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Department of Employee Trust Funds
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CORRESPONDENCE MEMORANDUM

DATE: February 28, 2008

TO: Employee Trust Funds Board

FROM: David Stella, Secretary

SUBJECT: Variable Fund

At the December 2007 joint informational meeting, the State of Wisconsin Investment Board (SWIB) Executive Director, Keith Bozarth, and I presented information and discussed policy concerns related to the Variable Fund. All of the retirement boards subsequently discussed various issues related to the risks and relative performance of the Variable Fund over time.

While there was no consensus among the boards about whether or not the Variable Fund should be retained, it was agreed that the Department should increase its efforts to educate members about the significantly higher risks of the Variable Fund and its historical performance. In that regard, the Department has created a media site video on the Variable Fund and plans to continue articles that have appeared in the Trust Fund News for the past eight years on the issues and concerns about this Fund.

The comments of the retirement boards were shared with the SWIB trustees at their meeting on January 9, 2008. At that meeting, SWIB adopted new strategic asset allocation targets for the Core and Variable Funds. Based on substantial analysis and input from Strategic Investment Solutions, SWIB's investment consultant, the Core and Variable Fund strategic asset allocation targets were changed as follows:

Core Fund	Current Allocation	New Allocation
Total Equities	58%	58%
• U.S. Equities	36%	32%
• International Equities	22%	26%
Fixed Income	30%	30%
Private Equity	5%	5%
Real Estate	5%	5%
Multi-Asset	2%	2%

Variable Fund	Current Allocation	New Allocation
U.S. Equities	79%	69%
International Equities	20%	30%
Multi-Asset	1%	1%

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The allocation to international equities was increased by 4% in the Core Fund and by 10% in the Variable Fund. The reallocation of assets will require asset transfers from U.S. equities to international equities and will be completed by the end of 2008.

In adopting the strategic allocation targets for the Variable Fund, SWIB noted that the new allocations are expected to generate slightly higher returns, create only slightly higher risk and result in the highest Sharpe Ratio. The Sharpe Ratio is a measure of the excess return per unit of risk in a portfolio. It is used to characterize how well the return of a portfolio compensates the investor for the risk taken. A higher Sharpe Ratio gives more return for the same level of risk taken on.

SWIB staff also recommended that discussions with the Department and the ETF Board continue about the future of the Variable Fund. SWIB trustees agreed with the SWIB staff's recommendation and expressed continued concern about the Variable Fund's structure. SWIB trustees are concerned that the portfolio cannot be structured to optimize return within acceptable risk measures.

In changing the strategic asset allocation for the Variable Fund, SWIB has done what it can to optimize the return within acceptable risk parameters. However, discussion needs to continue about whether the Variable Fund should exist at all given the fundamental changes in the Core Fund asset allocation over the past 25 years. For example, in 1982, 70% of the Core Fund assets were allocated to fixed income and real estate investments and 30% to equities. By 1995 only 40% of the Core Fund was invested fixed income and real estate and steadily declined since then to 35% in 2007.

The changes in Core Fund asset allocation have resulted in a diversified portfolio of fixed income and equity investments at the efficient frontier of risk and return. The efficient frontier is a time tested concept that plots risk (volatility) as measured by standard deviation and the expected return of a diversified portfolio in order to identify the point on a risk/return curve that produce optimum risk/return balance.

The annualized Core and Variable Fund returns over the past twenty years illustrate the advantages of a diversified portfolio of investments. The Core Fund outperformed the Variable Funds over one-year, three-year, and ten-year periods. Over twenty years, there is relatively little difference in the return for the significantly higher risk a member takes when participating in the Variable Fund, (Variable return 11.0% vs. Core return 10.6%).

Recommendation

The Department recommends that discussion of various policy alternatives be considered by the ETF Board at the June 2008 meeting. ETF will work with SWIB staff to identify appropriate policy alternatives ranging from retaining a restructured Variable Fund to various alternatives that ultimately result in its elimination.