment style managers typically select securities with the goal of achieving rather than exceeding the performance of a market index such as the Wilshire 2500 Index. Passive investment style managers engage in minimal trading activity and incur lower transaction costs and charge lower fees than active style investment managers. Active investment style managers select stocks based on various strategies with the goal of achieving a rate of return higher than a market index. The SBA's *1996-97 Investment Report* states that the SBA expected the active investment style managers, "to provide the added 'pop' to performance to allow us to exceed our benchmark."[2]

We determined that the aggregate return rate achieved by the SBA's external active investment style managers in Fiscal Year 1996-97 (26.81%) was significantly lower than the aggregated return rate for its external passive investment style managers (32.08%). The SBA's external active investment style managers were paid $51.2 million in fees to manage $14.8 billion in assets while the external passive investment style managers were paid $1.3 million to manage $9.0 billion in assets.

We further determined that 18 of the SBA's 31 external active investment style managers (58%) had return rates below the asset class benchmark of 30.28% during Fiscal Year 1996-97. These 18 managers were paid a total of $29.3 million to invest $6.8 billion in FRS assets. During the same year, two of the SBA's four external passive investment style managers also had return rates below the asset class benchmark. However, these passive investment managers were paid significantly lower fees by the SBA ($293,000 to invest $1.5 billion in FRS assets). Appendix A shows each external active and passive manager's market value of funds invested, return rates, and management fees for Fiscal Year 1996-97.

Significant Under-Performance is a Concern

This significant under-performance is a concern. We estimate the SBA would have earned an additional $407 million if its external active investment style managers achieved a return as high as the overall asset class benchmark (30.28%) and $612 million if their returns were as high as those achieved by the external passive investment style managers (32.08%). It also would have saved an estimated $49 million if all of its externally managed domestic equity assets were invested with passive style managers.

Similar results have occurred over periods longer than a single fiscal year. Passive investment style managers as a group have outperformed active investment style managers over the last 10 fiscal years. Over the period from July 1, 1987, to June 30, 1997, the average return for all passive investment style managers was 14.41% compared to 13.65% for all active investment style

[1] The SBA uses both in-house staff and contracted external investment firms to invest equity assets. The SBA contracts with external firms to provide diversification of investment styles.

[2] *1996-97 Investment Report*, State Board of Administration, November 1997, p.25.

managers. (See Appendix B.) We also noted that passive investment style managers were outperforming active style managers in prior reports.[3]

Some other states have identified similar trends for their pension fund investments and have taken steps to increase the percentage of domestic equity funds invested with passive investment style managers. For example, the Washington State Investment Board recently decided to have all of its domestic equity assets invested with passive investment style managers.

The SBA's *1996-97 Investment Report* contains reasonably accurate and reliable performance data. However, some areas could have been improved with the disclosure of additional information.

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 and information provided by SBA and its performance consultant, State Street Analytics, 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. In addition, the investment report included the information required by Section 215.44(5), F.S. However, we identified several areas in which disclosure of additional information would have been helpful to interested readers:

- The SBA's *1996-97 Investment Report* does not disclose that the return rate for the Fixed Income Asset Class does not include the return rate for its Dedicated Bond Fund which had a market value at June 30, 1997, of approximately $1.4 billion. The Dedicated Bond Fund is used to match projected liabilities of specific retirement obligations. This fund is used only when yields can be locked in at historically high levels using zero coupon securities. Based on State Street Analytics data, the Dedicated Bond Fund had a return rate for Fiscal Year 1996-97 of 10.17%.

- The *1996-97 Investment Report* discloses in a footnote on the target return for the Cash Asset Class that returns have been restated for the one-to five-year periods to reflect an average yield approach rather than a total return approach as used in prior years.[4] However, the effect of this change in methodology is not disclosed in the Investment Report. Based on additional data provided by SBA personnel, the average yield approach reduces the target return rate for the Cash Asset Class from 10 to 30 basis points over the one- to five-year period. In OPPAGA Report No. 12175, dated October 18, 1993, we recommended that in future investment reports, the SBA should describe changes in the basis or methods of calculating return rates presented in the annual investment report and disclose whether those changes have an effect on the reported results.

- The *1996-97 Investment Report* discloses in a footnote in a table that the target return for domestic equities was the Wilshire 2500 from July 1, 1996, through May 31, 1997, and for June 1997, it was the Wilshire 2500 excluding tobacco stocks. However, the effect of this change is not disclosed in the investment report. Based on additional data provided by SBA personnel, this change would have increased the asset class target by five basis points for Fiscal Year 1996-97.

Recommendations

We recommend that the SBA invest all FRSTF assets allocated to domestic equities with passive style investment managers. The SBA's passive style investment managers have consistently outperformed active investment style managers over the last 10 fiscal years. If the SBA had invested all of its externally managed domestic equity assets with passive style managers in Fiscal Year 1996-97, it would have saved $49 million in management fees and earned an additional $612 million.

We also recommend that in future investment reports, the SBA disclose and describe changes in the basis or methods used to calculate return rates and targets presented in the investment report and disclose whether these changes have an effect on the reported results.

[3] *Oversight Report on the State Board of Administration's 1994-95 Investment Report*, OPPAGA Report No. 96-09, September 1996; *Performance Audit of the State Board of Administration's Equity Portfolio Managers' Performance In Investing Florida Retirement System Trust Fund Assets,* Office of the Auditor General Report No. 11921, August 3, 1992.

[4] The average yield approach calculates returns with interest growth according to the average yield of 3-month treasury bills. The total return approach using market prices to value the securities at month end.

Appendix A
Domestic Equities External Managers Performance and Fees in Fiscal Year 1996-97

Manager	Market Value June 30, 1997	Gain/(Loss)	Rate of Return[1]	Asset Class Benchmark[1]	Management Fees
Active Managers					
Alliance Capital Management	$2,455,672,212	$698,343,598	36.95%	30.28%	$3,370,058
Aronson & Partners	207,911,198	56,798,033	35.60%	30.28%	563,562
Barnett Capital Advisors	29,067,174	1,112,681	4.50%	30.28%	108,276
Barrow, Hanley, MeWhinney & Strauss	1,123,351,352	267,639,081	30.14%	30.28%	1,938,070
Carl Domino Associates	63,841,883	14,517,345	28.19%	30.28%	277,830
Centre Capital Investments	22,825,915	-9,732,184	-17.95%	30.28%	2,881,549
Corporate Advisors, L.P.	94,171,376	37,128,546	34.91%	30.28%	633,486
Cypress Equity Fund	2,166,844	-141,061	-1.06%	30.28%	143,243
David L. Babson	298,756,836	67,239,460	29.66%	30.28%	1,260,072
Denver Investment Advisors	943,462,570	110,689,968	13.49%	30.28%	2,809,561
Enhanced Investment Technologies	726,982,514	181,703,467	32.86%	30.28%	1,389,447
First Quadrant Corp.	923,583,291	231,699,206	35.21%	30.28%	2,216,568
Goldman, Sachs & Co.	1,072,476,112	229,584,919	27.34%	30.28%	3,713,334
Haven Capital Mgmt.	77,005,772	12,182,722	21.39%	30.28%	262,136
IDS Growth Spectrum Advisors	1,054,447,987	28,573,479	3.34%	30.28%	6,072,796
Independence Investment Assoc.	705,562,488	155,426,390	27.93%	30.28%	1,529,209
Lazard Freres Asset Management	1,442,627,454	342,364,893	30.40%	30.28%	3,136,149
Liberty Partners	512,330,327	20,169,413	6.72%	30.28%	5,829,781
Newbold Asset Management	688,808,995	142,857,911	25.91%	30.28%	1,544,550
Private Capital Management	69,118,714	12,584,116	33.17%	30.28%	203,395
American RE Asset Management	45,346,338	11,794,357	35.81%	30.28%	196,566
Brown Capital Management	53,090,243	11,275,133	27.60%	30.28%	233,734
Edgar Lomax	41,435,046	9,069,288	28.66%	30.28%	186,541
Fortaleza Asset Management	12,432,503	963,356	8.97%	30.28%	56,498
Globalt, Inc.	45,672,971	10,638,055	31.00%	30.28%	196,755
New Amsterdam Partners	33,682,227	8,305,591	33.38%	30.28%	146,051
Paradigm Asset Management	42,141,460	10,573,456	34.15%	30.28%	182,376
Sloate, Weisman, Murray & Co.	47,268,529	8,361,476	22.07%	30.28%	205,627
Sturdivant & Co.	49,281,752	8,697,496	22.03%	30.28%	221,850
Prudential Asset Management Co.	1,348,504,866	342,158,243	32.73%	30.28%	2,497,409
Putnam Advisory Co.	411,356,721	97,351,813	33.13%	30.28%	1,412,950
Carlyle Investment Management	21,787,356	-2,361,991	Not Provided	30.28%	1,928,669
Hicks, Muse, Tate & Furst	91,920,550	-3,264,573	Not Provided	30.28%	1,778,510
Apodaca-Johnston Capital Management	0[2]	-3,426,305	Not Provided	30.28%	29,298
Valenzuela Capital Management	28,699,175	6,689,861	Not Provided	30.28%	91,523
Ripplewood Partners, L.P.	3,277,630	-2,092,528	Not Provided	30.28%	1,941,597
Total Active	**$14,790,068,381**	**$3,115,474,711**	**26.81%**	**30.28%**	**$51,189,026**

(Continued on next page)

[1] The domestic equity asset class's benchmark is the Wilshire 2500 market index. The Wilshire 2500 return rate for Fiscal Year 1996-97 was 30.28%.

[2] The SBA closed its account with Apodaca-Johnston Capital Management during the fiscal year.

Appendix A (Continued)

Manager	Market Value June 30, 1997	Gain/(Loss)	Rate of Return[1]	Asset Class Benchmark[1]	Management Fees
Passive Managers					
Barclays Global Investors Index	$ 6,996,486,591	$ 1,816,341,622	34.85%	30.28%	$ 833,246
Barclays Global Investors Low Cap	1,112,331,666	163,018,517	16.84%	30.28%	140,606
Wilshire Large Growth Fund	533,772,673	126,793,641	37.06%	30.28%	201,100
Wilshire Large Value Fund	327,680,049	72,304,191	28.38%	30.28%	152,409
Total Passive	**$ 8,970,270,979**	**$2,178,457,971**	**32.08%**	**30.28%**	**$ 1,327,361**
Total External	**$23,760,339,360**	**$5,293,932,682**	**28.31%**	**30.28%**	**$52,516,387**

[1] The domestic equity asset class's benchmark is the Wilshire 2500 market index. The Wilshire 2500 return rate for Fiscal Year 1996-97 was 30.28%.
[2] The SBA closed its account with Apodaca-Johnston Capital Management during the fiscal year.

Appendix B
Domestic Equities Annualized Rates of Return (Net of Management Fees)

	Annualized									
	1 Year 1996-97	**2 Years 1995-97**	**3 Years 1994-97**	**4 Years 1993-97**	**5 Years 1992-97**	**6 Years 1991-97**	**7 Years 1990-97**	**8 Years 1989-97**	**9 Years 1988-97**	**10 Years 1987-97**
External										
Active	26.23%	26.44%	25.14%	19.03%	18.51%	17.98%	16.33%	16.14%	16.47%	13.70%
Passive	32.06%	28.68%	27.05%	19.94%	18.76%	17.95%	16.45%	16.43%	16.86%	14.16%
Total External	28.31%	27.28%	25.85%	19.34%	18.57%	17.92%	16.35%	16.24%	16.60%	13.87%
Internal										
Active	29.34%	26.10%	25.08%	18.46%	17.33%	17.28%	16.22%	15.16%	15.92%	13.65%
Passive	31.82%	28.92%	27.51%	20.62%	19.30%	18.41%	16.84%	16.66%	17.22%	14.58%
Total Internal	31.60%	28.82%	27.05%	20.12%	18.87%	18.10%	16.59%	16.32%	16.93%	14.37%
Total All Active	**26.58%**	**26.23%**	**25.07%**	**18.91%**	**18.28%**	**17.84%**	**16.28%**	**15.95%**	**16.33%**	**13.65%**
Total All Passive	**31.92%**	**28.99%**	**27.35%**	**20.38%**	**19.11%**	**18.24%**	**16.70%**	**16.58%**	**17.08%**	**14.41%**
Domestic Equities	29.60%	27.93%	26.34%	19.64%	18.64%	17.95%	16.41%	16.23%	16.69%	14.02%
Asset Class Benchmark	30.28%	28.18%	26.90%	19.99%	18.68%	17.80%	16.26%	16.25%	16.72%	14.07%

Source: Data provided by State Street Analytics

STATE BOARD OF ADMINISTRATION OF FLORIDA
Post Office Box 13300
32317-3300
1801 Hermitage Boulevard
Tallahassee, Florida 32308
(850) 488-4406

LAWTON CBILES
GOVERNOR
AS CHAIRMAN

BILL NELSON
STATE TREASURER
AS TREASURER

ROBERT F. MILLIGAN
STATE CONTROLLER
AS SECRETARY

TOM IIERNDON
EXECUTIVE DIRECTOR

July 29, 1998

Mr. John W. Turcotte, Director
Office of Program Policy Analysis and
Government Accountability
111 West Madison Street, Room 312
Tallahassee, Florida 32301

Dear Mr. Turcotte:

On behalf of the State Board of Administration (SBA) and pursuant to Section 11.45(7)(d), Florida Statutes, I submit the following response to the preliminary findings and recommendations contained in the Oversight Report on the 1996-97 Investment Report:

The SBA welcomes OPPAGA's efforts to offer recommendations intended to improve the quality and effectiveness of the Annual Investment Report and appreciates the professional manner in which the audit was performed. However, the SBA strongly disagrees with the **first recommendation** to invest all FRSTF assets allocated to domestic equities with passive investment managers. The analysis utilized to render this recommendation was inadequate for a determination of the optimal mix of passive and active management styles in domestic equities. Also, some of the facts presented are erroneous. In my judgement, a completely passively managed domestic equities program would be contrary to the interests of the FRS beneficiaries and Florida taxpayers.

For the last eighteen months, the SBA has been reviewing and reformulating policies on the use of active management strategies. New policies covering active asset allocation strategies were developed and implemented in calendar 1997. I expect that new policies covering the use of active management strategies in the individual asset classes, including domestic equities, will be implemented in calendar 1998. OPPAGA has been provided copies of the May 19, 1998 SBA staff report, Returns to Active Management: Phase II, Installment 1. While our analysis is generally consistent with the concept of increasing the SBA's utilization of passive strategies and more closely controlling risk in several aspects of asset class implementation, I completely disagree that the interests of the FRS beneficiaries would be better served by managing the entire domestic equity asset class in a passive index fund. The SBA's general investment consultant, Ennis, Knupp and Associates, has reviewed the due diligence on this question and concurs with this conclusion.

OPPAGA's Comment

OPPAGA is pleased that the conclusions of SBA's internal analyses are consistent with increasing the use of passive investment strategies. However, OPPAGA disagrees with the SBA's assertion that OPPAGA is questioning the adequacy of the SBA's due diligence. Further, OPPAGA did not recommend that the SBA manage the entire domestic asset class in a single passive index fund. As shown in Appendix A of our draft report, OPPAGA is aware that the SBA already contracts with separate external passive style managers to invest in large and small capitalization companies as well as companies that have growth or value characteristics. The investment firms the SBA contracts with to passively manage funds also offer other passively managed portfolios that could provide exposure to other parts of the domestic equity market and thereby help manage risk and investment diversification. OPPAGA therefore continues to believe that investing all domestic equity assets with passive style investment **managers** (our emphasis) is a viable option that would reduce the SBA's costs while providing long-term returns needed to generate sufficient funds to meet the SBA's overall investment goals.

Fundamentally, the analysis utilized by OPPAGA is inadequate for the purpose of determining the extent to which domestic equity assets should be passively managed. In judging the effectiveness of active management, it is extremely important to compare the investment returns of active managers (net of transaction costs and management fees) with the returns that would have been earned if those same managers' investment style had been implemented with a passively-managed index fund. In this context, a manager's style is largely determined by what types of equity securities they were hired to invest in: small capitalization, large capitalization, value or growth stocks.

OPPAGA's Comment

OPPAGA strongly disagrees with the SBA's statement that our approach is inadequate for determining the extent to which domestic equity assets should be passively managed. In reviewing the performance of the SBA's equity managers, OPPAGA considered the types of securities invested in by the SBA's external managers, such as small capitalization and large capitalization stocks, and manager investment styles. For example, OPPAGA's analyses included the performance of a SBA external manager that passively invested $1.112 billion in the stocks of small capitalization companies. Our point is that, taken as a whole, the SBA's external domestic equity managers that used passive investment styles continued to outperform its active investment style managers and were paid significantly lower fees.

- The SBA enters into legal contracts with investment managers which delineate the specific passive performance benchmark that the manager is expected to outperform over significant periods of time.

- During different periods, the investment returns of indices of stocks representing different styles can vary greatly. For instance, Ibbotson Associates[5] reports that between 1986 and 1990, an investment in small capitalization stocks returned 0.6 percent and large capitalization stocks (e.g. S&P 500 stocks) returned 13.1 percent per year. In contrast, between 1991 and 1995, small capitalization stocks returned 24.5 percent and large capitalization stocks returned 16.6 percent per year. Obviously, comparing a small capitalization manager to a large capitalization index, or vice versa, offers no insight into the effectiveness of that manager.

[5] Stocks, Bonds, Bills and Inflation, 1998 Yearbook: Market Results for 1926-1996, Ibbotson Associates

- Variation in style returns is not a recent phenomenon and has been much greater in the past. Ibbotson reports that between 1926 and 1997, the annual difference between the investment returns on indices of large- and small-capitalization stocks has ranged between -89 percent and +43 percent, with an average annual difference of -4.8 percent.

OPPAGA's analysis violates this basic rule of analytical comparability by comparing the aggregate investment returns of external active investment managers with the Wilshire 2500 index returns and the aggregate investment returns of passive managers (page 4 of OPPAGA 1996-97 Oversight Report). This error is compounded and repeated by comparing individual manager returns to the Wilshire 2500 returns, rather than to their contractual performance benchmarks. Conclusions based on these types of comparisons are meaningless because the respective returns result from materially different investment strategies and styles.

> **OPPAGA's Comment**
>
> The SBA's comment appears to refer to a table in our draft that shows the performance of each individual manager compared to the return rate for the SBA's overall asset class benchmark (Wilshire 2500). The table provides a basis for assessing each manager's performance and relative contribution toward achieving the overall domestic equity asset class objective of meeting or exceeding the return rate for the Wilshire 2500 Index.
>
> As continually noted in our prior reports, OPPAGA believes that it is essential for the SBA to monitor the performance of individual external managers against the managers' specific contracted benchmarks. However, while this type of analysis is essential for monitoring, it is not useful for assessing the aggregated performance of a group of managers using a particular investment approach, such as passive investment strategies.

SBA staff explained the problems with this analytical approach in a written communication to OPPAGA dated June 3, 1998.

> **OPPAGA's Comment**
>
> OPPAGA agrees with the point made by SBA staff in the referenced written communication that each portfolio manager has a specific performance benchmark that differs from the asset class target index and that as a result, groups of portfolios could outperform their aggregate benchmarks but not the overall asset class target index. However, this does not invalidate our conclusion that passive style managers outperformed active style managers. To illustrate, in its 1996-97 Investment Report, the SBA presented data indicating that only 8 of 18 external domestic equity managers using an active investment style met or exceeded their specific performance benchmarks. In contrast, all four of the SBA's external passive style managers met or exceeded their contracted performance benchmarks.

For instance, OPPAGA notes that during fiscal 1997, the aggregate investment return of the SBA's passive domestic equities accounts was higher than the overall asset class benchmark, the Wilshire 2500. With 20-20 hindsight, we can attribute this return differential to the fact that the passive funds had mandates that were weighted more heavily toward large capitalization stocks (S&P 500 stocks), which significantly outperformed the collection of smaller capitalization stocks in the Wilshire 2500 index. However, this weighting reflects the SBA's judgement that there are less opportunities for active management to add value, net of costs, in the highly efficient markets for large capitalization stocks. Active management styles are more heavily utilized in markets for smaller capitalization stocks.

OPPAGA's Comment

The SBA's comment does not take into consideration that various investment firms have developed portfolios that use passive investment styles to invest in stocks of small capitalization companies. In fact, the SBA uses an external passive style manager that invests in small capitalization companies. This manager was paid approximately $141,000 in fees to manage $1.112 billion in assets (fees to assets ratio of 1.3 basis points), which is considerably lower than the fees the SBA paid to active managers that invested in stocks of low capitalization companies. To illustrate, the SBA paid one of its active style small capitalization managers approximately $108,000 in fees to manage $29 million in assets (fees to assets ratio of 37 basis points). Consequently, OPPAGA continues to believe the SBA could use passive style managers if it wants to maintain investments in the low capitalization segment of the domestic equity market.

Failure to isolate the impact of the SBA's private equity program on domestic equities' investment returns also seriously distorts OPPAGA's characterization of the effectiveness of external active domestic equities investment managers. The private equity program is designed to provide investment returns in excess of public market equity investments, but it is a long-term active strategy that typically does not show significant performance for 2 to 4 years.[6] In the three years ending June 30, 1997, the SBA made $585 million of private equity investments. Overall, private equity investments have exerted a significant drag on aggregate external active domestic equity returns, lowering returns by 0.80 percentage points per year for the last three fiscal years and 1.11 percentage points for fiscal 1996-97.

OPPAGA's Comment

The SBA's private equity investments include investments through intermediary managers and partners to buy out companies or provide venture capital funding in exchange for equity. These investments are typically long-term in nature and illiquid. The SBA's long-term, overall investment return rate objective for these investments is to exceed the equity asset class target (Wilshire 2500) by 750 basis points or 7.5% over a 10-year period. The SBA included its private equity managers among the list of domestic equity managers in its 1996-97 Investment Report. Given this, OPPAGA believes it is appropriate to review the SBA's private equity investments as a strategic investment decision and assess their performance not only against the long-term objective (Wilshire 2500 plus 7.5%), but the opportunity cost to the Florida Retirement System Trust Fund resulting from foregoing the returns that would have been achieved if the same amount of funds instead had been invested using another approach, such as investing with a passive style domestic equity manager.

Correcting these shortcomings in the analysis leads to a different characterization of the effectiveness of active management at the SBA. Table 1 presents aggregate investment return data from the SBA's performance consultant, State Street Corporation. The table compares the aggregate returns of external active managers—after removing the impact of the private equity accounts and subtracting all transaction costs and investment management fees—to the aggregate returns of their contractual performance benchmarks. Aggregate returns represent weighted averages of the underlying returns. The main body of the table contains data through fiscal 1997, but performance data is also presented through June 1998. As discussed below, the updated information helps demonstrate how sensitive investment results are to the measurement period.

[6] 1997 Investment Benchmarks Report: Buyouts and Other Private Equity, Venture Economics Investor Services

Table 1: Domestic Equities' Annualized Net Rates of Returns: External Active Managers, Excluding Private Equity Accounts
Manager Return Data is Net of Investment Manager Fees

Periods Ending June 30, 1997	Annualized Aggregate Manager Returns	Annualized Aggregate Benchmark Returns	Annualized Net Value-Added
10 Years	13.92%	13.74%	0.17%
9 Years	16.71%	16.21%	0.50%
8 Years	16.39%	16.03%	0.37%
7 Years	16.59%	16.45%	0.14%
6 Years	18.32%	18.11%	0.21%
5 Years	18.94%	19.16%	-0.22%
4 Years	19.42%	19.85%	-0.42%
3 Years	25.94%	26.58%	-0.64%
2 Years	27.24%	27.17%	0.07%
1 Year	27.34%	28.88%	-1.54%
Memo:			
July 1987 to June 1998	15.39%	15.03%	0.36%
5 Years ending June 1998	21.68%	21.56%	0.12%

Source: State Street Corporation and SBA

Table 1 shows that over long periods of time external active managers have added value relative to their benchmarks, after payment of management fees. Performance was somewhat mixed in the five years ending fiscal 1997 and this motivated, in part, the SBA's active management research project referenced above. However, it is important to note that the aggregate performance of external active managers has improved markedly in fiscal 1998, a potential trend highlighted in the 1996-97 Annual Investment Report[7]. In fact, for the 5 years ending June 1998, the aggregate return of the SBA's external active domestic equity managers, excluding private equity, exceeded their aggregate benchmark by 0.12 percentage points, net of investment management fees. In my judgement, the long-term experience of the SBA does not argue that we should move to a fully passive implementation of domestic equities assets.

OPPAGA's Comment

OPPAGA is not questioning whether the SBA's external active style managers' performance added value compared to an aggregation of their individual contracted benchmarks. Our point is that the active style managers significantly under-performed passive style managers on both a short- and long-term basis. Accordingly, the SBA could have added even more value to the total portfolio by using passive style managers.

[7] "A major theme behind successful investment strategy for the year was to be invested in the largest companies. Ample evidence of this is the finding that approximately 50% of the gain in the S&P 500 Index came from the 50 largest stocks in the Index ranked by market capitalization.... Our active managers were underexposed to the 'Top 50' list. We feel, however, that this was rational. It seems to us that the share prices of these large companies have been excessively bid up by large investors like the mutual funds who have to invest their large cash flows quickly and so choose to use these highly liquid names. It will be interesting to see if there is a reversal of this trend in the upcoming year, which would likely aid our relative performance." 1996-97 Annual Investment Report, page 25.

Moreover, objective academic research clearly indicates that there are inefficiencies in the domestic equity markets: the value effect and small-cap effect are widely cited. A review of published research on market inefficiencies has been provided to OPPAGA. Furthermore, implementing a passive index fund entails investment and operational risk that must be balanced against the risk of under-performance by active managers. I believe that structuring an investment program that exploits market inefficiencies, while carefully controlling risk, is in the interests of the FRS beneficiaries and Florida taxpayers. A successful active management program can enhance benefit security and lower public employer contribution rates.

OPPAGA's Comment

OPPAGA concluded that the SBA's active management program has not been very successful on a short- and long-term basis when compared against the performance of its passive investment style managers.

Were we to invest all of our Domestic Equity assets in passive vehicles only, we would be guilty of the worst kind of risk controls - None! We would gain a full share of any market upside and lose a full share of any downturn. In other words, we would have all of our Domestic Equity eggs in one very volatile basket.

OPPAGA's Comment

OPPAGA believes the SBA's response misstates the issue of risk as it relates to the volatility of returns in response to market downturns. In this case, concern would arise not from a manager's use of active versus passive investment styles, but rather from the SBA's over- or under-exposure to investments in various segments of the market, such as large and small capitalization companies or to investments in the stocks of companies having certain attributes (i.e., growth, value, yield, etc.). The SBA already uses external passive style managers to invest in small capitalization companies as well as companies that have growth or value characteristics. Further, the investment firms the SBA contracts with to passively manage certain funds also offer other passively managed portfolios that could provide exposure to other parts of the domestic equity market and thereby help manage risk and investment diversification. Accordingly, OPPAGA's recommendation does not contemplate that the SBA would "have all of our Domestic Equity eggs in one very volatile basket" such as a single index fund.

OPPAGA's recommendation to use passive style managers is consistent with investment tenets stated in the SBA's 1996-97 Investment Report—namely, that "risk is a long-term notion related to how confident we are in our asset return expectations over the life of the plan" (p.14) and that "90% of the expected return/volatility of any balanced portfolio is determined by the mix of the classes of invested assets, with the remainder coming from security selection within individual portfolios" (p.15). Using passive style managers would allow the SBA to maintain a targeted level of investments in domestic equities while reducing the long-term risk of failing to meet return expectations for that asset class.

In addition, other large public pension funds have examined these same issues and have rejected the completely passive approach. In particular, the Oversight Report is in error when it states, "Washington State Investment Board recently decided to have all of its domestic equity assets invested with passive investment styles" (page 4 of OPPAGA 1996-97 Oversight Report). Washington State invests in domestic equity assets in both its U.S. Equity Program and its Private Equity Program (Table 2). The U.S. Equity Program is implemented with passive index funds, however, none of the private equity program is passively managed. Moreover, roughly one-half of the private equity investments are in publicly-traded companies.

OPPAGA's Comment

OPPAGA agrees that the Washington State Investment Board actively invests its private equity funds which consist of leveraged buy-outs and venture capital investments. However, we believe it is very clear from the context of our remarks that we were referring to the portion of that board's investments made in publicly-offered stocks of U.S. companies. Private equities are typically long-term, illiquid investments. OPPAGA further notes that the Washington State Investment Board, unlike the SBA, segregates domestic equity and private equity investments for external reporting purposes and accordingly separately reports the performance and market value of its venture capital and leveraged buyout investments.

Table 3 shows how large U.S. public pension funds currently approach the active/passive issue for their public-market domestic equity investments.

Table 2: Washington State Investment Board's Allocation of Domestic Equity Assets
Data as of June 30, 1997 with Market Values in Millions

Category	Market Value	Share of Total Domestic Equity
U.S. Equity Program	$13,498,105	84%
S&P 500 Index	$9,991,878	
Extended Markets Index	$3,506,227	
Domestic Private Equity Program	$2,608,392	16%
Total Domestic Equity	$16,106,497	100%

Source: Sixteenth Annual Investment Report, Washington State Investment Board, June 30, 1997

Table 3: Passive Management of Domestic Equity Assets at Large Public Pension Funds: Excluding Private Equity Investments

All Figures Percentages of Public Market Asset Class, Except Asset Totals

Fund	Dec-97 Total Assets (Millions)	Percent Passively Managed	Data
CALPERS	$ 127,656	87	Sep-97
NY State Common	$95,812	76	Dec-97
CALSTERS	$78,900	83	Feb-98
SBA	$71,940	59	Mar-98
NY State Teachers	$68,738	88	Dec-97
Texas Teachers	$64,221	11	Jun-97
New Jersey	$59,933	0	Jun-97
New York City	$54,712	86	Sep-97
Wisconsin	$50,051	58	Dec-97
Memo: Other Substantial Passive Implementations			
Pa. Schools	$39,133	65	Dee-97
NY City Teachers*	$35,062	70/100	Sep-97
Washington State	$33,946	100	Nov-97
Virginia	$28,832	59	Jan-98
Maryland	$26,011	89	Dec-97
Colorado	$23,275	69	Dec-97
Massachusetts	$22,654	73	Feb-98

* 70 percent passive allocation in a defined contribution program and 100 percent in a defined benefit program

Source: Pensions and Investments and IFE Network

OPPAGA's Comment

While this table indicates that only two other large plans have all of their domestic equities passively managed (excluding private equity investments), it also shows that the four largest public employee plans (excluding the SBA) have significantly higher percentages of their domestic equities passively managed than the SBA.

In summary, the SBA expects that new policies covering the use of active strategies in the individual asset classes, including domestic equities, will be implemented in calendar 1998. SBA's analysis is generally consistent with the concept of increasing the utilization of passive strategies and more closely controlling risk in several aspects of asset class implementation. However, I strongly disagree that the interests of the FRS beneficiaries and Florida taxpayers would be better served by managing the entire domestic equity asset class in a passive index fund.

OPPAGA's Comment

Again, OPPAGA is pleased that the SBA is considering increasing the use of passive strategies, but continues to believe that the SBA could achieve better performance with lower management costs by having all of its domestic equities invested by passive style **managers** (our emphasis). OPPAGA does not recommend the SBA manage the entire domestic asset class by using a single passively managed index fund.

As identified in the **second recommendation,** in future Investment Reports, the SBA will disclose and describe changes in the basis or methods used to calculate return rates and targets presented and disclose whether the changes have an effect on the reported results.

Finally, I also want to respond to OPPAGA's request to report any factual errors in the Draft Oversight Report.

- On page 4, OPPAGA reports the fiscal 1996-97 performance of the SBA's passive domestic equities investment managers as 32.08 percent. Appendix A of the Oversight Report shows that 32.08 percent was the return earned by the external passive managers. Domestic equities' passive investment managers, internal and external combined, had a return of 31.92 percent in fiscal 1996-97.

> **OPPAGA's Comment**
>
> OPPAGA has added the word "external" to the appropriate place in our draft.

- On page 7, OPPAGA reports the 1996-97 net investment return for domestic equities as 29.80 percent. The correct return was 29.60 percent.

> **OPPAGA's Comment**
>
> OPPAGA has changed the figure to 29.6%.

- On page 7, OPPAGA reports the 1987-97 net investment return for internal passive managers as 14.58 percent. Internal passive management was not conducted for the entire ten years ending June 1997, therefore there is no ten-year return.

> **OPPAGA's Comment**
>
> The SBA's 1987-88 Investment Report shows the SBA had $2.451 billion invested in domestic equities that was managed internally using a passive investment style. Therefore, internal passive management was conducted for the entire 10-year period. However, State Street Analytics did not provide the SBA or OPPAGA with Fiscal Year 1987-88 performance data for these investments. Based on data presented in the SBA's 1987-88 Investment Report, OPPAGA estimated the return rate for internal passively managed portfolios during that year to be -6.7%. The 10-year annualized rate of return figure referenced in the SBA's response (14.58%) incorporates OPPAGA's estimated return for Fiscal Year 1987-88.

Please contact Gwenn Thomas or me at 488-4406 if you have any questions or require further information.

Sincerely,

/s/
Tom Herndon

TH/jb

The Florida Legislature

Office of Program Policy Analysis and Government Accountability

ANNOUNCEMENT

The Office of Program Policy Analysis and Government Accountability announces the availability of its newest reporting service. The **F**lorida **G**overnment **A**ccountability **R**eport (**FGAR**), an electronic publication specifically designed for the World Wide Web, is now up and operating for your use.

FGAR provides Florida legislators, their staff, and other concerned citizens with approximately 400 reports on all programs provided by the State of Florida. Reports include a description of the program and who is served, funding and personnel authorized for the program, evaluative comments by OPPAGA analysts, and other sources of information about the program.

Please visit **FGAR** at http://www.oppaga.state.fl.us/government. Your comments and suggestions about improving our services are always welcome.

Gena Wade, FGAR Coordinator (850) 487-9245

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. 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 (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.oppaga.state.fl.us

Project supervised by: Thomas S. Roth (850/488-1024)

Project conducted by: A. B. Verhine, C.P.A. (850/487-9276)