

STATE OF CONNECTICUT

**AUDITORS' REPORT
INVESTMENT ADVISORY COUNCIL
FOR THE FISCAL YEAR ENDED JUNE 30, 2003**

AUDITORS OF PUBLIC ACCOUNTS
KEVIN P. JOHNSTON ♦ ROBERT G. JAEKLE

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**AUDITORS' REPORT
INVESTMENT ADVISORY COUNCIL
FOR THE FISCAL YEAR ENDED JUNE 30, 2003**

We have made an examination of the financial records of the Treasurer of the State of Connecticut as they pertain to the operations of the Investment Advisory Council for the fiscal year ended June 30, 2003.

This report on the above examination consists of the following Comments and Recommendations. Separate reports are issued on the State Treasurer financial operations and internal operations of the State Treasury that include auditors' certifications. This report also includes information concerning the Combined Investment Funds that was obtained from our audit of the State Treasurer-State Financial Operations for the fiscal year ended June 30, 2003.

COMMENTS

FOREWORD:

The Investment Advisory Council (referred to as "IAC" or "Council" in this report) operates under the provisions of various statutes, primarily Section 3-13b. The Council's statutory responsibilities consist basically of the following:

1. Review Trust Fund investments by the State Treasurer (Section 3-13b, subsection (c) (2)).
2. Review and approve for adoption, an Investment Policy Statement which shall set forth the standards governing investment of trust funds by the State Treasurer. Any revisions to the Investment Policy Statement shall be made in consultation with and with the approval of the Investment Advisory Council. (Section 3-13b, subsection (c) (1)).
3. Give its advice and consent to the appointment of a Chief Investment Officer for the retirement, pension and trust funds (Section 3-13a, subsection (a)).
4. Make a complete examination of the security investments of the State and determine as of June 30, the value of such investments in the custody of the Treasurer and report thereon to the Governor (Section 3-13b, subsection (c) (2)).

Auditors of Public Accounts

Further, the Governor may direct the Treasurer to change any investment made by the Treasurer when, in the judgment of the Council, such action is in the best interest of the State.

The Council is within the State Treasurer's Office for administrative purposes only and the Treasurer's Office continues to maintain the minutes, provide office space for meetings and other support services. The Council's expenses are paid by the Treasurer's Office from the investment earnings of the retirement and trust funds.

Council Members:

Pursuant to Section 3-13b of the General Statutes, the Investment Advisory Council, as of June 30, 2003, should consist of 12 members. The State Treasurer is an ex-officio member that also serves as Secretary of the Council. Members of the Investment Advisory Council as of June 30, 2003, were as follows:

Ex-officio members:

Denise L. Nappier - State Treasurer and Secretary of the Investment Advisory Council
Marc S. Ryan - Secretary, Office of Policy and Management

Public members - One appointed by the Governor and four appointed by Legislative leaders:

Steven W. Hart, Chairman
Henry E. Parker
Reginald Martin
George H. Mason
Clarence L. Roberts, Jr.

Teachers' unions representatives:

Sharon M. Palmer
Clare H. Barnett
Roselyn B. Schoonmaker

State employees' unions representatives:

Carol M. Thomas
Vacancy

RÉSUMÉ OF OPERATIONS:

Council Expenditures:

State Treasurer expenditures, presented below on the accrual basis, for the IAC for the fiscal year ended June 30, 2003 and June 30, 2002, are summarized as follows:

<u>Description</u>	<u>2002-2003</u>	<u>2001-2002</u>
Consultant	\$ -	\$ 50,000
Travel – Out of State	11,658	7,553
Travel – In State	2,304	5,301
Overnight Mail	2,172	3,314
Meeting Costs	1,776	3,205
Other	414	1,125
Subscriptions	750	899
Total	<u>\$ 19,074</u>	<u>\$ 71,397</u>

Consultant expenses were paid to a firm to review the statutory and fiduciary responsibility of the IAC. Out of State travel expenditures were for members' attendance at various investment-related conferences held throughout the country. Most of the remaining expenditures were for the cost of the IAC meetings.

Investment Advisory Council Meetings:

The Investment Advisory Council held ten regular meetings during the fiscal year. Investment performance of the Treasurer's external managers and in-house staff (for the Short Term Investment Fund) were reviewed at these meetings. In summary, the Council reviewed and discussed items such as statistical, analytical and historical data prepared by Treasury staff, outside advisors and consultants, the overall performance data of Combined Investment Funds (CIF) and the Short Term Investment Fund (STIF) and the relative performance of the investment managers.

Some of the actions/activities, which occurred during the 2002-2003 fiscal year, follow:

1. Continued discussions regarding investment fund performance; pending litigation; the search for International Stock Fund managers and a consultant for the Real Estate Fund; and the status of proxy voting.
2. Discussed International Stock Fund restructuring including the implementation of a currency overlay manager.
3. Endorsed the Treasurer's selection of a consultant to provide investment oversight of the Real Estate Fund.
4. The IAC budgets for the 2002-2003 and 2003-2004 fiscal years was reviewed and approved.
5. Adopted an IAC member handbook.

In addition to the historical review functions and discussions of the investment matters mentioned above, the Council periodically requested the external managers to present, in person and/or in writing, reports and explanations on their overall investment approach including styles, diversification, goals and strategies. In essence, the external advisors are to provide diverse portfolio management approaches compatible with investment objectives, standards, and restrictions set by the Council, Treasurer and applicable statutes. The Treasurer also utilizes a financial consulting firm on an ongoing basis to provide analytical and performance information of the individual investment funds, as well as the Combined Investment Fund as a whole. A representative of the firm attends the IAC meetings, and written reports of investment results are provided to the IAC at least quarterly. These reports include a summary of the Securities Lending Program used by the Combined Investment Fund.

Information concerning the Combined Investment Fund and the results of its operations during the 2002-2003 fiscal year, together with recent developments follow. Most of this information is also included in our Audit Report on the State Treasurer – State Financial Operations for the fiscal year ended June 30, 2003.

Combined Investment Funds:

In general, the Pension Funds Management Division (PFMD) operates under the provisions contained primarily in Part I, Chapter 32, of the General Statutes, particularly Sections 3-13a, 3-13b, 3-13d, 3-31a and 3-31b.

The Pension Funds Management Division is responsible for managing the assets of six pension funds and eight trust funds having total net assets of more than \$18,700,000,000, as of June 30, 2003. The Division invests the assets of these funds in accordance with an investment program through the purchase of ownership interests in a Combined Investment Fund. Each asset class (i.e., Fixed Income, U.S. Equity, etc.) within the Fund holds investments of the Combined Investment Fund. During the audited fiscal year, and as of June 30, 2003, the Combined Investment Fund (CIF) consisted of the Mutual Fixed Income (MFIF), Mutual Equity (MEF), Real Estate (REF), International Stock (ISF), Private Investment (PIF), Commercial Mortgage (CMF), and the Cash Reserve (CRF) Funds. Record keeping and custody of most assets is provided by a master custodian (State Street Bank). As of June 30, 2003, the Division employed 65 external advisors to manage and invest the assets of the Combined Investment Fund.

The cost of operating the Treasury's Pension Funds Management Division, including the cost of personnel and professional investment advisors retained, is charged against the investment income of the Combined Investment Fund. Transfers are made from the investment funds to a special General Fund account from which Pension Funds Management Division operating expenses (salaries, advisor and management fees, supplies, etc.) are paid. Expenses of the Combined Investment Funds, excluding external advisor expenses, were approximately \$6,000,000 for the 2002-2003 fiscal year.

During the fiscal year ended June 30, 2003, the Combined Investment Funds realized an annual total return of 2.49 percent, according to the Annual Report. The fund return of 2.49 percent is lower than the calculated benchmark of the Connecticut Multiple Market Index of 3.88 percent. The

Connecticut Multiple Market Index is a blended index calculated by the Treasury to compare the overall return of the fund against market conditions using the weighted averages of various indexes associated with the asset classes. These indexes represent "benchmarks" used by the Division to evaluate investment return. Another benchmark is the actuarially determined assumed rate of return of 8.5 percent that is internally established. During the previous fiscal year ended June 30, 2002, the Combined Investment Funds realized a negative annual total return of (6.39) percent.

A summary of the percentage returns of the Combined Investment Funds and the retirement and trust funds that are invested in the Combined Investment Funds, as reported in the State Treasurer's Annual Report, for the fiscal years ended June 30, 2003 and 2002 are presented below.

		<u>Percentage Return</u>	
<u>Combined Investment Funds:</u>		<u>2002-2003</u>	<u>2001-2002</u>
Net Total Combined Investment Funds		2.49 %	(6.39) %
Mutual Equity	MEF	0.48 %	(14.95) %
International Stock	ISF	(6.39)%	(9.00) %
Real Estate	REF	3.30 %	0.81 %
Mutual Fixed Income	MFIF	12.03 %	5.64 %
Commercial Mortgage	CMF	20.62 %	1.19 %
Private Investment	PIF	(11.94)%	(10.81)%
Cash Reserve	CRF	1.80 %	3.03 %
 <u>Retirement and Trust Funds:</u>			
Net Total Return Retirement and Trust Funds		2.49 %	(6.39) %
Teachers' Retirement Fund (TRF)		2.13 %	(6.58) %
State Employees' Retirement Fund (SERF)		2.06 %	(6.62) %
Municipal Employees' Retirement Fund (MERF)		2.12 %	(6.41) %
Probate Court Retirement Fund (Probate)		2.88 %	(5.89) %
Judges' Retirement Fund (Judges')		2.41 %	(5.88) %
State's Attorneys' Retirement Fund (St. Atty.)		3.85 %	(7.94) %
Trust Funds		8.88 %	1.16 %

Investment performance for individual retirement funds varies based on the mixture of asset class types held by each. The investment performance for trust funds is a composite of returns earned by nine trust funds that participate in the Treasurer's Combined Investment Fund. During the fiscal year, Trust Funds included the School and Agricultural College Funds, The Soldiers' Sailors' and Marines' Fund, the Police and Fireman's Survivors' Benefit Fund, Endowment for the Arts, Hopemead Fund, Ida Eaton Cotton Fund, Andrew Clark Fund and the Tobacco and Health Trust Fund, which was closed during the year.

Asset Allocation Policy:

The Treasurer's Asset Allocation Policy is presented below. The policy was in force during the period under review.

<u>Investments</u>	<u>Asset Class</u>	<u>Target Policy</u>	<u>Holdings as of June 30, 2003</u>
<i>U.S. Equity</i>	<i>36%: MEF</i>	36%	36.1%
<i>International Equity</i>	<i>18%: ISF</i>	18%	11.1%
Developed Markets	15% ISF		
Emerging Markets	3% ISF		
<i>Fixed Income</i>	<i>30%: MFIF, CRF, CMF</i>	30%	40.4%
Cash	1% CRF		
Core Bonds	20% MFIF, CMF		
Inflation-linked Bonds	1% MFIF		
High-yield Bonds	5% MFIF		
Non-U.S. Emerging Markets	3% MFIF		
<i>Real Estate and Alternative</i>	<i>16%: REF, PIF</i>	16%	12.4%
Equity Real Estate	5% REF		
Private Investments	11% PIF		

The Treasury's Asset Allocation Policy includes lower and upper ranges for the investment allocations. All variations above are within the established ranges except for the Fixed Income. The upper range for Fixed Income is 33% and the upper range for Cash is 1%.

Investment Mix:

A summary of the Retirement Funds' investment activity in the Combined Investment Fund is presented below. This information is presented in detail in the Treasurer's Annual Report, pages S-2 through S-6. The amounts below are presented in millions of dollars.

Participant Funds	6/30/02	Realized Change					6/30/03		Inv.
	Market Values	Share Transactions			Gain on Redemp	in Mkt. Value	Mkt. Values	Percent Holdings	
	\$	\$	\$	\$	\$	\$	\$	\$	\$
TRF	10,107.3	781.9	776.0	5.9	11.7	(278.8)	9,846.0	53.8 %	453.0
SERF	7,090.4	425.5	342.9	82.6	9.0	(195.0)	6,987.2	38.2 %	319.2
MERF	1,184.5	71.8	52.9	18.9	1.4	(30.4)	1,174.5	6.4 %	52.2
Probate	60.9	4.4	4.0	0.4	0.1	(0.9)	60.5	0.3 %	2.3
Judges'	125.2	7.5	4.9	2.6	0.1	(2.8)	125.2	0.7 %	5.5
St. Atty.	0.7	0.0	0.0	0.0	0.0	0.0	0.6	0.0 %	0.0
All Other	137.2	8.4	42.7	(34.3)	(2.3)	4.0	106.4	0.6 %	4.7
Accrual Chg.									
Totals	\$18,706.2	\$1,299.5	\$1,223.4	\$76.1	\$22.0	\$(503.9)	\$18,300.4	100%	\$836.9

The separate investment funds mentioned previously are used to account for different types of investments. For instance, CRF invests primarily in money market instruments having maturities of two years or less. Most of the MEF and ISF portfolios consist of investments in stocks and most of the MFIF portfolio consists of investments in bonds. The net assets (net worth or equity) of each fund at market gives some idea of the investment mix. A summary of the Combined Investment Fund's activity is presented below. This information is presented in detail in the Treasurer's Annual Report, page F-12. The amounts below are presented in millions of dollars.

Combined Investment Funds	6/30/02	Participant Fund Activity				Invest Return	6/30/03	
	Net Assets	Purch	Redemp	Income Distrib	Net Contrib		Net Assets	Percent Holdings
CRF	\$1,442.9	\$ 4,230.8	\$ 3,821.0	\$ 34.0	\$ 375.8	\$ 34.0	\$1,852.8	10.1 %
MEF	6,676.6	0.0	7.5	81.9	(89.4)	11.3	6,598.5	36.1 %
ISF	2,226.7	0.0	0.0	37.3	(37.3)	(155.3)	2,034.0	11.1 %
MFIF	6,526.3	2.4	292.4	337.7	(627.7)	711.1	6,609.6	36.1 %
REF	471.2	6.5	23.0	43.4	(59.9)	14.5	425.8	2.3 %
CMF	73.3	0.0	6.8	7.7	(14.5)	13.5	72.3	0.4 %
PIF	2,281.0	136.0	0.0	317.1	(181.1)	(251.7)	1,848.1	10.1 %
Elim. Entry*	(991.9)	(3,076.2)	(2,927.3)	(22.2)	(126.7)	(22.2)	(1,140.7)	(6.2)%
Totals	\$18,706.1	\$1,299.5	\$1,223.4	\$836.9	\$(760.8)	\$355.1	\$18,300.4	100%

*The "elimination entry" removes the Cash Reserve Fund investments of each of the other asset classes so that it will not be counted twice in the totals.

Outside Advisors:

During the fiscal years ended June 30, 2003 and 2002, outside advisors managed all of the CIF portfolios. The number of outside advisors and advisor expenses by fund, as reported in the Combined Investment Funds financial statements and notes included in the State Treasurer's Annual Report, for services rendered during the 2002-2003 and 2001-2002 fiscal years are summarized below:

<u>CIF</u>	<u># of Advisors- June 30, 2003</u>	<u>Expenses 2002-2003</u>	<u># of Advisors- June 30, 2002</u>	<u>Expenses 2001-2002</u>
MFIF	9	\$ 9,007,994	10	\$ 10,766,845
MEF	7	13,885,595	8	18,468,060
ISF	6	12,077,535	6	15,058,168
CRF	1	402,399	1	221,652
CMF	1	417,400	1	442,777
PIF	34	40,393,005	35	42,177,620
REF	<u>7</u>	<u>4,872,125</u>	<u>7</u>	<u>4,711,148</u>
Total	<u>65</u>	<u>\$81,056,053</u>	<u>68</u>	<u>\$ 91,846,270</u>

The above consists of the Mutual Fixed Income (MFIF), Mutual Equity (MEF), International Stock (ISF), Cash Reserve (CRF), Commercial Mortgage (CMF), Private Investment (PIF), and the Real Estate (REF) Funds.

The performance-based fee structures for investment advisors for the MEF, ISF and MFIF are based on whether the investment advisors' returns exceeded their relative benchmarks during the year. If investment returns of the advisors exceed the benchmark returns, they have the potential to earn significant incentive fees. It appears more investment advisors outperformed their benchmark in the ISF, compared to the MEF where many investment advisors did not appear to meet their earnings benchmark.

The management fees for the MFIF, MEF and ISF as reported in the Annual Report are based on estimates of the performance bonus, which is paid subsequent to June 30th. The actual advisor fee expense differed from the reported amount, due to these performance bonus estimations.

Audit Findings Reported in Our State Treasurer – State Financial Operations Audit Reports:

Our State Treasurer – State Financial Operations Audit Report for the Fiscal Year Ended June 30, 2003, included no findings or recommendations concerning the Pension Fund Management Division or the Combined Investment Fund.

Our prior State Treasurer – State Financial Operations Audit Report for the Fiscal Year Ended June 30, 2002, included one recommendation concerning the Pension Fund Management Division. It was recommended that wire log information be periodically reconciled to bank records.

Subsequent Events:

The following subsequent events were disclosed in the Combined Investment Fund's Notes to Financial Statements for the year ended June 30, 2003. Subsequent to June 30, 2003, an investment advisor within the Private Investment Fund entered into a definitive purchase agreement for the sale of interests in its entire portfolio. Subsequent to June 30, 2003, the Treasurer took steps to sever all ties with an investment advisor firm that manages three limited partnership investments in the Private Investment Fund and one investment in the Mutual Fixed Income Fund. The investment advisor firm and its general counsel were convicted on Federal charges of bribery, racketeering, conspiracy and obstruction of justice. Also, a managing partner and consultant of the investment advisor firm plead guilty to Federal crimes. In another matter, the Treasurer requested that the United State Attorney for Connecticut and the Securities and Exchange Commission investigate alleged connections between certain principals of a partnership in which the Private Investment Fund has a limited partnership interest and individuals involved in criminal and improper activities.

Investment Advisory Council Meetings:

Between July 1, 2003, and December 10, 2003, four meetings were held. Matters covered by the IAC at those meetings, in addition to those mentioned earlier follow:

Agreed to terminate the Combined Investment Fund's relationship with one investment advisor due to poor performance. Terminated the Combined Investment Fund's relationship with another investment advisor that was convicted of fraud and other crimes. Restructured the International Stock Fund.

RECOMMENDATIONS

Status of Prior Audit Recommendations:

Our previous report on the Investment Advisory Council revealed no areas that required disclosure.

Current Recommendations:

There are no recommendations presented as a result of our current audit examination.

AUDITORS' CERTIFICATIONS

As mentioned previously, separate reports are issued on the State Treasurer financial operations and internal operations of the State Treasury both of which include Auditors' Certifications. These Certifications cover the operations and activities discussed in this report.

CONCLUSION

In conclusion, we wish to express our appreciation for the cooperation and courtesies extended to our representatives by the personnel of the State Treasurer's Office and the Investment Advisory Council during the course of our examination.

Thomas W. Willametz
Administrative Auditor

Approved:

Kevin P. Johnston
Auditor of Public Accounts

Robert G. Jaekle
Auditor of Public Accounts