

Investments

State of Wisconsin Investment Board

The State of Wisconsin Investment Board (SWIB) is a state agency responsible for investing the assets of the Wisconsin Retirement System (WRS) and six other trust funds established by the state. Investments are made according to the purpose and risk profile of each trust. Although SWIB is a separate agency from the Department of Employee Trust Funds (ETF), it plays a critical role in the funding of the WRS.

Over the long term, investment earnings are a major factor in the financing of retirement system benefits. Approximately \$2.7 billion was paid to WRS participants in 2003. Approximately 85% of the cost of benefits that today's retirees receive is funded from investment income earnings, lowering the contribution costs of the retirement system. Without these investment earnings, employee and employer contributions would need to increase to meet future benefit obligations.

WRS pension assets are managed as part of the Fixed (or balanced) Trust Fund or the Variable Trust Fund. As of December 31, 2003, the fixed fund assets were \$56.9 billion, up from \$46.3 billion for the same time period in 2002. The variable fund assets were \$5.9 billion, up from \$4.7 billion the previous year. The two trust funds make up 91% of the total assets under management by SWIB.

Board of Trustees

SWIB is directed by a nine-person, independent Board of Trustees and staffed with professional money managers and support personnel. The Board of Trustees appoints the Executive Director of the Investment Board. The Executive Director oversees the staff, develops and recommends agency and investment policies for Board adoption, and ensures adherence to state and federal law and policies.

The Trustees of the Investment Board as of December 31, 2003, were as follows:

1. Six public members appointed by the Governor to six-year terms and confirmed by the State Senate including four with at least ten years of investment experience and one with at least ten years of financial experience, who work for a local government in the Local Government Investment Pool, a fund managed by SWIB.

James A. Senty - Chair (Public Member)
President, Midwest Bottle Gas Company,
La Crosse

Allen Sampson - Vice-Chair
(Public Member), Milwaukee

Tom Boldt, (Public Member)
President, The Boldt Group, Inc./CEO
The Boldt Co., Appleton

William Levit, Jr., (Public Member)
Attorney, Godfrey & Kahn S.C.,
Milwaukee

Delores Sims, (Public Member)
President & CEO Legacy Bank Inc.,
Milwaukee

Vacant (Local Government Public
Member)

2. Two retirement system members: a teacher participant in the WRS appointed by the Teacher Retirement Board, and a non teacher participant in the WRS appointed by the Wisconsin Retirement Board.

Wayne McCaffery (WRS, Teacher Retirement Board Appointee), teacher, Stevens Point Area Senior High School.

Eric O. Stanchfield (WRS, Wisconsin Retirement Board Appointee), Secretary, Department of Employee Trust Funds.

3. Secretary of the Wisconsin Department of Administration (DOA) or designee.

Marc Marotta, Secretary, Department of Administration (Designee **Laura Engan**, Deputy Secretary)

Note: SWIB publishes its annual report for the fiscal year ending June 30 and a separate list of investments that include the WRS assets. To receive a copy of either publication by mail, call (608) 266-2381 or e-mail info@swib.state.wi.us. To view it online, visit SWIB's Internet site at www.swib.state.wi.us.

Fixed Fund

The fixed fund is the largest of the two trust funds that make up the WRS. All participants have at least 50% of their actual annual pension contributions placed in the fixed fund.

Investment Goals: One basic investment goal is to earn an average 7.8% annual return over the long term, which includes an annual rate of return of 3.7% above the expected annual average increase of wages of employees covered by the WRS. The 7.8% return is the interest assumption recommended by the WRS actuary and set by the ETF Board. The ten-year annualized return as of December 31, 2003, was 9.1%, 1.3% above the 7.8% goal.

A second goal is to exceed the benchmark established by the Board of Trustees. The benchmark measures SWIB's performance to see if we are doing as well as or better than the markets. The fixed fund benchmark is mainly a composite of several industry indices rolled up and weighted to the asset allocation targets.

Investment Strategy: In keeping with the extended time horizon of the fund's obligations to provide pensions for all participants, this fully diversified, balanced fund seeks long-term growth. Asset allocation is reviewed annually.

Variable Fund

About 9.2% of WRS assets are managed in the variable fund, which was closed by law to new participants in 1980 and reopened to active participants in 2001. Participants who choose the variable fund can place half of their future pension fund contributions in this fund. Participants in the variable fund option also accept a greater degree of risk, in part because it is a stock fund, with the potential for greater long-term returns.

Investment Goal: The investment objective is to achieve returns that equal or exceed that of similar equity portfolios. The variable fund benchmark is a composite of individual indices rolled up and weighted to the asset allocation targets. The Standard & Poor's Index of 500 stocks, which features large company stocks, is additionally observed for comparison. However, for diversification, a significant portion of the fund is invested in stocks, including the international and small company stocks, that are not represented in the S&P 500.

Investment Strategy: According to Wisconsin Statutes, the "assets of the Variable Fund shall be invested primarily in equity securities, which shall include common stocks, real estate or other recognized forms of equities...". Asset allocation remains 100% in equities.

Stock Exposure

WRS participants who remain only in the fixed fund currently have about 58% of their current pension contributions invested in stocks. Participants who decide to divide their current pension contributions between fixed and variable funds have a stock exposure of about 80%. This proportion changes as stock values change in the marketplace relative to other types of investments. (These comments reflect individual participant balances; defined benefit calculations are not directly

affected by these asset allocations, except through participation in the variable fund).

Investment Results

Investment income in excess of the WRS actuarial assumption generally means lower employer (largely taxpayer) and employee costs, as well as increased payments to beneficiaries to offset inflation. Investment income that is less than actuarial assumptions means higher contributions by employers and employees. Wisconsin's retirement system permits increased payments to beneficiaries if investment results exceed salary growth assumptions by the amount necessary to maintain level payments. In addition, investment results directly affect the benefits paid to employees who terminate their employment prior to retirement but leave their funds in the WRS, and the benefits paid to their surviving beneficiaries.

Interest Credits

The interest credit, paid at the end of each year, is expressed as a percentage and applied to the year's beginning balance in the participant's account. The Fixed Trust Fund interest credit paid at the end of the year is based on an established formula. Annual market gains and losses in the fixed trust are spread over five years to stabilize the Fixed Trust Fund income credit and smooth contribution rate changes and fixed annuity adjustments for participant accounts.

The Variable Trust Fund interest credit consists of income plus capital gains and losses of the fund, with no averaging or stabilizing provision. Since the Variable Trust Fund is invested almost entirely in common stocks, the inherent volatility of the stock market results in widely varying annual returns.

Total Rate of Return

While interest credits reflect SWIB's performance in a meaningful way to beneficiaries, they differ from measures commonly used to evaluate investment management. Total rate of return over various time periods is widely accepted for comparing investment results. It combines current yield plus changes in current market value.

The interest credit for the Fixed Trust Fund is similar to the yield (dividends and interest), adjusted by the portion of prior gains and losses "smoothed" into the current year. This similarity exists because the credit fully reflects the current year's dividends and interest received by the Fixed Trust Fund. The Fixed Trust Fund interest credit is comparatively stable and is less susceptible to fluctuations.

The interest credit for the Variable Trust Fund, on the other hand, is close to the total return of that fund, fully reflecting changes in market value as well as yield. The deviations between Variable Trust Fund interest credit and total rate of return reflect non-investment changes such as changes in reserves, turnover, and the timing of payments.

Individual benchmarks are set for the fixed trust and variable trust funds to determine the relative success of SWIB's investment strategy. Typically, the Investment Board annually reviews all benchmarks with the help of an outside consultant. Trust fund benchmarks are based on published indices (that measure changes in financial markets) or are customized to reflect a specific investment strategy. The fixed and variable trust funds each consist of a composite of a number of indices and other customized benchmarks that are rolled up and weighted to match SWIB's asset allocation targets. Where possible, SWIB uses published indices. For example, domestic equities are measured against the Russell 3000 because it represents the mixture of large, medium and small

companies held in the WRS domestic equities portfolios.

Performance Objectives

Fixed Trust Fund

Perhaps the most important measure of results is performance compared with established investment objectives. An objective for the Fixed Trust Fund is to exceed a benchmark composed of market indices weighted to reflect adopted asset allocation policies. Another objective is to exceed wage rate growth by 3.7% per year over long periods of time. This objective is consistent with future actuarial expectations of the retirement plan. The WRS wage rate growth is selected rather than the national wage growth experience because this measure is believed to better represent long-term wage trends.

Variable Trust Fund

For the Variable Trust Fund, the objective is to exceed a benchmark composed of market indices weighted to reflect adopted asset allocation policies. The S&P 500 Index (with income added) is also observed as a secondary comparison. The S&P 500 Index is widely regarded as a good measure of average results for larger U.S. common stock funds. Another objective of the variable fund is to equal or exceed a broad equity benchmark more closely resembling SWIB's mixture of U.S. and non-U.S. equity assets.

Interpretation of Results

There are many ways of assessing investment results; some are incorrect. For example; it is not appropriate to compare the results of funds with very different objects or guidelines. Funds with different types and mixes of investments should not be directly compared. To properly assess investment results, comparisons must reflect similar objectives, guidelines and opportunities. The

best period of time used for measurement of investment success for pension funds is consistent, long-term results.

One way to review SWIB's performance is to compare its investment returns to other large pension funds. As of December 31, 2003, the fixed fund ranked third for one-year returns, first for five-year and eighth for ten-year returns compared to nine other large public pension funds surveyed by the Legislative Audit Bureau in the past. The fixed fund's five-year return ranked second on a risk adjusted basis. While returns varied significantly for the one- and five-year periods, the ten-year variance was less than 1%. Another survey conducted by the Trust Universe Comparison Service ranked the fixed fund one-year return in the top third and the five- and ten-year returns above the median of about 40 other public pension funds with assets over \$1 billion. These returns are not evaluated on a risk-adjusted basis.