



A REPORT
TO THE
MONTANA
LEGISLATURE

PERFORMANCE AUDIT

*State Investment
Management and
Governance Practices*

Montana Board of Investments

JANUARY 2014

LEGISLATIVE AUDIT
DIVISION

12P-10

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PERFORMANCE AUDITS

Performance audits conducted by the Legislative Audit Division are designed to assess state government operations. From the audit work, a determination is made as to whether agencies and programs are accomplishing their purposes, and whether they can do so with greater efficiency and economy.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Members of the performance audit staff hold degrees in disciplines appropriate to the audit process.

Performance audits are performed at the request of the Legislative Audit Committee which is a bicameral and bipartisan standing committee of the Montana Legislature. The committee consists of six members of the Senate and six members of the House of Representatives.

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January 2014

The Legislative Audit Committee
of the Montana State Legislature:

This is our performance audit of the management and governance practices at the state's Board of Investments. This report presents audit findings and includes recommendations addressing the qualifications required for board membership and adopting policies to ensure operational standards are maintained on an ongoing basis. A written response from the Board of Investments staff is included at the end of the report.

We wish to express our appreciation to Board of Investments officials and staff for their cooperation and assistance throughout the audit.

Respectfully submitted,

/s/ Tori Hunthausen

Tori Hunthausen, CPA
Legislative Auditor

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APPOINTED AND ADMINISTRATIVE OFFICIALS

			<u>Term Expires</u>
Montana Board of Investments	Mark Noennig, Chairman	Billings	2017
	Kathy Bessette	Havre	2017
	Gary Buchanan	Billings	2015
	Karl Englund, Vice Chair	Missoula	2015
	Quinton Nyman	Helena	2015
	Jack Prothero	Great Falls	2017
	Marilyn Ryan	Missoula	2017
	Jon Satre	Helena	2015
	Sheena Wilson	Helena	2017
		David Lewis, Senate Liaison	
	Kelly McCarthy, House of Representatives Liaison		

Administrative Officials

David Ewer, Executive Director

Geri Burton, Deputy Director

Cliff Sheets, Chief Investment Officer

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MONTANA LEGISLATIVE AUDIT DIVISION

PERFORMANCE AUDIT

State Investment Management and Governance Practices

Montana Board of Investments

JANUARY 2014

12P-10

REPORT SUMMARY

The Montana Board of Investments provides effective oversight of over \$15 billion in assets; strengthening the credentials and qualifications of Board of Investments members and making other changes in management and governance practices would improve the Board of Investments' ability to manage the large, complex assets under its care.

Context

In 1972, Montana voters ratified a new constitution that directed the legislature to provide for a Unified Investment Program. This program includes responsibility for investing state pension moneys and public funds. The Montana Board of Investments (board) as it exists today is a product of this constitutional mandate, which resulted in all the assets of the state's retirement systems, and those of other state and local government agencies, being invested through a single program. Today the board is responsible for management of over \$15 billion in assets on behalf of the state's pension funds and state and local government agencies.

During our review, we determined the qualifications for citizens appointed by the Governor to the board have not changed since the 1980s. Meanwhile, the institutional investing arena has grown exponentially more complex over that time. Further, many states have more stringent experience and education requirements for the people with fiduciary responsibility for investing pension funds and other public money.

Results

Our audit found that board staff is following its policies and generally meeting industry best practice standards in performing due diligence on potential investments. We also found the organizational structure of the board's investment staff is appropriate for the asset mix and investment style currently mandated by the board, and the compensation policies of the board are consistent with peers within the public institutional investment industry.

Our report includes six recommendations related to the management and governance of the investing activities of the board, including recommending:

- ◆ The Montana Legislature increase the experience requirements for members of the board,
- ◆ The board enhance and require the ongoing educational activities provided to board members, and
- ◆ The board seek revisions to the Montana Procurement Act to provide an exemption for the contracting of external investment services.

Other recommendations are in the areas of asset allocation and the annual affirmation thereof; other tasks required by the charters of the board and its various committees; and the board's proxy voting program.

(continued on back)

Recommendation Concurrence	
Concur	4
Partially Concur	0
Do Not Concur	1

Source: Agency audit response included in final report.

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Call toll-free 1-800-222-4446, or e-mail ladhotline@mt.gov.

Chapter I – Introduction and Background

Introduction

In 1972, Montana voters ratified a new constitution that directed the legislature to provide for a Unified Investment Program. This program includes responsibilities for investing state pension moneys and public funds. The Montana Board of Investments (board) as it exists today is a product of this constitutional mandate, which resulted in all the assets of the state's retirement systems, and those of other state and local government agencies, being invested through a single program. Today the board is responsible for management of over \$15 billion in assets on behalf of the state's pension funds and state and local government agencies.

Background

The board is allocated for administrative purposes to the Department of Commerce. It operates with a staff of approximately 30. The chief investment officer (CIO), executive director, and six professional staff serve at the pleasure of the board.

Goals and Objectives

The three primary goals and objectives of the board are: to provide prudent investment management of state and local government funds; to work with financial institutions, state agencies and local governments to enhance and expand Montana's economy and assist new and expanding Montana businesses; and to lend low-interest funds to eligible governments for a variety of infrastructure and other projects. The majority of the board's investment activities are focused on management of public funds, but the board also operates several programs that look more like traditional banking activities. These banking activities include the investment of coal severance tax trust fund assets, and the Intercap Loan program, which provides eligible state and local government units with low-cost variable rate loan financing. The board's organizational structure also includes a financial management function providing accounting support for all board activities, and administrative support.

Board Membership

The board consists of nine voting members (appointed by the governor and confirmed by the Senate) and two nonvoting legislative liaisons, one each from the Senate and House, from different political parties and appointed by legislative leadership. As a quasi-judicial board, statute requires one of the members to be an attorney, one a member of the Montana Public Employees' Retirement board and one a member of the Teachers' Retirement board, and the others to represent small business, agriculture,

labor, and the financial community. The nine board members also comprise three subcommittees: the Audit Committee, the Human Resource Committee and the Loan Committee.

Prudent Expert Principle

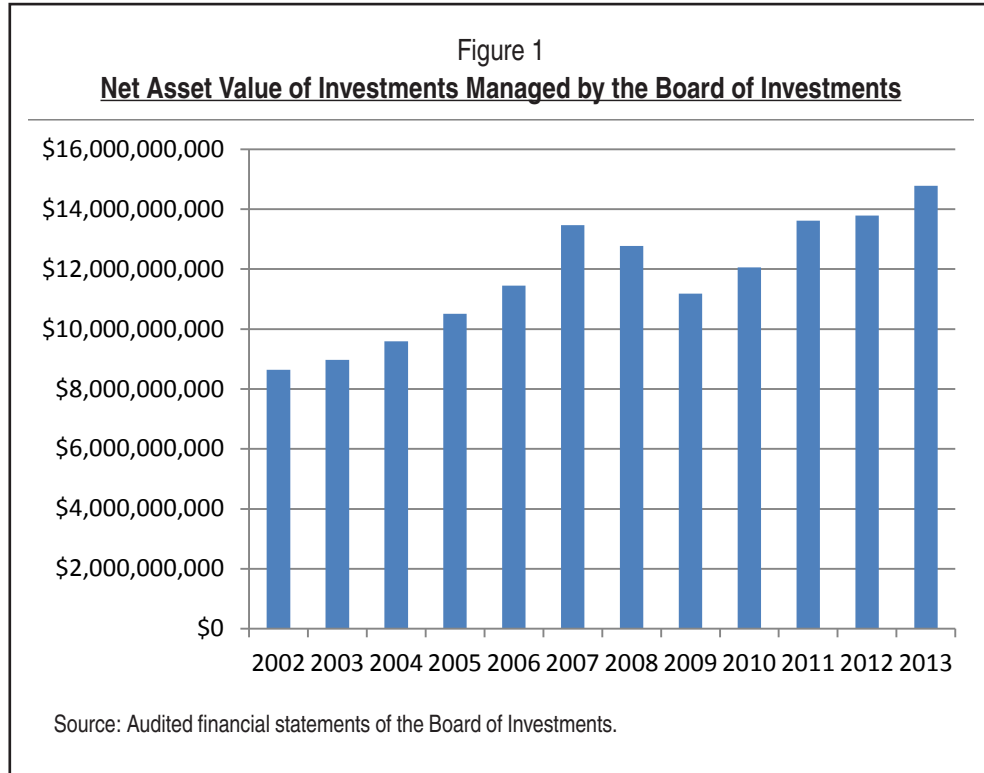
The Montana Constitution (article VIII, section 13) requires investment of assets “be managed in a fiduciary capacity in the same manner that a prudent expert acting in a fiduciary capacity and familiar with the circumstances would use.” Additionally, §17-6-201, MCA, requires an investment manager to:

- ◆ Discharge the duties with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity with the same resources and familiar with like matters exercises in the conduct of an enterprise of a like character with like aims,
- ◆ Diversify the holdings of each fund within the unified investment program to minimize the risk of loss and to maximize the rate of return unless, under the circumstances, it is clearly prudent not to do so, and
- ◆ Discharge the duties solely in the interest of and for the benefit of the funds forming the unified investment program.

Investment Activities

Unless otherwise provided by law, the board must invest state funds. Local governments at their discretion may invest funds with the board. Local government funds are invested in the Short Term Investment Pool (STIP). During fiscal year 2013, the board invested 495 individual accounts, consisting of 326 state agency accounts and 169 local government accounts.

The assets managed by the board have grown from a net asset value of \$321 million at year-end 1972 to a net asset value of nearly \$15 billion by the end of fiscal year 2013. Since 2002, the assets have experienced steady growth, with the exception of the 2008-09 global financial crisis. Figure 1 depicts the growth in total assets under the control of the board since 2002.



To facilitate management of the Unified Investment Program, the board has created seven investment pools, which operate like mutual funds.

Cash is initially deposited in STIP, which operates similar to a money market fund. Depending on the account, some or most of the account balances may be transferred from STIP to other investment pools, which include equity, fixed-income and alternative investments. If accounts may be invested in longer-term investments but their investment parameters do not permit investment in the pools, they are invested in individual nonpooled portfolios collectively known as All Other Funds.

Table 1
Board of Investment Pools/Investments

Pool	Established	What is it?
Retirement Funds Bond Pool (RFBP)	1995	Limited to pension funds only. Pool securities are a mix of corporate bonds and government bonds. Some managed by board staff, some by external managers.
Trust Funds Investment Pool (TFIP)	1995	Formerly known as Trust Funds Bond Pool, current income is important to the participants in this pool so it is managed for income generation, rather than total rate of return.
Short Term Investment Pool (STIP)	1974	Provides participants access to a short-term money market fund. Pool investments are managed by board staff. Approximately 500 accounts invested in STIP, including state and local government accounts.
Montana Domestic Equity Pool (MDEP)	1980	Actively-managed small, mid and large cap domestic stock and passively-managed mid and large cap domestic stock. The pool is managed by contracted external managers.
Montana International Equity Pool (MTIP)	1996	Limited to pension funds only. Pool securities consist of both actively-managed and passively-managed equity securities. Managed by contracted external managers.
Montana Private Equity Pool (MPEP)	2002	Limited to pension funds only. The board partners with private equity managers to invest in venture capital, leveraged buyout, and other types of alternative investments.
Montana Real Estate Pool (MTRP)	2006	Limited to pension funds only. Board partners with real estate managers to invest in core real estate, value-added real estate, and opportunistic real estate. In the "risk/return" spectrum core real estate is the lowest, while opportunistic real estate is the highest.
All Other Funds	N/A	Includes all other investments not held in the seven investment pools. Securities include bonds, mortgages/loans, and a passive index stock fund and direct real estate.

Source: Compiled by Legislative Audit Division from Board of Investments information.

Most state agency accounts and all local government accounts are limited to STIP investments only. Since the state's trust funds cannot be invested in equities, they are invested in the Trust Funds Investment Pool (TFIP), or individual fixed-income portfolios. There are no restrictions on the investment of state pension funds, so these are invested in bonds, equity pools, and alternatives in proportions directed by the board. Because many of the pools invested by the board are exclusive to the retirement system funds and the retirement funds constitute the majority of assets under board management, this report may sometimes focus on the management of these funds.

Investment Objectives

The board's overall objective is to achieve the highest level of investment performance that is compatible with its risk tolerance and prudent investment practices. According to the board's investment policy statement for pension funds, investment performance is measured by three integrated long-term objectives:

- ◆ The actuarial target rates of return, which are established by the pension boards whose funds the board invests. The policy statement indicates the board seeks to generate long-term investment performance that will exceed the actuarial annual target rate of return, net of all investment and administrative expenses.
- ◆ An investment policy benchmark calculated by applying the investment performance of the asset class benchmarks to the plans' actual asset allocation during the measurement period.
- ◆ Comparison of each plan's total performance, before all fees, to appropriate public plan sponsor universes.

The board expects to meet or exceed these objectives over a long-term investment horizon though short-term volatility may lead to unfavorable deviation from these objectives.

Asset Allocation

Within statutory guidelines that restrict or prevent equity investment in some funds, the board has the authority to allocate portfolios to any previously board-approved asset class in the proportions it considers prudent. Asset allocation decisions made by the board must be made in a public meeting. The asset allocation ranges are subject to change as modifications are adopted by the board. The actual asset allocation mix may deviate from time to time from the approved asset allocation ranges due to financial market performance, cash flows, and manager performance. Rebalancing the plans' assets to remain within the board-approved allocation ranges is delegated to the CIO, in consultation with the executive director. Any necessary rebalancing must be made in a timely manner and take into consideration associated costs and current market conditions. The CIO informs the board of rebalancing activity at the board's next regularly scheduled meeting.

Board's Governance Manual

The board maintains a governance manual to detail the responsibilities of board members and define when those responsibilities are delegated to board staff. This document recognizes that fiduciary duty ultimately falls to the members of the board. The manual delegates some powers to board staff but only those specifically delineated. Among the responsibilities assigned to members of the board in this manual are:

- ◆ Members of the board meet publicly and the public is provided notice of meetings and opportunities for public comment.
- ◆ Board members reserve the right to make selection of custodial bank and investment consultants.
- ◆ The authority to establish asset allocation ranges and approve investment policy statements is reserved exclusively for board members.

- ◆ Where granted rule-making authority under state law the board members retain authority to revise rules.
- ◆ Board members select the executive director and CIO and set the duties and compensation for all exempt staff.

The governance manual also delegates some authority to the board staff. Certain positions are granted specific authority. For example, the executive director supervises all staff, authorizes expenditures, and can sign any document required to conduct board business. The CIO is charged with managing assets within approved ranges, recommending new asset classes, and overseeing the investment process—including hiring and terminating external managers and setting appropriate due diligence standards. The manual also provides more general guidance such as the method for contracting for investment managers and other contracts and describes when board staff can initiate legal action.

Investment Policy Statements

The members of the board approve investment policy statements for the pools it uses to direct investments and for the funds it invests. These documents provide a broad strategic framework for the investments. They set investment objectives and asset allocations for investments managed, among other things. The policy statements for the pools used to manage the assets also provide direction related to investment style, eligible types of investments and defines roles for board members, board staff, and external managers.

Investment Style

Within each of the asset classes in which the board invests, there are often several different investment “styles” available. For example, assets can be managed by either internal (board staff members) or external fund managers (outside fund managers). Furthermore, some equity assets can be managed in either an “active” or “passive” fashion. Passive management typically means that the equities are picked to mimic the market as a whole or some other index and do not require the fund manager to pick individual securities. Active management means that a fund manager is trying to outperform the market as a whole by picking the most desirable securities.

Over time the investment style of the board has changed somewhat. Early on, all or nearly all of the securities were managed internally by board staff members. This has gradually changed and now board assets are managed through a mix of internal and external management. Equities and alternative assets are now primarily managed externally (board staff members select the external managers) while a large percentage of the fixed income and cash equivalents remain under internal management.

There have also been periodic shifts in the board's preference for active vs. passive management. In 2012, the board directed staff to increase passive management for asset classes where investment markets are thought to be efficient. Passive management is generally less costly and when it is difficult for an active manager to beat the market as a whole, the extra cost of active management may not be worthwhile.

Investment Management Fees

The investment program is funded by fees charged to the board's clients. The legislature sets the maximum operational fee the board may charge which is then allocated to all board clients. The board's methodology used to allocate charges is not included as part of this performance audit.

Fee Type	Amount	% of Total
Board (operational)	\$4,066,500	9.3%
Custodial Bank	\$1,616,355	3.7%
External Managers	\$38,236,118	87.0%
Total	\$43,918,973	

Source: Audited financial statements of the Board of Investments.

The board contracts with a major bank for a variety of custodial banking and account management services. Custodial bank fees are paid by a statutory appropriation from the state general fund. For investments within many of the pools, the board contracts with external investment managers or general partners to manage funds within the pool. External manager fees are paid directly from the

accounts they manage. The costs for board activities and external bank and manager fees for fiscal year 2013 are shown in Table 2.

Audit Scope

The scope of our audit was developed by determining which aspects of the board's functions are most significant to the public and to the long-term health of the various funds over which the board has management and investing authority. As such, this audit focused primarily on one of the board's three primary activities: the management and investing of funds belonging to state pensions and other account holders. Specifically, the audit examined:

- ◆ The board's governance structure, to include the composition and activities of the appointed board, its level of expertise in the areas in which the board operates, and its relationship with management and senior staff.
- ◆ Investment risk management and due diligence, particularly in investing in the areas of private equity and real estate.

- ◆ Personnel policies, to include compensation of exempt employees and policies related to conflicts of interest.
- ◆ External costs and services, including external investment manager fees and the use of other outside services such as a custodial bank and investment consultant.

The majority of our audit focused on review of documents, meetings, and reports from fiscal years 2012 and 2013. However, certain elements of the audit required review of reports and trends from the past 10-15 years.

Scope Exclusions

Our risk assessment process resulted in the decision to exclude certain areas of the board's operations from the scope of this audit. These areas could be worthy of consideration for future performance audits as they are significant to the operation of the board and the economic well-being of the state of Montana and a number of its municipalities. However, these functions are distinctly separate from the board's institutional investing function and thus would better stand as topics for their own audits in the future. Specifically, those board functions beyond the scope of this audit include:

- ◆ The board's role as an agent of economic development for the state, working with both local governments and private sector entities with a goal of helping establish new businesses and grow existing ones.
- ◆ The board's banking functions, in particular its lending of low-interest funds to eligible local governments for a variety of infrastructure and related projects.

Audit Objectives

Risk assessment work and the establishment of the scope of this audit led to the following audit objectives:

1. Are the legal and organizational structures of the board consistent with the prudent expert principle?
2. Are the risk management strategies and due diligence practices of the board sufficient to mitigate risk?
3. Are board personnel policies and staff structure appropriate for a public institutional investment organization?
4. Are board external investment and custodial expenses and external deliverables comparable with those across the public institutional investment industry?

To address these objectives, we performed the following types of methodologies:

- ◆ Reviewed sources of criteria for significant elements related to public institutional investment governance practices.

- ◆ Reviewed Montana statutes, agendas, minutes and other materials from board meetings and policies and procedures adopted by the board.
- ◆ Conducted structured interviews with board members.
- ◆ Observed due diligence practices of board staff.
- ◆ Regularly attended and observed meetings of the board.
- ◆ Analyzed board consideration of its asset allocation decisions.
- ◆ Reviewed methods for establishing market compensation rates.
- ◆ Reviewed Statewide Accounting, Budgeting, and Human Resource System human resource records, board meeting minutes, and other applicable sources, to compile information to illustrate trends in the organization and allocation of staff resources over time.
- ◆ Reviewed hiring process and contracts for custodial banking services and investment consulting services.
- ◆ Reviewed procurement practices for outside investment management services.
- ◆ Analyzed board budgeting and reporting.

Report Organization

The remainder of this report details our analysis of the objectives and contains six recommendations. It is organized in four additional chapters, each addressing one of the objectives.

- ◆ Chapter II Board Composition and Ongoing Education
- ◆ Chapter III Risk Management Strategies and Due Diligence Practices
- ◆ Chapter IV Personnel Policies and Organizational Structure
- ◆ Chapter V Relationships with External Service Providers

Chapter II – Board Composition and Ongoing Education

Introduction

The primary responsibilities of appointed board members of the Board of Investments (board) are to serve in a fiduciary capacity and to do so in a manner consistent with the prudent expert principle. The board has nine members and both the number and qualifications of its members are prescribed by law. Members are appointed by the Governor to staggered four-year terms. Members serve until a successor is appointed and may be removed by the Governor only for cause. The Governor appoints the chairperson, and all members must be confirmed by the state Senate.

Membership Criteria

The board is established as a quasi-judicial board, meaning one member must be an attorney. Additionally, state law specifies member criteria as follows:

- ◆ One member from the Public Employees' Retirement Board.
- ◆ One member from the Teachers' Retirement Board.

Seven members who will provide a balance of professional expertise and public interest and accountability, who are informed and experienced in the subject of investments, and who are representatives of:

- ◆ The financial community
- ◆ Small business
- ◆ Agriculture
- ◆ Labor

Additionally, there are two ex officio, nonvoting legislative liaisons to the board. One must be a senator appointed by the President of the Senate and one must be a representative appointed by the Speaker of the House. The liaisons may not be from the same political party.

Other Public Institutional Investment Boards

Many public jurisdictions are charged with managing investments on behalf of pension funds or other public funds. The structure and composition of these boards vary quite a bit in terms of the number of trustees, their qualifications, and whether members are elected, appointed, or a combination of both. To consider how well Montana's board composition meets established norms within the public institutional investment industry we considered best practices as set forth by industry organizations

and research, boards in other states that manage assets of similar size, and boards that are separate from pension boards and manage numerous funds.

Industry Organizations and Research

The Stanford Institutional Investors' Forum (forum) is a well-known group of institutional investment professionals. This forum has set forth a number of best practice principles for fund governance that include guidelines for board composition. Among these principles are:

- ◆ Viewed as a group, the board should be composed of individuals with a portfolio of skills that allows it to make responsible, informed investment and legal decisions, and to discharge its fiduciary obligations to fund beneficiaries.
- ◆ A governing body should, in particular, consist of a sufficient number of trustees competent in financial and accounting matters so that the body is capable of understanding modern portfolio theory, diversification principles, basic financial analysis, and fundamental accounting principles.

The forum also recognizes that institutional investment is an increasingly complex area. Trustees “face markets that are more complicated, in certain aspects less regulated, and increasingly more global than in prior times.” For mature funds that feature a large number of beneficiaries drawing from a fund, trustee acumen is especially important.

Other Unified Investment Boards

Because Montana's Board of Investments is separate from the pension system board, we looked at the composition of boards in six states that have similar separate unified investment programs.

North Dakota—the North Dakota state investment board consists of the governor, the state treasurer, the commissioner of university and school lands, the director of workforce safety and insurance, the insurance commissioner, three members of the teachers' fund for retirement board, and three members of the public employees retirement system board. The state investment board may establish an advisory council composed of individuals who are experienced and knowledgeable in the field of investments.

South Dakota—the South Dakota Investment Council consists of eight voting members. South Dakota law stipulates that “the members of the state investment council shall be qualified by training and experience in the field of investment or finance.”

Iowa—in Iowa, seven voting members sit on the Investment Board of the Iowa Public Employees Retirement System (IPERS). One member is the state treasurer, and three are members or retirees of the system. The remaining three are not members of IPERS and each has “substantial institutional investment experience or substantial institutional financial experience.”

Wisconsin—members of the state’s investment board consist of the secretary of administration, one member who is a representative of a local government and has been employed by the local government in a finance position and has at least 10 years of financial experience, five members appointed for staggered 6-year terms, four of whom shall have had at least 10 years experience in making investments, and two participants in the Wisconsin retirement system.

Oregon—five voting members serve on the Oregon Investment Council. Members include the state treasurer and four appointed members who must be qualified by training and experience in the field of investment or finance. One appointed member may also be a member of the Public Employees Retirement Board.

South Carolina—the seven-member South Carolina Retirement System Investment Commission invests the assets of five retirement systems. Each member is appointed, by various entities. Each appointed member must possess at least one of the following qualifications: the Chartered Financial Analyst credential, the Certified Financial Planner credential, at least twenty years professional actuarial experience, at least twenty years professional teaching experience in economics or finance, an earned Ph.D. in economics or finance, or the Certified Internal Auditor credential.

Boards Managing Similar Assets

To examine the board composition of other boards which manage assets of value similar to Montana, we obtained information related to the composition of boards in three other states.

Maine—the Board of the Maine Public Employees Retirement System is composed of eight trustees. These include the Treasurer of State; two members of the State Employee and Teacher Retirement Program; four persons appointed by the Governor, at least two of whom must be qualified through training or experience in the field of investments, accounting, banking or insurance or as actuaries; one nominee submitted by the Maine Retired Teachers’ Association; one nominee submitted by retired state employees; and one nominee of the Maine Municipal Association.

Kentucky—the Kentucky Retirement System board of trustees is composed of 13 individuals. Most trustees are members or retirees of various pension systems whose funds are invested by the board, but two trustees must have investment experience. “Investment experience” is defined to mean an individual with at least ten years’ experience in portfolio management, securities analysis, as a chartered financial analyst, or other exceptional professional experience in public or private finances. Both of these two members serve on the five-member investment committee that manages the assets of the funds.

Kansas—the Kansas Public Employees Retirement System board of trustees consists of nine members. One is the state treasurer and two are elected by members or retirees of the retirement system. The remaining six members are appointed. Each appointed member must have demonstrated experience in the financial affairs of a public or private organization or entity which employs 100 or more employees, or had at least five years’ experience in the field of investment management or analysis, actuarial analysis, or administration of an employee benefit plan.

Unified and of Similar Size

Finally, there are a few other states that are both similar in size of assets managed and have a separate, unified investment board. The board composition of two such states is described below.

West Virginia—This state’s Investment Management Board consists of thirteen members. Three serve because they fulfill a specific public office (governor, auditor, and treasurer). The other ten are appointed by the Governor and confirmed by the Senate. All appointees must have experience in pension management, institutional management or financial markets. In addition, one must be an attorney experienced in finance and investment matters and another must be a Certified Public Accountant. Only six of the ten appointed trustees may be from the same political party. A member of each defined benefit retirement plan is designated to represent the plans’ interests and these members do not have a vote but have the right to be heard at the annual meetings of the board.

Nebraska—Nebraska’s Investment Council has five voting members. Each appointed member of the council must have at least seven years of experience in the field of investment management or analysis or have at least twelve years of experience in the financial management of a public or private organization. There is a preference for members who are appointed to have experience in investment management or analysis. During 2013, three of the five members held a Chartered Financial Analyst designation.

Research and Other States Demonstrate Importance of Investment Acumen

Industry research and practices in other states demonstrate that an investment board should include individuals with a substantial amount of investment expertise. Institutional investing is a complex arena. Modern fund trustees must have appropriate experience and knowledge to ensure they can substantially and materially evaluate the issues presented to them. Boards are faced with decisions related to complicated, global, and in some ways less-regulated markets than in the past.

The board has demonstrated its ability to make good choices related to complex asset allocation decisions. The board's investment consultant recommended the board allocate a small percentage of its portfolio to hedge funds, however, the board declined to do so. Since making this decision, the performance of hedge funds has been generally poor. The investment activities of hedge funds can also sometimes be controversial, so the board has also avoided potential risks related to investing in controversial activities.

Nonetheless, the assets managed by the board are invested in increasingly complex areas. The current asset allocation has evolved from a portfolio dominated by fixed income securities to a much more diversified asset mix that includes substantial investments in alternative assets like real estate and private equity. Board members have indicated that without formal investment experience, there is a steep learning curve in order to understand and manage the assets of such a portfolio.

Additional Investment Expertise Would Benefit Board

Section 2-15-1808, MCA, requires that certain board members are "informed and experienced in the subject of investments" but does not provide further guidance related to the amount or depth of knowledge or experience. The law does require that representatives of the pension boards, small business, agriculture, and labor are included on the board but requires only one member who represents the financial community.

State law (§17-6-201, MCA) also requires the board to administer the unified investment program in accordance with the prudent expert principle. This principle states that the management of the funds must be discharged with the "care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity with the same resources and familiar with like matters exercises" in managing a similar program. Due to the statutory qualifications for board membership, collectively the board may have less institutional investing expertise than is suggested by best practices in other states and industry research. Board members with

institutional investing experience could be better prepared to scrutinize, analyze, and make decisions based upon the information provided by board staff and investment consultant.

The Council of Institutional Investors suggests that a substantially independent board is important to good governance because independent members will have the necessary ability to monitor and assess performance; select, monitor, evaluate and, when necessary, fire the chief executive and other senior managers; oversee management succession; and structure, monitor and approve compensation paid to the chief executive and other senior managers.

Legislation Required to Address Board Composition

Because the board qualification requirements are set forth in state law, changing the requirements for membership requires legislative action. The Stanford Institutional Investors' Forum suggests legislative changes should be made when membership selection "could be inconsistent with the appropriate exercise of fiduciary responsibility on behalf of fund beneficiaries." The Forum concludes, "the board should at all times include individuals with investment and financial market expertise and experience relevant to the fund's ability to exercise its fiduciary obligations to its beneficiaries."

The inclusion of individuals with specific legal or investment management experience or knowledge does not necessarily preclude participation by individuals who offer other unique contributions to the board. But the Stanford Institutional Investors' Forum cautions the flexibility to include others "should be narrowly construed and should be exercised in a manner consistent with fiduciary principles."

The current statutory qualifications for collective membership of the board do not provide a level of investment expertise comparable to some similar institutional investment organizations. The Unified Investment Program was created 1972. At that time, the required knowledge and experience specific to institutional investing was not as extensive. Investment vehicles were fewer and more easily understood. Yet the composition requirements of the board have not changed since the mid-1980s. Revising the qualifications for board composition would improve the board's ability to manage the large, complex assets under its care.

There are a number of options the legislature could consider for revising board composition, including:

- ◆ Adding additional members with institutional investing knowledge and/or experience.

- ◆ Revising current membership to include additional representation from investment industry.
- ◆ Requiring professional certifications (Chartered Financial Analyst, Certified Public Accountant, Securities and Exchange Commission registered broker/dealer, etc.) for one or more board members.
- ◆ Requiring a minimum level of investment experience for all board members.
- ◆ Adding a nonvoting advisory committee composed of investment professionals.
- ◆ Other options for increasing the collective investment expertise of the board.

RECOMMENDATION #1

We recommend the Montana Legislature revise the professional and experience requirements for the composition of the Board of Investments to increase the board's collective knowledge and understanding of institutional investing.

Ongoing Education Requirements

In addition to appointing individuals with investing expertise, another method for ensuring board members are able to discharge their duties in a manner consistent with the prudent expert principle is through ongoing education efforts. As has been discussed, institutional investing is an ever-evolving field with new types of investments to consider and associated risks. It is necessary for board members to maintain currency in the field.

Board's Education Policy

At its April 2013 meeting, the board voted to amend its education policy. The changes removed language mandating board members attend training and education opportunities. The policy continues to affirm the importance of ongoing education in order to fulfill the board's fiduciary duties, but instead of mandating attendance of appropriate educational tools, such as conferences, seminars, workshops, relevant reading materials and in-house presentations, it now only encourages such activities.

There is a broad array of issues on which education is encouraged, including:

- ◆ Governance and fiduciary duty.
- ◆ Actuarial policies and pension funding.
- ◆ Best practices in total fund, asset class composite and investment manager monitoring, funding and decision-making.

- ◆ Key institutional investment management concepts, such as portfolio management theory and strategies, asset class attributes and investment strategies, and performance evaluation concepts.

Prior to this policy revision, new board members were also required to attend an orientation session geared towards ensuring new “Board Members are in a position to contribute fully to Board and Committee deliberations and effectively carry out their fiduciary duties as soon as possible after joining the Board.” Board staff continue to provide an orientation opportunity, but board member attendance is now optional.

Board staff indicated that these policy revisions were necessary because as gubernatorial appointees, board members could not be compelled to attend the orientation or other educational opportunities.

Best Practices in Board Education

In general, industry experts recognize the need for ongoing professional education on the part of fiduciaries in order to maintain currency in the field of institutional investing. For example, the Stanford Institutional Investors’ Forum suggests “trustees, on a regular basis, should obtain education that provides and improves core competencies, and that assists them in remaining current with regard to their evolving obligations as fiduciaries.” Other best practices guidance also suggests that a board that is overly reliant on outside experts such as attorneys, consultants, and financial experts is less responsive to changing plan participant needs and circumstances.

Education Policies in Other States

To compare Montana’s board education policy to those policies in place in other states, we reviewed the education policies in five other states where the investment board manages a unified investment program.

Nebraska—the Nebraska Investment Council places the responsibility of providing board education on the state’s investment officer. Among the responsibilities of that position are to provide the board with periodic educational sessions on investment topics of current relevance and inform the council of educational opportunities for fiduciaries.

West Virginia—each trustee and any board designated employee of the West Virginian Investment Management Board is required to complete at least twelve hours of approved continuing education each fiscal year. The executive director determines what may qualify as “approved continuing education,” which may include seminars, presentations, classes, articles, books, videotapes and conferences related to investing,

ethics, and fiduciary responsibilities. Each individual member provides a written education compliance report. A subcommittee of the board reviews compliance with this policy and may recommend disciplinary action to the Board of Trustees. Action may include reporting noncompliance to the Governor or appropriate selection body.

Vermont—the Vermont Pension Investment Committee requires each member to participate in ongoing training in investments, securities and fiduciary responsibilities. The authority responsible for electing or appointing each member informs the member of the education requirement. The board then provides an annual report to the respective authorities responsible for electing and appointing members regarding attendance at relevant educational programs attended.

South Carolina—Commissioners are encouraged to participate in at least 16 hours of continuing education annually, including in-house seminars, pertinent national conferences, select investment and pension plan administration courses, and continuing educational courses offered through local colleges and universities. New commissioners must attend an investment and administration orientation within sixty days of becoming a commissioner and are encouraged to attend at least one conference or seminar relating to pension fund investments within his or her first year as a commissioner.

Washington—members of the Washington State Investment Board are expected to attend eight hours of continuing education activities per year and new board members can also participate in an orientation and mentoring program. The aim of the orientation program is to ensure that new board members are in a position to contribute fully to board and committee deliberations and effectively carry out their fiduciary duties as soon as possible after joining the board. During orientation, new members are offered to participate in a mentorship with a standing board member who will review with the new member meeting materials prior to the new member's first meetings and contact the new member on a quarterly basis over a one-year period. The executive director submits an annual report on the educational activities of the board.

Ongoing Education at the Board of Investments

During our interviews with board members, several members indicated there is a great deal to learn about board activities. Some reported that it takes years to become truly comfortable in exercising the duties of a board member. Several of the newer board members have attended outside training courses and have reported these to be valuable learning experiences. Other members indicated the primary vehicle for ongoing education are sessions held during regular board meetings, provided either by board staff members or the investment consultant.

In recent years, staff leadership has instituted a work plan for the board that covers a rotating variety of topics. This plan includes topics related to ongoing board member education in addition to regular reports on board operations. The work plan is a useful tool in helping to ensure the board members receive ongoing updates related to board business but neither the contents nor the completion of the work plan are required by board policy.

In its November 2012 meeting minutes, the board reports that it and the consultant agree that the consultant is expected to provide a semi-annual educational presentation on any matter desired, and specifically identifies best practices, governance, what other state pension systems are doing, trend investments, and risk management as possible topics. The consultant is expected to be a resource for providing material, seminars or other training opportunities for board member education.

In our interviews with board members, staff, and the consultant, all agree that steps have been taken to provide such educational opportunities and there is a virtually unlimited supply of topics that could be covered. The board minutes indicate the board chairman will act as liaison for information or educational requests to the consultant.

The board's contract with the consultant does stipulate that the consultant will provide training to board members and staff on requested investment topics, as needed. Board members we interviewed thought informal training opportunities with the consultants prior to regular board meetings, a list of suggested reading materials, and a glossary of terms have all helped with ongoing educational needs, especially for newer board members.

Ad Hoc Ongoing Education Could Lead to Shortcomings

Without an organized, mandatory ongoing education program there is a chance that an individual board member or the board collectively may not keep up to date with topics that are required to discharge their duties with the skill and knowledge necessary to comply with the prudent expert principle.

Possible Enhancements to Board Education Policy

Ongoing educational activities have been made available to board members but the current board policy may allow individual members or the board collectively to fall behind in maintaining currency in the field of institutional investing. To ensure that relevant educational topics are not overlooked or missed, the board should consider the following:

- ◆ Require (rather than make optional) attendance at board member orientation and ongoing training courses.

- ◆ Formalize the educational opportunities provided by the investment consultant in the contract to more clearly define the expected scope of training to be provided.
- ◆ Institute some type of reporting mechanism through which board member attendance at educational activities is monitored and can be reported to the board, through its annual report, or to the governor (who appoints board members).
- ◆ Institutionalize the rotating work plan to ensure that relevant educational topics are covered at regularly scheduled board meetings.

RECOMMENDATION #2

We recommend the Board of Investments require ongoing educational activities be provided to board members.

Chapter III – Risk Management Strategies and Due Diligence Practices

Introduction

As the fiduciary charged with investing billions of dollars, the Board of Investments (board) confronts risk in a number of different areas, and must be prudent and thoughtful in weighing and managing that risk. Among the types of risk identified by the board and its investment staff during the course of the audit: investment risk, or the risk that investments will decline in value or fail to meet established benchmarks; liquidity risk, or the risk that too much money is tied up in long-term investments and cash is not readily available to meet monthly benefits obligations or other needs; and agency risk, or the risk that the board's actions will serve to benefit itself above the interests of its beneficiaries.

To mitigate these various types of risk, it's imperative that the board act prudently and perform adequate research when determining broadly what types of investments to make, and more specifically, with which external managers to invest or partner with.

Due Diligence Practices

In the world of institutional investing, due diligence refers to the vetting of a potential investment before any funds are committed. In practice, this can include interviews with external fund managers; examination of a fund's history, prospectus and detailed financial statements; reference calls to other clients, past employees and others with knowledge of the fund's operations; and other background work to assess the risk and opportunity presented.

Throughout the course of the audit we made detailed observations of several aspects of the board staff's due diligence work as the investment staff weighed potential investments. The following summarizes the observations we made for each of two separate efforts to identify appropriate investment opportunities.

Private Equity

Unlike the purchase of stocks or bonds, investment in private equity is not done through a public exchange or market. Rather, private investors or funds make investments directly in privately held companies, or in public companies with a goal of taking them private. Private equity is considered a less liquid investment than stocks or bonds. Once capital is committed to a private equity fund, it can be several years before capital is "called" by the fund for commitment, and years more beyond that before returns are realized. Also, private equity funds do not undergo the same regulatory

scrutiny as public companies, making due diligence on the part of the investor even more important.

In establishing criteria for measuring the due diligence practices of the board's alternative investments staff, we looked to national organizations with established best practices in the area of due diligence on alternative investments.

The Institutional Limited Partner Association (ILPA), a membership organization dedicated to the interests of limited partners in alternative investments, developed a due diligence questionnaire tool that provides a detailed list of suggested questions and topics to be answered and addressed by private equity firms during the due diligence process. The ILPA suggests potential investors perform diligence in multiple areas, including: fund and firm information; investment strategy and process; the fund team; alignment of interest; market environment; fund terms; governance; risk and compliance; track record; accounting/valuation/reporting; and legal/administrative structures and considerations.

Also, the Greenwich Roundtable, an organization of alternative investment experts dedicated to providing education about alternative forms of investing, has developed a series of best practices documents that address due diligence in the selection of alternative fund managers. These documents address many of the same areas covered by the ILPA and reinforce the accepted best practices necessary for prudent investment in the alternative arena.

We also examined the board's Montana Private Equity Investment Policy Statement for guidance on due diligence. According to the policy, the board's staff is to review and select appropriate funds to fulfill the objectives of the private equity pool. In evaluating potential investments, staff is to determine whether fund managers have the appropriate skills and experience necessary to execute the strategy being proposed for the fund. Among its due diligence responsibilities, staff must also assess the fund manager's proposed strategy and business plan, the risk/reward trade-off in the particular market in which the fund would operate, the quality of the fund's corporate governance, and the integrity and experience of key principals and employees as well as the reputation of the firm.

Locally, work in this area included observations of two meetings with private equity fund managers who had traveled to Helena to meet with board staff. These fund managers were each in the process of soliciting commitments for new private equity funds, and the board was considering investing around \$25 million as a limited partner with each. In each meeting, staff sought information on the fund managers' investment philosophy, discussed specific investments made by the partners in previous

funds, sought assurances that key people would remain with the organization for the life of the fund, and discussed the funds' fee structures and how the board might limit its costs.

Following these two meetings, we observed a meeting of the "alternatives" team, whose members discussed these two meetings as well as several other private equity and real estate proposals that were under consideration at the time. We collected eight samples of due diligence documents and checklists used by board staff to ensure all appropriate work is done prior to making a decision to commit to a fund or pass on the opportunity, including review of files for four private equity commitments that were made, as well as four opportunities that were declined. Review determined the board alternatives staff is completing its checklists, performing reference checks and fulfilling its due diligence obligations.

We found that the board alternative investments staff is generally meeting industry best practices in the due diligence screening of potential general partners. The staff makes reasonable efforts to balance the appropriate use of resources with the need to exercise its due diligence responsibilities.

Small Cap International Equity

The board is utilizing more active (thus expensive) management to invest in smaller companies, where the board believes that active management has a better chance of improving returns net of fees over time.

Due diligence in this area is similar to what is performed in the private equity arena, although there are differences due to the more transparent and regulated world of public equities. Nonetheless, it is important for the board equities staff to properly vet its potential external managers before committing dollars to a particular fund.

We measured the board equities staff's due diligence work against best practices espoused by the Chartered Financial Analyst Institute and found that the board staff is generally meeting accepted due diligence practices for hiring external managers of public equities.

For this portion of the objective, we observed telephone interviews with three firms offering small cap international investing opportunities, and also observed separate in-person meetings with two additional small cap international managers. We reviewed the fund documents submitted by prospective managers and observed meetings of the board investment staff as the advantages and disadvantages of each candidate were discussed.

We also interviewed the board investment consultant's expert on small cap international fund managers. The board sought her guidance in the selection process as a service agreed to in the consultant's contract. In our interview she shared thoughts on what the board staff does well and might improve upon in choosing its external managers. She characterized the board's staff as "above average" in the level of due diligence performed, and suggested they might improve their investment decisions by making more visits to fund managers at their own offices as opposed to doing most work over the phone or by invitation to Helena.

CONCLUSION

The Board of Investments research and investment staff performs appropriate levels of due diligence when researching and weighing potential investment opportunities.

Asset Allocation: Deciding Where to Invest

The concept of asset allocation refers to how an investor, or in the case of the board, a fiduciary, elects to divide the funds to be invested among various asset classes. Broadly, these categories might include public equities (stocks), private equity funds, real estate, fixed income (bonds), and cash and cash equivalents, although there may also be several sub-categories within each of those classifications, as well as other types of investments, such as hedge funds, that the board does not utilize at this time.

Asset allocations typically involve a range of percentages allowable for each asset class, to permit some flexibility to the investment staff as various markets move up and down and the total weights in the portfolio shift.

Asset Allocation Is a Critical Function of the Board as a Driver of Returns

Many academic and industry sources identified throughout the course of the audit cite asset allocation as one of the primary drivers of actual and anticipated returns on investments. According to the board's investment consultant, "Multiple studies conclude that asset allocation is the most important determinant of total fund performance in the long run. Studies estimate that 90 percent of the volatility in annual fund returns is attributable to asset allocation (as opposed to individual manager selection)." Thus, setting these allocation ranges is one of the most important functions of the board.

While the movement of markets as a whole is the single largest factor in a portfolio's performance, how investments are divided among various asset classes also plays a

significant role in the fund's volatility and potential return. For example, a portfolio heavily weighted toward fixed income investments (U.S. Treasury bonds, corporate bonds, and the like) would be expected to provide less investment risk and a lower but more stable return. A portfolio more heavily weighted in equities, including domestic and international stocks, would be expected to be more volatile year to year, but with a greater chance at a higher rate of return.

In determining its asset allocation ranges, the board must weigh its appetite for risk, in both the short and long term, with the demands of its clients—primarily the pension funds—who have in part based their contribution and benefit calculations on the expectations of certain rates of return on their investments. Additionally, the board must manage funds to be liquid enough to make regular payments to pensions for distribution to beneficiaries.

The board's investment consultant is on the record at several public meetings emphasizing the importance of asset allocation, and stressing to the board the need to use it to balance risk and return in a way that can minimize the former and maximize the latter.

According to its Public Retirement Plans Investment Policy Statement, the board is to employ the same asset allocation blend for all retirement funds it invests. Also, any changes the board makes to its asset allocation blend must be made in a public meeting. Further, the board is required to formally affirm or revise its asset allocation ranges for the Plans at least annually.

The Board Regularly Discusses its Asset Allocation Ranges

Throughout the course of the audit we observed a number of public discussions of asset allocation. Nearly every board meeting we attended included some talk of the concept, and as early as April 2013 the director was preparing the board for a vote at its November 2013 meeting.

For illustrative purposes, Table 3 indicates the asset allocation changes recommended by staff and approved unanimously by the board at its November 2013 meeting:

Table 3
**Current Asset Allocation Ranges for
Pension Funds**

Asset Category	Previous Allocation Range	New Allocation Range
Total Public Equity	60-70%	58-72%
Domestic Equity	30-50%	28-44%
International Equity	15-30%	14-22%
Private Equity	9-15%	9-15%
Bond Pool (fixed income)	22-32%	22-30%
Real Estate	4-10%	6-10%
Short Term (cash, etc.)	1-5%	1-5%

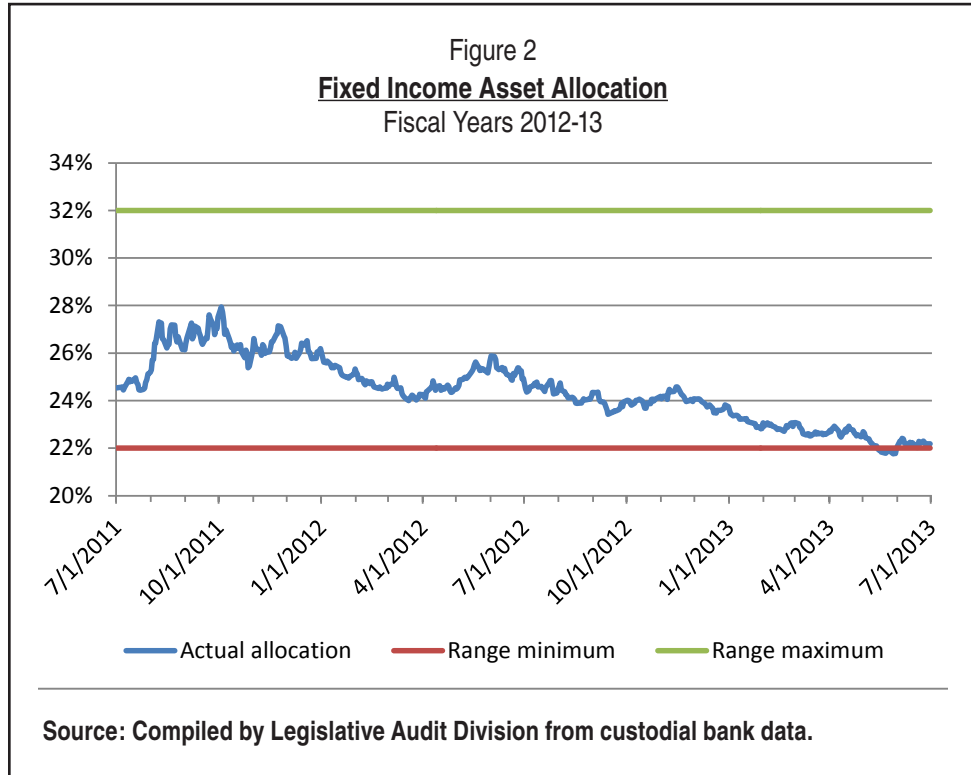
Source: Compiled by Legislative Audit Division from Board of Investments data.

Once the board has established its asset allocation targets, it is the job of the investment staff to ensure the retirement portfolios remain within these established ranges. If assets in one class become overweight, the staff must sell from that asset class and buy in another, rebalancing the portfolio to ensure the appropriate asset ranges are maintained.

Audit work revealed that the investment staff receives daily reports from its custodial bank, indicating whether the various investment pools were within the board-mandated allocation guidelines. We also examined a number of daily, monthly and quarterly portfolio statements that showed how asset allocations changed as market conditions fluctuated.

When looking in more detail at specific investments or the allocations within individual retirement systems, we did identify instances when a particular asset class fell outside its board-approved range. When this occurred, the investment staff took steps to rebalance the portfolio in a timely fashion so that assets were allocated appropriately.

Figure 2 shows only the allocation to fixed income securities for the most recent two fiscal years. Near the end of the period, the allocation to bonds did dip below the minimum threshold but at the first of the following month, board staff took steps to bring it back within the guidelines by selling equities and using the proceeds to fuel the bond portfolio.



Similarly, the allocation to cash equivalents has also dipped below the minimum for very short periods of time until income from the retirement systems has accumulated to bring it back above minimum levels. Certain retirement systems receive lump sums of income at infrequent intervals. This raises the amount of cash equivalents for those individual systems above the maximum allocation and causes some other asset classes to dip below their minimums until board staff takes steps to rebalance. In each of the instances we noted, this occurred at the beginning of the month following the cash infusion.

Audit work also examined the agendas and minutes from meetings of the board over the past three years. From mid-2010 to the present, we found that while the board regularly discussed its asset allocations, and at times voted to tweak the allowable ranges for certain specific asset classes within the allocation, the board did not in that time period, until November 2013, formally vote to revise or affirm its asset allocation as a whole as called for by its own Montana Public Retirement Plans Investment Policy Statement.

In an interview, management noted that while the board and its consultant and staff regularly discuss aspects of asset allocation at nearly every board meeting, and that certain aspects of asset allocation may be adjusted from time to time, the board did not actively affirm its entire asset allocation in 2011 or 2012. Management suggested

that perhaps the mandate to do so was previously overlooked because the requirement is stated in the Pension Investment Policy Statement and not in the higher profile Governance Policy.

While acknowledging the importance of asset allocation, the board has not annually affirmed or revised its asset allocation ranges as required by policy. Board staff does take the steps necessary to keep various asset classes within the appropriate allocation ranges within the broad portfolio.

RECOMMENDATION #3

We recommend the Board of Investments amend its Governance Policy to more strongly emphasize its commitment to annual affirmation of the asset allocation of its entire portfolio of investments.

Board Committees

The board has three sub-committees comprised of board members: the Audit Committee, the Human Resources Committee, and the Loan Committee. Given the scope of this project, audit work focused primarily on the board's Audit Committee and Human Resource Committee.

Audit Committee Fulfills Most of the Duties in its Charter

The purpose of the Audit Committee is to assist the board in fulfilling its oversight responsibilities for the financial reporting process, the system of internal control, the audit process, and the board's process for monitoring compliance with laws and regulations and its code of ethical conduct. The committee, of at least three "financially literate" (as defined by the board) board members, must meet a minimum of twice a year and has several responsibilities spelled out in its Charter, including:

- ◆ Review of financial statements with management and external auditors.
- ◆ Consideration of effectiveness of board's internal controls.
- ◆ Review with management of annual internal audit (currently contracted to a local accounting firm).
- ◆ Review of any external audits performed on the board.
- ◆ Review of board's compliance with laws and regulations, including internal ethics policy.
- ◆ Annual confirmation that all mandates in the Audit Committee Charter have been carried out, and regular evaluation of the performance of the

committee as a whole and of individual committee members on a regular basis.

Audit work, including attendance at Audit Committee meetings and interviews with Audit Committee members, determined that the Committee is fulfilling the majority of its obligations; however the Committee is not regularly reviewing its own performance as a whole, nor reviewing the performance of individual members of the committee, as required by its Charter.

Human Resource Committee Fulfills Most of the Duties in its Charter

The purpose of the Human Resources Committee is to discharge the board's responsibilities relating to personnel matters of all board staff, and compensation of the board's exempt staff. The committee is comprised of at least three board members and per its Charter must meet no fewer than two times per year. The committee's responsibilities include:

- ◆ Establishing pay ranges for exempt staff based on peer surveys.
- ◆ Recommending compensation levels for exempt staff.
- ◆ Overseeing staff in development of Job Profiles and performance criteria for exempt staff.
- ◆ Overseeing the director in development and maintenance of a succession plan.
- ◆ Issuing an annual Report of the Human Resources Committee on exempt staff compensation.
- ◆ Conducting annual performance evaluation of the committee, comparing the performance of the committee with the requirements of the Charter.

Work in this area included attendance at multiple meetings of the Human Resources Committee; interviews with members of the committee and the director regarding the committee's work; and examination of three years' worth of meeting minutes (both of the committee and of the board as a whole) to determine whether required activities are being completed by the committee.

We found that although the committee is meeting a number of the requirements of its charter, we saw no evidence of committee reports on exempt compensation, nor annual performance evaluations of the committee itself in complying with the Charter's mandates.

These policies of the board are secondary to its main activities related to asset allocation and investment management but were still deemed important enough to be included

in the board's committee charters. The activities prescribed by each of the charters or policy statements should be followed but without adequate visibility have sometimes been overlooked. If the current board members no longer find a required activity to be worthwhile, those could be removed through board action. Otherwise, the board should adopt a list of the requirements and place this list within its governance policy to ensure they are not overlooked.

RECOMMENDATION #4

We recommend the Board of Investments ensure that its regularly required votes, reports and affirmations are adhered to in accordance with its charters.

Proxy Voting

Proxy voting is a right belonging to owners of shares in publicly held companies. Owners of shares are allowed to vote on matters at companies' annual meetings, typically including composition of the board of directors, certain executive compensation matters, and other matters presented to shareholders either by the board or by other shareholders.

In the case of the board, it is the board members who have the fiduciary responsibility over investment activity to the owners of the state's pension assets and other funds overseen and managed by the board. To that end, proxy voting is addressed in the Investment Policy Statement for both the Domestic Equity Pool and the International Equity Pool.

In each case, the responsibility for voting proxies is delegated to the external money managers, and board staff is directed to establish a proxy voting program with external money managers, who are to vote shares "in the interest of the Plans' beneficiaries." Proxy voting policies are also discussed in the retirement funds investment policy statement, which indicates "the Board will prudently manage these assets of the Plans for the exclusive purpose of enhancing the value of the Plans for its participating systems' members and beneficiaries through such means as adopting and implementing a proxy voting policy." External service providers may be retained by either the board or the managers to assist in monitoring efforts. This monitoring will be coordinated with each manager to reasonably assure the staff that managers are fulfilling their responsibilities with respect to proxy voting.

Analysis of other states found varying levels of detail in proxy voting policies with some that provide guidance to investment managers on how to vote in many specific situations that may arise in proxy materials. The board policy regarding proxy voting should cover all public equities invested in by the board and provide staff and external managers with sufficient guidance to act in the best interests of account holders.

RECOMMENDATION #5

We recommend the Board of Investments adopt a proxy voting policy which provides staff and external managers with sufficient guidance to act in the best interests of account holders and that board members periodically review proxy voting results.

Personal Investment Disclosure/Conflict of Interest

The board's Governance Policy includes a Code of Ethics designed to ensure that board members and staff have no conflicting or competing interests that would harm the integrity of the board, harm the clients for whom the board invests funds, or interfere with the board's fiduciary responsibility.

The board's policy notes that "perhaps the greatest potential for conflicts of interest of board members and staff is with private investment vendor relationships. The board's mission requires it to have numerous relationships with these vendors... Vendors selected by the board... will receive millions in fees during the contract period. Therefore, the process for establishing and terminating these relationships must be based on well-established protocol."

The Montana Board of Investments' Code of Ethics includes provisions in the following areas:

- ◆ **Monetary:** Board members may not attend conferences subsidized by current or potential investment vendors; gifts exceeding \$50 in value must be declared, documented, and donated to charity (perishable gifts may be shared with staff); restaurant dinners are to be no-host.
- ◆ **Relationship:** Board staff with material personal or financial relationships with current or potential vendors must recuse themselves from any part of decisions to select, negotiate contracts with, or terminate services with a vendor, and must not influence the decision; board members with similar relationships must recuse themselves from similar decisions and must disclose in public meetings the reasons for their recusal; similar recusal requirements are in place for both board members and staff in the areas of borrowing

and lending; board members may vote on INTERCAP loans made to local governments in their home towns.

- ◆ **Time and Facilities:** Board staff may not use state time or facilities to conduct private business, including researching of securities for personal portfolios, securities trading, or any activities for a revenue-generating business.
- ◆ **Dual Salaries:** Board members who are also public employees must declare if their salaries are being paid at times when they are also eligible for a board per diem; board members may receive travel expenses but not per diem in such circumstances.

Board members and staff are required annually to sign the board's ethics policy, and we verified this had been done by all investment staff and board members during 2013.

Audit work determined that several other states require varying levels of disclosure of personal brokerage accounts, investments and trades, or some combination thereof, by investment staff and board members. The director believes that such disclosure is not necessary in Montana as the board and investment staff are not directly researching and buying individual securities, but rather contracts with external managers for its public equity management.

CONCLUSION

The Board of Investments' conflict of interest/disclosure policy is regularly affirmed by staff and board members.

Chapter IV – Personnel Policies and Organizational Structure

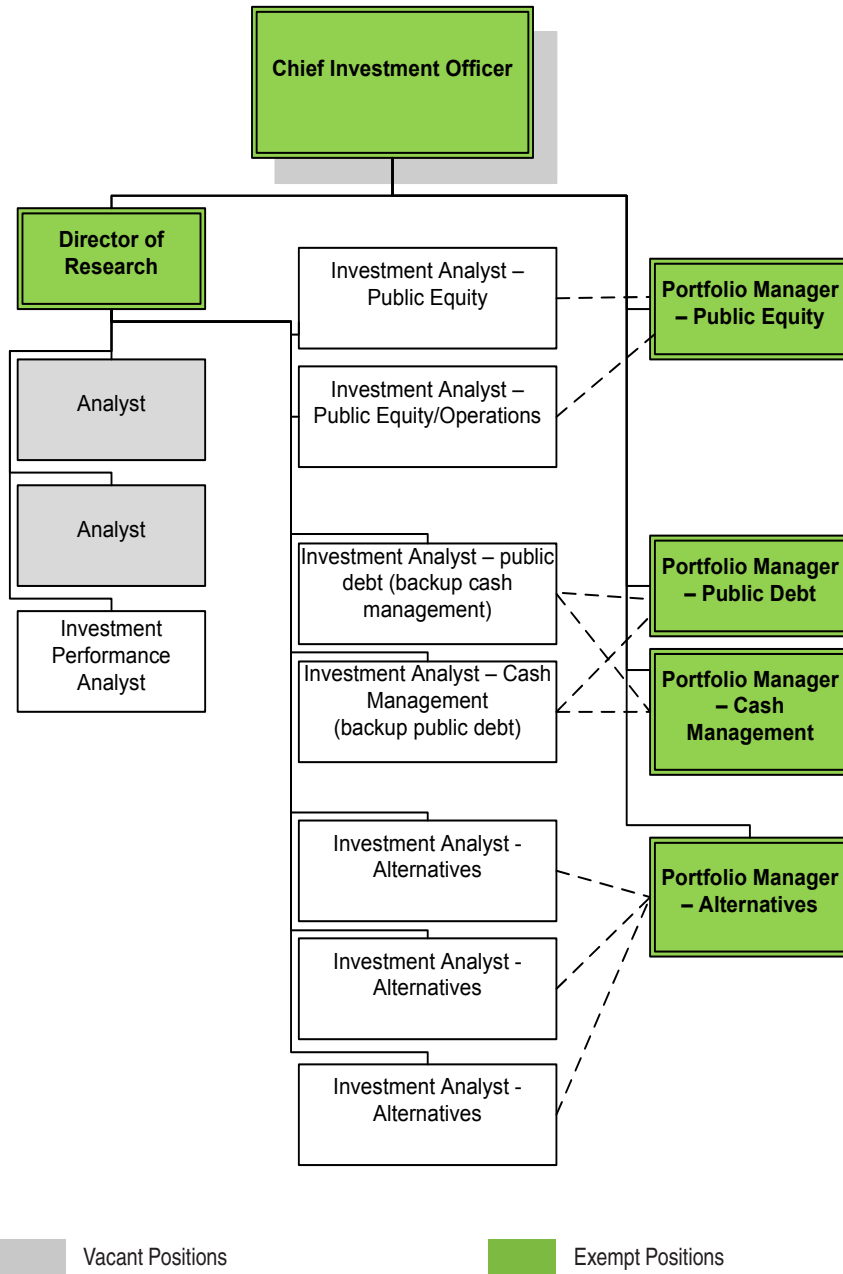
Introduction

The Board of Investments (board) is currently allocated 32 full-time positions. Of the 32 positions, 16 are strictly investment-related under the supervision of the chief investment officer. Two of the investment positions were vacant as of January 2014, though the board was actively trying to fill one of those positions, and the other is being transferred to the accounting function pending board approval. Figure 3 describes the organization of the investment staff.

In recent years, this organization has changed somewhat. Two positions that were formerly allocated to the board were reassigned to perform other duties within the Department of Commerce. One position is now an attorney and the other works in human resources. Furthermore, several of the investment analyst positions have been reassigned to different asset classes as the asset allocation and management style of funds invested has changed.

For example, for public equity funds, the board has changed its strategy from internal to external management, in an effort to increase returns, and also from active to passive management for a large portion of the domestic equity portfolio, in an effort to decrease costs. In addition, the allocation to alternative assets such as private equity and real estate has increased significantly over the past decade. The duties of the equity investment analysts on the staff have shifted from a focus on picking individual stocks to selecting and monitoring external managers. Also, as the allocation to alternative assets has grown, analysts have moved from public equity to alternatives. Ten years ago, there was only one alternative analyst, and now there are four positions in this area. Staff leadership indicated that as asset allocation changes or there are shifts in management styles, there will likely be future reallocation of investment staff resources.

Figure 3
Board of Investments Organizational Chart (Investment Staff)
 as of January 2014



Source: Compiled by Legislative Audit Division from Board of Investments records.

Alternative Staff Organizations

We obtained staffing information from several other states that manage assets of similar size to Montana. Based on these comparisons, it is evident that there are a number of possible staffing strategies but there does not appear to be a single standard that is recognized as a best-practice model. The appropriate staff strategy varies based on:

- ◆ Asset allocation
- ◆ Investment style
- ◆ Reliance on investment consultants
- ◆ Amount of diligence when selecting external managers

Asset Allocation

Managing a broad array of asset classes may require more staff members than a narrow band of assets. Even if assets are managed externally, board staff would need to be familiar with the asset class generally. Montana invests in many but not all of the potential asset classes available to institutional investors.

Investment Style

Assets can be managed by internal staff or external managers and may be passively or actively invested. Increasing the amount of external and passive management can reduce the amount of internal staff required but may reduce diversification. For example, one state used a single external manager for all of its equity and fixed income assets and was able to oversee this manager with a single employee. Montana employs a mix of internal and external management, using internal staff in areas where staff has expertise but hiring external managers when necessary. Montana also uses a mix of passive and active styles, preferring active management for markets that are thought to be less efficient and therefore where active management can provide positive value.

Reliance on Investment Consultants

Investment consultants are available for hire with a wide variety of investment expertise. Our review of other states found that virtually all institutional investors employ consultants of some type, with many states hiring multiple specialty consultants. States that make heavy use of consultants may also be able to use fewer internal staff members but must also pay additional consulting fees. Montana uses a single general investment consultant (and in recent years has hired a cost benchmarking consultant) but continues to use internal staff expertise in some areas where consultants may sometimes be used. This can cause a greater need for internal staff than in states that rely more on outside consultants.

Amount of Diligence When Selecting External Managers

As discussed in the previous chapter, we have concluded that the board staff are meeting industry practices for due diligence related to potential investments. It may be possible to perform less due diligence and reduce staff but in order to maintain the level of diligence, additional reliance (and therefore costs) would likely be placed on an investment consultant.

Internal Management Requires More Staff, May Increase Returns

While it may appear there is an opportunity to reduce staff levels by reducing the amount of internal management and increase reliance on consultants for decision making, such a strategy may come at a cost. A study completed by an external consulting firm (one which counts the board among its clients for its annual survey of public institutional investing funds) found that 70 percent of the difference in total investment full-time equivalent among the survey participants was attributed to differences in internal management, with the asset mix also playing an important role. The authors of the study conclude funds with more internal management performed better than funds with less due to lower costs. For every 10 percent increase in internal management, there was an increase of 3.6 basis points in net value added; this increase was driven largely by the lower costs attributed to internal management.

Some public institutions are even exploring the idea of managing some alternative assets in-house. For labor-intensive investments such as private equity, such internal management is probably feasible for only the very largest of institutional investors.

Staff Organization Appropriate for Asset Mix, Investment Style

The organization of Montana's Board of Investments staff has changed over time based on the asset allocation set by the board and the preferred investment style of the times. The board continues to manage assets internally in areas in which it has expertise but has outsourced some management to external providers. If these factors change in the future, staff organization changes may be required.

CONCLUSION

The organizational structure of the board's investment staff is appropriate for the asset mix and investment style currently mandated by the board.

Institutional Investing Industry Compensation

Careers within the institutional investment industry frequently offer monetary compensation that far exceeds typical public employer pay ranges. For example, a survey of over 70 firms cited in Forbes Magazine found that the average first-year equity research analyst earned over \$72,000, and by the third year earned nearly \$150,000 annually. Experienced individuals have the opportunity to earn \$300,000 per year or more, with top executives earning in the millions. This compensation usually comes partly in the form of base salary and partly as a bonus. The wages do not come without long hours. In private industry, equity researchers may be expected to work 60-70 hours per week while investment banking associates may work up to 100 hours a week.

Employment Policies at Board of Investments

It is not realistic to expect a public institutional investment entity such as the state of Montana to compete for top talent within the investment industry strictly on a monetary basis. The state can hope to attract and retain talented employees with a combination of wages comparable to other public institutional investment opportunities coupled with working fewer hours per week and offering a desirable location in which to live and work.

Exempt Employees

Eight positions in the board are exempt from the requirements of Montana's job classification and pay system. The exempt positions include:

- ◆ Chief investment officer,
- ◆ Executive director, and
- ◆ Six professional staff designated by the board. The four portfolio managers and the director of research are designated as exempt. The sixth designated position is the portfolio manager for the in-state loan program.

The salaries for exempt positions are established by the board. By policy, the board is to conduct a salary survey of similar organizations to establish market pay rates for comparable positions. To do this, the board contracts with a compensation benchmarking firm specializing in the financial services industry. The contractor conducts an annual survey of public investment institutions. The 2012 survey was the most recent available when we were conducting fieldwork. This survey included 53 participating agencies.

The board used the survey results to establish the market rates for the exempt positions, then, according to its pay policy, used the market to establish a range for each of the positions. Salary ranges are calculated as described in Table 4.

Table 4
Exempt Staff Salary Ranges

Staff Type	Market Salary	Bottom of Range	Top of Range
Executive Director	\$217,300	62.5% of market	137.5% of market
Chief Investment Officer	\$245,000	62.5% of market	137.5% of market
Other designated staff members	\$125,000	72.5% of market	127.5% of market

Source: Compiled by Legislative Audit Division from Board of Investments information.

Once pay ranges have been established by the board, the salary of each exempt employee is set after considering performance, professional credentials, experience, skill, and pay equity. The board may choose the weight each factor may have and may also adjust the factors to be considered. For these employees, the board can make temporary, lump sum, or conditional pay adjustments.

Classified Employees

The remaining positions at the board are classified employees of the Department of Commerce. The pay rates for these positions are established through a combination of legislative action and classification actions by the Department of Commerce and the State Personnel Division.

During the two-year period between December 1, 2011, and December 1, 2013, the classified employees generally received a series of three across-the-board increases: 1 percent in December 2011, 7.5 percent in June 2012, and 3 percent in June 2013. These increases are consistent with other employees of the Department of Commerce.

Board Action for Exempt Employees

We verified the board conducted annual salary surveys for 2011 and 2012. At its February 2012 meeting, the board authorized 1 percent increases for all exempt employees except the executive director, who received no increase. In addition, at its August 2012 meeting, the board authorized a 7.5 percent disparity adjustment for two portfolio managers, retroactively effective to January 1, 2012. In May 2013, the board awarded all exempt employees an increase ranging from 5.5 to 9.75 percent.

The current market rate for the portfolio managers and research director is \$125,000, which corresponds to the 2012 market median established by the contractor's survey for a Senior Portfolio Manager II for all asset classes. The Director of Research position market rate is also set using portfolio manager data.

The five exempt investment employees now earn between 96.1 and 122.9 percent of the market rate, all of which fall within the range established by policy. The executive director earns 79.9 percent of market and the chief investment officer 88.7 percent.

Turnover at Board of Investments

The board staff has generally experienced lower turnover rates than state government as a whole. The annualized five-year turnover rate between fiscal years 2009 and 2013 for the board of investments was 10.5 percent. This compares favorably to the Department of Commerce overall, which experienced an annualized 26.5 percent turnover rate for the same period. The board's staff turnover rate also compares well against other agencies such as the pension administration organizations which had a 21.2 percent rate and Montana State Fund, which was 13 percent. In this context, the current salary structure at the board would not appear to be contributing to undue organizational turnover.

Board staff leadership has reported some difficulty in filling some positions. In fall 2013, the board attempted to hire an analyst for alternative investments, but successful applicants turned down offers in favor of other opportunities. It has successfully competed to fill other positions. In one case, however, the successful candidate was able to negotiate a \$25,000 relocation fee as one of the conditions of acceptance.

Performance Pay

As mentioned earlier, professionals in the investment industry are commonly compensated with some portion of their pay based on job performance. Frequently this is explicitly tied to the performance of the employee's portfolio of assets. According to the market survey, 64.4 percent of senior portfolio managers are eligible to receive performance compensation. In Montana, the board does evaluate employee performance but does not exclusively tie job performance to the portfolio performance.

All of the board's portfolio managers are eligible for lump sum, temporary compensation should the board deem it appropriate. Per its pay policy, the board recognizes its statutory ability to set all exempt salaries, but it also recognizes the general compensation or pay adjustments received by other state employees could factor in its consideration for exempt employee pay. In the past two years, the board has opted not

to provide lump sum performance pay, but could institute such payment if a majority of board members agree to do so.

CONCLUSION

The compensation policies of the Board of Investments are consistent with peers within the public institutional investment industry.

Chapter V – Relationships with External Service Providers

Introduction

The Board of Investments (board) and its staff rely on external providers for several types of services, including custodial banking, investment consulting, and external investment management. The need for these services has evolved over time as the board has changed its investment philosophy. For example, equity investments were formerly managed internally, with board staff buying and selling individual stocks. Equities are now managed externally via investments in vehicles that are similar to retail mutual funds. As the board has increased its allocation in alternative assets, additional external management has also been required in that area.

Custodial Bank Services are Necessary for Board to Fulfill Its Duties

The board contracts with a major bank for a variety of custodial banking and account management services, including:

- ◆ Securities safekeeping.
- ◆ Securities accounting and reporting.
- ◆ Participant accounting (mutual fund type accounting and reporting).
- ◆ Investment performance and analytics reporting (daily, monthly, quarterly).
- ◆ Securities lending.
- ◆ Providing and maintaining a comprehensive online accounting system to account for the board's entire portfolio and all transactions.
- ◆ Providing an electronic interface to permit the board to customize and download all accounting and investment data.

The contract calls for base annual payments to the bank of \$1.5 million. The total annual payment may be \$1.65 million, depending upon additional services provided.

Securities lending is a common practice among institutional investors and provides added income by lending securities to borrowers who need additional inventory to settle sales. The transfer of the assets to the borrower is protected by collateral in the form of cash or securities exceeding 102-105 percent of the securities' value. The securities loaned generated net income of \$5 million in fiscal year 2012 and \$3.4 million in fiscal year 2013. While this is a relatively small margin, it can boost overall fund results.

Given limitations of staff resources and in-house expertise as well as the need for accounting controls, this contracted custodial banking relationship is necessary and appropriate for the board. Its most recent contract with the bank was executed in 2007, and a Request for Proposals (RFP) is currently being prepared for 2014, when the current custodial banking contract expires. The board's investment consultant counts among its duties assisting the board in its search for custodial services (see below). Members of the consulting team have told the board they expect a strong response from the limited number of eligible custodial banks when the next RFP is advertised.

Investment Consultants are Common Among Institutional Investment Organizations

The board contracts with an independent investment consulting firm, to provide an array of services for board members and staff. Service areas contracted with the investment consultant include:

- ◆ Physical presence at six board meetings per year.
- ◆ Annual review of existing asset allocation.
- ◆ Generation of quarterly investment performance reports, broken down by pool and by retirement plan and including high level performance attribution, performance versus benchmarks, and other performance metrics.
- ◆ Advice on the board's investment management structure.
- ◆ Assistance in searches for external investment managers.
- ◆ Review of benchmarks for all external managers, internally managed portfolios and investment pools.
- ◆ Expert testimony (i.e., to legislative committees) as needed.
- ◆ Pacing studies for private equity and real estate investments.
- ◆ Private equity and real estate peer performance comparisons.
- ◆ Real estate services.
- ◆ Review of investment guidelines and policies.
- ◆ Assistance in searches for custodial and securities lending services.
- ◆ Cost analysis.
- ◆ Proxy vote guidance.
- ◆ Board and staff education.

In addition, in our interviews with board members, several cited the investment consultant as an important independent check on the staff and a source of additional information and guidance should board members question any decisions or proposals made by staff.

The five-year investment consulting contract calls for annual payments of \$295,000 in each of the first three years, \$303,850 in year four and \$312,966 in year five. The board issued a Request for Proposals in 2012, received six responses, and interviewed two firms in person before selecting the current consultant and executing a five-year contract.

Audit work revealed that other, similarly sized and structured states' investment boards routinely employ investment consultants, though the range of services contracted may vary. For example, some states use consultants to perform due diligence on potential private equity partnerships, whereas Montana's investment staff performs this function internally. One state of similar size to Montana employs three different investment consultants, receiving different services from each.

For the past several years the board has contracted with a consulting firm to provide analysis of the board's investment performance and expenses in the context of other similarly sized institutional investing organizations. The most recent study, delivered in August, 2013, found that the board's costs were normal for an organization managing assets of similar size and with a similar asset allocation.

CONCLUSION

The services provided by the board's custodial bank and investment consultant are reasonable for an organization of the board's size and expertise.

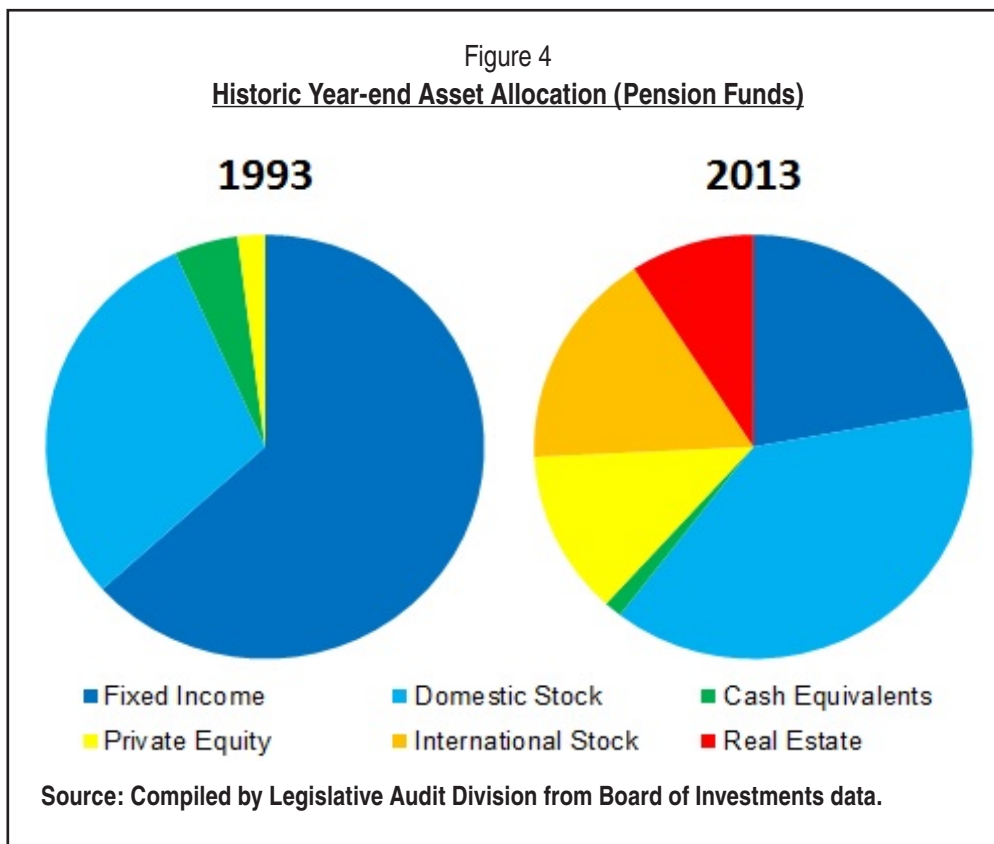
Investment Costs Have Risen as Pools Have Grown and Asset Allocation Shifted

The 2015 Biennium Executive Budget shows the board with Total Executive Budgets of \$5.40 million for fiscal year 2014 and \$5.36 million for fiscal year 2015. Other than the statutory general appropriation to cover custodial banking fees, the board recovers its operational costs from the entities that use its services.

In addition to the costs that are borne in the Executive Budget, the board incurs fees on the money it invests that are paid to various money managers and investment partners, a category that includes external managers of domestic and international equity funds, as well as alternative investment (private equity and real estate) general partners. By state law, the cost of administering and accounting for each investment fund must be deducted from the income for each fund.

According to board documents, these fees totaled \$40.0 million in fiscal year 2012 and \$38.2 million in fiscal year 2013. Over time, the amount of money paid to money managers as fees has increased dramatically, this most recent decrease notwithstanding, due to both the growing portfolios (fees are typically assessed as a percentage of assets under management) as well as to an increased exposure to private equity and other alternative investments. Generally, private equity and other alternatives are some of the most expensive asset classes in which to invest, with active external management, passive external management, and internal management usually being progressively less costly in the area of fees.

Between 1993 and 2013, high cost investment types, including international equity, private equity, and real estate have increased from 2 percent to 38.3 percent of the pensions portfolio.



We reviewed the difference paid in external management fees from fiscal year 2007 to 2013. Overall, external fees increased \$21,304,925 between these years, with most of the increase coming early during that time period. Most of the difference is attributable to the growth in fees paid to managers of alternative investments. Table 5 displays the change in external fees paid by pool over the most recent seven years.

Of the total increase, \$17,763,868 (83.4 percent), was attributable to higher cost alternative assets. Over the same time period, the investment expenses related to internal board staff also increased. The total increase was \$887,584, of which 80 percent was in alternative assets, likely due to the increasing size of the alternative asset analyst staff discussed in Chapter IV.

It is important to note that the board and its staff recognize the high cost of alternative assets, and demand higher returns from these investments in exchange for the high cost and elevated investment and liquidity risk assumed. The internal performance benchmark for private equity is the performance of the S&P 1500 (a broad measure of market performance) plus 4 percent, a threshold for success much higher than that for safer and more liquid investments. While returns vary for each pool from year to year, the Montana Private Equity Pool (12.65 percent annualized return)

has outperformed both the Montana Domestic Equity Pool (7.28 percent) and the Montana International Equity Pool (7.35 percent) over the last 10 years.

Through observation and interviews we learned that board members and staff are aware of the increasing costs associated with changing the asset allocation, and staff routinely looks to negotiate lower fees whenever possible. In interviews with private equity general partners, board staff asked for ways to lower the board's expenses. And in discussions over hiring external fund managers for small cap international stocks, the board's consultant offered guidance on which managers under consideration might be more likely to accept lower fee payments from the board.

CONCLUSION

Fees paid to external investment managers and alternative assets managers by the Board of Investments have increased as the board's allocation of assets and other investment decisions have shifted funds into more expensive asset classes.

Table 5
Change in External Management Fees Paid
Fiscal Years 2007-13

Fund	External Management Fees
RFBP	\$1,533,111
TFIP	\$1,617,475
MDEP	\$3,224,927
MTIP	-\$2,840,885
MPEP	\$9,277,111
MTRP	\$8,486,757
STIP	\$0
AOF	\$6,429
Total	\$21,304,925

Source: Audited financial statements of the Board of Investments

External Manager Contracting and the Montana Procurement Act

The legislature created the board and gives the board primary authority to invest state funds in accordance with state law and the Montana Constitution. Historically, the board has operated within the framework of the Montana Procurement Act (MPA) when acquiring most investment services. Among other reasons, the MPA exists to provide for consistency in the acquisition of goods and services across state government; to acquire goods and services in a fair and equitable manner; to encourage competition among bidders within the free enterprise system; and to foster public confidence that appropriate procurement procedures are being followed in the expenditure of public funds.

Procurement Act Applicability to Certain Board Contracts

Given how private equity commitments are identified and negotiated, it is not practicable for the board to operate within the constraints of the MPA when entering such arrangements. There is also some question as to whether private equity or real estate deals would fall under the MPA in any case, as rather than securing a good or service, the arrangement is typically structured as a partnership between fund managers (general partners) and the board (limited partner; typically one of several in a given private equity fund). The board has historically not followed traditional state procurement procedures when entering into such agreements.

In 2012, the board changed its Governance Policy with regard to its method for selecting external public asset managers. According to minutes from the February meeting this was done to “reassert the board’s authority over the type of investments to be made.” The unanimously approved changes had the effect of exempting the board’s investment staff from the requirements of the MPA when contracting with public equities managers, instead vesting the final authority in making such investments with the executive director and the chief investment officer.

In suggesting the policy change to the board, the executive director wrote that “Montana law directs that the board shall determine the type of investment to be made. It is staff’s recommendation that the Governance Policy accurately reflect that in choosing a type of investment, such as using a public or private equity manager and/or using passive or active styles and their corresponding external money managers, that this power rests solely with the board. It is not governed under Montana law by the Montana Procurement Act.”

Further, the director claimed, “the Unified Investment law is specific: where the board’s contracts are axiomatic to the board’s statutory mission in determining the type of investment to be made, the board has the sole say. Its contracts under this narrow statutory provision cannot be vetoed by another state agency under the law.”

The MPA is a general act that applies to the expenditure of public funds by the state acting through a governmental body under any contract, although there are several exemptions in the law for certain types of goods and services (see §18-4-132(3), MCA). Included in these exemptions are the acquisition of insurance-related services by the state compensation insurance fund; hiring of registered professional engineers, surveyors, real estate appraisers and registered architects; hiring of physicians, dentists, pharmacists or other medical, dental or health care providers; consulting actuaries; and others.

The acquisition of external investment management services bears similarities to other professional services for which there are exemptions to the MPA. These professionals are generally highly educated and qualified to work in a specialized field, and the best hiring practice may not necessarily entail choosing the low bidder. Further, the MPA can involve a cumbersome, lengthy process that does not lend itself well to procuring time-sensitive services of professionals with a specific investment expertise. Through research we determined that some other states follow their state’s formal procurement processes when contracting with external public equity managers, while others do not.

It would be appropriate for the board to be exempt from the MPA when hiring external investment managers. Other state agencies have sought and received from the legislature statutory exceptions to the MPA for various goods and services. However, the board did not seek legislation in changing the areas in which it follows the MPA.

RECOMMENDATION #6

We recommend the Board of Investments seek revisions to the Montana Procurement Act to provide an exemption to the board for the procurement of external investment management services.

MONTANA BOARD OF
INVESTMENTS

BOARD RESPONSE

MONTANA BOARD OF INVESTMENTS

Department of Commerce

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January 24, 2014

RECEIVED
JAN 24 2014
LEGISLATIVE AUDIT DIV.

Tori Hunthausen, CPA
Legislative Auditor
Legislative Audit Division
P.O. Box 201705
Helena MT 59620-1705

Dear Ms. Hunthausen:

The Board of Investments has received your office's performance audit covering various aspects of our Board. I want to express our appreciation to you and your staff who worked hard to understand our investment mission, practices, and perhaps most importantly, the oversight from our Board members.

The legislative audit process allows agencies to respond in writing and to have our comments become part of the final audit document for the Legislative Audit Committee and the public. We much appreciate this courtesy. Because your audit process currently provides that legislators who serve on the Legislative Audit Committee have the first public opportunity to receive and comment on your reports, the Board of Investments can only informally respond at this time. The Board is scheduled to formally consider this report in open meeting at its February meeting. The comments I offer below are my best efforts to represent the initial thoughts of the Board of Investments after receiving input from many of them on an individual basis.

Recommendation #1

We recommend the Montana Legislature revise the professional and experience requirements for the composition of the Board of Investments to increase the board's collective knowledge and understanding of institutional investing.

We acknowledge that the statutory makeup of the Board is the prerogative of both the Legislature and the Governor and that this recommendation is directed specifically to the Legislature, not the Board. Therefore, we respectfully request that our view be taken not on a concur/non-concur basis, but as an interested and knowledgeable party.

The current intent of the law is that the Board be a citizen board, composed (as the law requires), of a diverse make up. As you know, the law currently requires "a balance of professional

expertise and public interest and accountability." Over many years, governors have appointed investment brokers and financial advisors, bankers, attorneys, small business owners, farmers, ranchers, educators, engineers, working men and women and public employees. To serve on the Board of Investments is a high honor and significant responsibility.

A key strength that results from the diversity of membership of the Board is that the professional staff and consultants are required to explain their work and investment strategies to a representative group of Montanans. Good Board members are unafraid to ask even the most rudimentary questions in conjunction with the difficult technical ones. This helps all of us understand the recommendations and actions of the highly trained investment staff. This insures that the staff has a reasonable, explainable basis for its recommendations to the Board and helps all citizens better understand the Board's business and missions.

We believe that the current law on Board of Investments member composition is appropriate for the Board to function in fulfilling all of its responsibilities. As the audit report attests, the Board is meeting its fiduciary responsibilities in a competent manner. Finally, we believe that the current statute on Board of Investments composition and the requirement that seven out of nine of its members "be informed and experienced in the area of investments" is as strict as, or stricter, than many other states as to requiring financial knowledge or experience for Board eligibility.

Recommendation #2

We recommend the Board of Investments require ongoing educational activities be provided to Board members.

We Concur.

While the Board cannot legally compel members to participate on some conditional basis, no matter how worthy, the Board understands and appreciates how important it is for members to understand and be conversant in the many areas of the Board's responsibilities. The Board's existing education policy covers a wide number of guidelines and procedures. Additionally, two years ago, the Board adopted a 24-month work plan strategy, which exposes and educates members on a systematic basis to all of the functions that the Board must fulfill. Additionally, the Board has directed its consultant to provide educational services. Staff will request that the importance of this systematic work and education plan be elevated by incorporating that such a work/education plan be adopted within the Board's governance policy.

Staff offers a few other comments: The Board is sensitive about costs and the cost of attending educational seminars can be significant. The Board is also aware that many investment conferences are of dubious educational value and are instead either junkets or sales pitches. Thus, it is a difficult task to select educational seminars and investment conferences that are cost-effective and truly educational. The staff will continue its effort to do so.

Recommendation #3

We recommend the Board of Investments amend its Governance Policy to more strongly emphasize its commitment to annual affirmation of the asset allocation of its entire portfolio of investments

We Concur.

Staff will recommend to the Board that this matter be elevated to the Board's general governance policy. As the report noted, the Board has often addressed specific asset allocation issues. The global affirmation on asset allocation was scheduled in the Board's 2013 work plan and was addressed at its November 2013 meeting. While this recommendation covers a technical deficiency, nevertheless, it is a fair criticism given the importance of overall asset allocation.

Recommendation #4

We recommend the Board of Investments ensure that its regularly required votes, reports and affirmations are more strictly adhered to in accordance with its charters.

We Concur.

Staff will suggest that the best way to concur with this recommendation is to be sure that policies contain requirements on Board members that are truly enforceable. Some of the existing policies in the committee charters would therefore need to be modified or even eliminated.

Recommendation #5

We recommend the Board of Investments adopt a proxy voting policy which provides staff and external managers with sufficient guidance to act in the best interest of account holders and that board members periodically review proxy voting results.

We Concur.

Staff will work to ensure the matter of proxy voting for public equities will be reviewed on a timelier manner by the full Board. This subject is scheduled for the Board's May meeting and proxy voting is now included in the Board's 24-month systematic work plan.

Recommendation #6

We recommend the MBOI seek revisions to the Montana Procurement Act to provide an exemption to the Board for the procurement of external investment management services.

We respectfully do not concur.

The Board fully respects and complies with the state procurement law. Under the Uniform Investment Act, the Board is charged with choosing investment types which means choosing

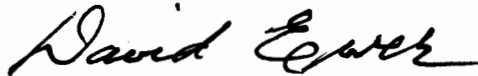
investment managers. The audit report points out the impracticability of using a procurement process for private equity. But the law is the law; a government body cannot ignore the law simply because it is impractical to comply.

The Board's position is that the Legislature has already given the Board the authority to contract with investment managers without going through the procurement process. The Board through its governance policy acknowledges that this exception is a very limited one. Consequently the Board has clarified that it has the sole responsibility under the law to choose private or public investment managers. This matter was reviewed and concurred with by the chief legal counsel for the Department of Administration.

Only one executive agency may administer the Unified Investment Program as required under the Montana Constitution. The Legislature has chosen the Board of Investments to serve this role. We also believe, and our view is supported by counsel for the Department of Administration, that there would be two state agencies with that final authority if investment managers were subject to the procurement process.

We acknowledge that the performance auditors support the Board's authority and acknowledge that the selection of investment managers should not be made through the procurement process. Instead, the auditors are recommending a 'clean up' statute. The Board, however, respectfully believes that accepting the very premise that such a statute is necessary runs counter to the legal opinion it received from the chief attorney for the department that implements the Procurement Act.

Sincerely,

A handwritten signature in black ink that reads "David Ewer". The signature is written in a cursive, flowing style.

David Ewer
Executive Director