SEPTEMBER 2001 **REPORT NO. 02-043**

AUDITOR GENERAL

William O. Monroe, CPA

EXTERNAL MANAGER SELECTION AND ALTERNATIVE INVESTMENTS MANAGEMENT FLORIDA STATE BOARD OF ADMINISTRATION OPERATIONAL AUDIT

SUMMARY

The State Board of Administration (SBA) had implemented effective management controls relating to the selection, engagement, and monitoring of external investment managers. However, as summarized below, our audit did disclose an area in which the external manager selection process might be improved and some opportunities for enhancing the management of the SBA's alternative (private equities) investments portfolio.

- ***During a first-level screening, investment products may have been eliminated from consideration because information was missing from the database used to identify and screen the products. The SBA did not attempt to contact the respective investment product managers to obtain the information. Absent the solicitation and consideration of all available information for each product identified, potentially profitable investment opportunities may be missed.***
- ***Planning documents, work plans, and policy and procedure statements relating to alternative investments were either out-of-date or still under development more than a year and a half after the creation of the Alternative Investments Department as a separate organizational entity. Absent current investment strategies, policies, and work plans, the SBA lacks a current framework for reasonably ensuring a coordinated and efficient approach to alternative investments management.***
- ***Due to a moratorium on pursuing new private equity relationships, Alternative Investments staff did not consider new private equity relationships beyond an initial review, while subsequently committing an additional $800 million to existing relationships. The moratorium had the effect of limiting the private equity investment opportunities available to the SBA, and may have resulted in missed investment opportunities.***

FINDINGS AND RECOMMENDATIONS

Domestic Equity External Investment Manager Selection

Pursuant to Section 215.44(2)(b), Florida Statutes, the State Board of Administration (SBA) is authorized to retain external investment managers to assist in carrying out its investment powers and responsibilities. According to SBA records, as of June 30, 2001, approximately $29.4 billion (55 percent) of the $53.6 billion (fair value) of domestic equity investments for the Florida Retirement System was being managed pursuant to contracts with 15 external investment managers.[1]

Finding No. 1: During a first-level screening, investment products may have been eliminated from consideration because information was missing from the database used to identify and screen the products. The SBA did not attempt to contact the respective investment product managers to obtain the information.

As part of our audit, we reviewed the extent to which the domestic equity external manager selection procedures

[1] Amounts derived from the SBA's draft of the 2000-01 Investment Report.

reasonably ensured the competitive selection of qualified candidates. In conducting our review, we focused on the recent selection of two domestic equity products and their respective external managers.

Our review of the process leading to the selection of these two investment products and the related managers disclosed that the products were, in general, selected in accordance with the established procedures and criteria applied to the 360 products initially identified and considered. However, our review did disclose that some products may have been improperly eliminated from consideration during initial screening processes.

Specifically, we found that 33 of the 204 products that were eliminated were rejected, not because of a failure to meet or exceed the requirements of a particular criterion, but because information needed for comparison to the criterion was not available in the database used by the SBA. In these instances, the SBA did not attempt to obtain the information by contacting the managers offering the products.

Absent the solicitation and consideration of relevant, available information for each product identified, potentially profitable investment opportunities may be missed. We recommend that the SBA modify its selection procedures to require that, prior to the elimination of investment products from further consideration, attempts be made to obtain all relevant product information.

Alternative Investments Management

The SBA's $3.5 billion (as of December 31, 2000) Alternative Investments portfolio consisted primarily of investments in "buyout" funds. Buyout funds consist of investments in enterprises that were considered, at the time of purchase, to be undervalued, underperforming, or subject to significant future growth. Buyout funds are managed by a buyout firm, which acts as a general partner. The general partner is responsible for identifying investment opportunities for the fund and for improving the performance of the enterprises, with the ultimate goal being to liquidate the fund's holdings and earn substantial profits.

Some believe that buyout fund investments carry a significant degree of investment risk. Also, investments in buyout funds are not as liquid as some investment opportunities, as the terms of the investment contract may dictate that the buyout fund investment be held for extended periods. However, those who advocate the purchase of these types of investments indicate that the potential for high rates of return adequately compensates the investor for the added risk and loss of liquidity.

Finding No. 2: Planning documents, work plans, and policy and procedure statements relating to alternative investments were either out-of-date or still under development more than a year and a half after the creation of the Alternative Investments Department.

The Alternative Investments Department, created November 1, 1999, is staffed with a Chief of Alternative Investments, two Portfolio Managers, an Assistant Portfolio Manager, and two support staff. Our review of the Alternative Investments Department's planning documents and policies and procedures disclosed the following:

- A long-term strategic plan (Private Equity Portfolio Strategy) was created effective May 23, 1997, when the Alternative Investments portfolio was a responsibility of the Domestic Equities Department. Since then, various changes have occurred at the SBA, such as the creation of an alternative investments asset class with its own asset allocation percentages, a change in performance benchmarks from the equity index target plus 7.5% to the equity index target plus 6.0%, the creation of a defined contribution retirement plan, and a moratorium on new investment relationships. However, the long-term strategic plan had not, as of the close of our audit fieldwork, been updated.
- An 18-month work plan was created for the period January 1, 1998, through June 30, 1999. However, no work plan had been created for subsequent periods.
- Policy and procedure statements designed to reasonably ensure the accomplishment of long-term strategic plan goals and objectives and the proper execution of work plan tasks were still under development as of the close of our audit fieldwork.

Absent current investment strategies, work plans, and policy and procedure statements, the SBA lacks a current framework for reasonably ensuring a coordinated and efficient approach to the management of alternative investments. We recommend that a current long-term strategic plan, an annual work plan, and policies and procedures be adopted for the alternative investments class of investments.

Finding No. 3: Due to a moratorium on pursuing new private equity (buyout fund) relationships, Alternative Investments staff did not consider new private equity relationships beyond an initial review, while committing an additional $800 million to existing relationships.

In March 1999, SBA staff implemented a moratorium on new private equity relationships. The moratorium was initiated, in part, so that the SBA could reevaluate its strategy concerning private equity investments. As originally envisioned, the moratorium was to last less than a year; however, the moratorium was still in effect as of the close of our audit fieldwork. Although the moratorium prohibits the SBA from forming new private equity relationships, it does not limit the placement of additional investments with existing private equity general partners.

While the moratorium has been in effect, the SBA has placed or planned to place an additional $800 million in private equity investments. Because of the moratorium on new relationships, the $800 million was committed to already existing relationships, as shown below:

Limited Partnership - Buyout Funds	Commitment Amount	Proposed Commitment Amount
Carlyle Partners III, L.P.	$200,000,000	
Hicks, Muse, Tate and Furst Equity Fund V, L.P.		$25,000,000
Willis Stein & Partners III, L.P.	100,000,000	
Thomas H. Lee Equity Fund V, L.P.	50,000,000	
Ripplewood Partners II, L.P.	50,000,000	25,000,000
Lexington Capital Partners IV, L.P.	200,000,000	
Apollo Investment Fund V, L.P.	100,000,000	50,000,000
Totals	$700,000,000	$100,000,000

The moratorium had the effect of limiting the private equity investment opportunities available to the SBA, and may have resulted in missed investment opportunities. According to the SBA's private equity consultant's *Private Equity Overview* dated February 2001, the year 2000 represented a year of unprecedented fundraising activity in private equity partnerships. Commitments of $154 billion were raised in 412 funds, of which $47.7 billion was raised by 74 investment firms for 74 buyout-oriented funds. This includes at least 60 investment firms with which the SBA did not have any private equity relationships.

As indicated above, private equity investments, while offering potentially high rates of return, do carry significant investment risks and an absence of liquidity. Should the SBA decide to continue investing in private equities, we recommend that the moratorium on establishing new relationships be lifted.

SCOPE, OBJECTIVES, AND METHODOLOGY

This operational audit focused on external manager selection and alternative investments management. Our objectives were:

- To determine the extent to which the State Board of Administration's management controls promote and encourage the achievement of management's control objectives.
- To evaluate the State Board of Administration management's performance in achieving compliance with controlling laws, administrative rules, and other guidelines; the economic, efficient, and effective operation of State government; the reliability of records and reports; and the safeguarding of assets.

In conducting our audit, we interviewed State Board of Administration personnel, obtained an understanding of relevant laws and management controls, and performed various tests relating to investment management. Our audit included tests of various transactions (as well as events and conditions) occurring during the period July 1, 1999, through January 31, 2001.

AUTHORITY

Pursuant to the provisions of Section 11.45, Florida Statutes, I have directed that this report be prepared to present the results of our operational audit.

William O. Monroe, CPA
Auditor General

AUDITEE RESPONSE

In a letter dated September 27, 2001, SBA management provided the following responses to the audit findings included in this report:

- Finding No. 1: We will consider this audit recommendation; however, we have reservations about creating policies that obligate the SBA to proactively contact prospective managers. When we search for external managers, we rely on databases maintained by external parties. We do so because of the large number of potential managers and to maintain an arms length perspective.

  The SBA message to prospective managers has consistently been that they must provide adequate data via the Wilshire Compass database in order to be considered in a manager search. We cannot assume the obligation to remind managers to update their data each and every time we wish to make a manager selection.

  Even so, in this particular search we did make a strong effort to contact those managers who were not in the Wilshire database and who had expressed an interest in managing assets for the SBA. This effort resulted in a delay in our search of about 2 to 3 months. Had we attempted to contact every manager whose data was not complete, the process would very possibly have become unworkable.

  Our first level screening produced 156 prospective products, and ultimately led us to eight very strong finalists, which we believe was a highly satisfactory result.

  Auditor General's Comment: It was not our intent to suggest that the SBA delay its search 2 to 3 months while waiting for the provision of information missing from the data base. However, we continue to believe that is appropriate to provide otherwise potentially strong candidates with a reasonable opportunity to furnish the missing information.

- Finding No. 2: The Alternative Investments Asset Class will develop a current long-term strategic plan, an annual work plan, and updated policies and procedures.

- Finding No. 3: The moratorium on new private equity relationships was established because the SBA did not want to incur any new long-term contractual relationships in the event it becomes necessary to liquidate portions of our alternative investments when the Defined Contribution plan takes effect. In light of this uncertainty, we believe the moratorium should remain in effect until the impact of the Defined Contribution plan is known. During the moratorium, the SBA staff directed its new commitments to our existing long-term partnership which had continued to demonstrate superior performance.

  If the SBA decides to expand its investment activities in Alternative Investments, whether in venture capital or in traditional private equity investments, we will pursue the best investment opportunities available in the markets.

SBA management's complete response can be viewed on the Auditor General Web site.

To promote accountability in government and improvement in government operations, the Auditor General makes operational audits of selected programs, activities, and functions of State agencies. This operational audit was made in accordance with applicable ***Government Auditing Standards*** issued by the Comptroller General of the United States. This audit was conducted by Leo Luttig, CPA, and Lisa Strickland, CPA, and supervised by Allen G. Weiner, CPA. Please address inquiries regarding this report to Donald R. Hancock, CPA, Audit Manager, via E-mail at **donhancock@aud.state.fl.us** or by telephone at **(850) 487-9037**.

This report and audit reports prepared by the Auditor General can be obtained on our Web site (http://www.state.fl.us/audgen); by telephone (850 487-9024); or by mail (G74 Claude Pepper Building, 111 West Madison Street, Tallahassee, Florida 32399-1450).

STATE BOARD OF ADMINISTRATION
OF FLORIDA

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September 27, 2001

Mr. William Monroe, CPA
Auditor General
111 West Madison Street
Claude Pepper Building, Room G74
Tallahassee, FL 32399-1450

Dear Mr. Monroe:

This is our response to the audit recommendations listed in your "Preliminary and Tentative Audit Findings and Recommendations" for the Operational Compliance Audit of the Florida State Board of Administration for the period July 1, 1999 through January 31, 2001. These findings cover the areas of External Manager Selection and Alternative Investments Management.

External Manager Selection

Audit Recommendation #1:

The SBA modify its selection procedures to require that, prior to the elimination of investment products from further consideration, attempts be made to obtain all relevant product information.

Response:

We will consider this audit recommendation, however, we have reservations about creating policies that obligate the SBA to proactively contact prospective managers. When we search for external managers, we rely on databases maintained by external parties. We do so because of the large number of potential managers and to maintain an arms length perspective.

The SBA message to prospective managers has consistently been that they must provide adequate data via the Wilshire Compass database in order to be considered in a manager search. We cannot assume the obligation to remind managers to update their data each and every time we wish to make a manager selection.

Even so, this particular search we did make a strong effort to contact those managers who were not in the Wilshire database and who had expressed an interest in managing assets for the SBA. This effort resulted in a delay in our search of about 2 to 3 months. Had we attempted to contact every manager whose data was not complete, the process would very possibly have become unworkable.

Our first level screening produced 156 prospective products, and ultimately led us to eight very strong finalists, which we believe was a highly satisfactory result.

Alternative Investments Management

Audit Recommendation #2: A current long-term strategic plan, an annual work plan, and policies and procedures be adopted for the alternative investments class of investments.

Response: The Alternative Investments Asset Class will develop a current long-term strategic plan, an annual work plan, and updated policies and procedures.

Audit Recommendation #3: Should the SBA decide to continue investing in private equities, the moratorium on establishing new relationships be lifted.

Response: The moratorium on new private equity relationships was established because the SBA did not want to incur any new long-term contractual relationships in the event it becomes necessary to liquidate portions of our alternative investments when the Defined Contribution plan takes effect. In light of this uncertainty, we believe the moratorium should remain in effect until the impact of the Defined Contribution is known. During the moratorium, the SBA staff directed its new commitments to our existing long-term partnership which had continued to demonstrate superior performance.

If the SBA decides to expand its investment activities in Alternative Investments, whether in venture capital or in traditional private equity investments, we will pursue the best investment opportunities available in the markets.

Please call the Chief Financial Officer, Gwenn Thomas (413-1393) or me (413-1250) if you need any further assistance. As always, we appreciate your diligence and assistance.

Sincerely,

C C [illegible]

for Tom Herndon

ks/TH