

# STATE OF CONNECTICUT

**AUDITORS' REPORT  
INVESTMENT ADVISORY COUNCIL  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 and 2005**

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

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May 24, 2006

**AUDITORS' REPORT  
INVESTMENT ADVISORY COUNCIL  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 and 2005**

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 years ended June 30, 2004 and 2005.

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.

**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 sets 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)).

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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, 2005, 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, 2005, were as follows:

#### Ex-officio members:

Denise L. Nappier - State Treasurer and Secretary of the Investment Advisory Council  
Robert L. Genuario - Secretary, Office of Policy and Management

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

Clarence L. Roberts Jr., Chairman  
David Himmelreich  
Reginald Martin  
James Larkin  
David Roth

#### Teachers' unions representatives:

Sharon M. Palmer  
Michael Freeman  
William Murray

#### State employees' unions representatives:

Carol M. Thomas  
Peter Thor

### **Also serving during the Two-year audited period:**

Steven W. Hart (former IAC Chairman)  
Clare H. Barnett  
Rosalyn B. Schoonmaker  
Henry E. Parker  
George H. Mason

## **RÉSUMÉ OF OPERATIONS:**

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**Council Expenditures:**

State Treasurer expenditures, presented below on the accrual basis, for the IAC for the fiscal years ended June 30, 2005 and June 30, 2004, are summarized as follows:

| <b><u>Description</u></b> | <b><u>2004-2005</u></b> | <b><u>2003-2004</u></b> |
|---------------------------|-------------------------|-------------------------|
| Travel – Out of State     | 1,268                   | 6,515                   |
| Travel – In State         | 3,301                   | 2,531                   |
| Overnight Mail            | 2,436                   | 2,661                   |
| Meeting Costs             | 3,605                   | 3,059                   |
| Other                     | 882                     | 5,153                   |
| Subscriptions             | 414                     | 1,044                   |
| <b>Total</b>              | <b><u>\$ 11,906</u></b> | <b><u>\$ 20,963</u></b> |

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 nine regular meetings and one special meeting during the fiscal year ended June 30, 2004. Investment performance of the Treasurer's external managers and the (in-house) Short Term Investment Fund were reviewed at these meetings. 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 the Combined Investment Funds (CIF), the Short Term Investment Fund (STIF) and the relative performance of the investment managers.

Some of the actions/activities, which occurred during the fiscal year ended June 30, 2004, follow:

- Continued discussions regarding investment fund performance, proxy voting, litigation, and the search for investment managers and consultants to work with the Treasurer's Office.
- Continued to work with the Treasurer on changes to the Investment Policy Statement.
- Approved new Real Estate Fund Investment Guidelines.
- Reviewed IAC expenditures compared to the 2003-2004 budget.

The Investment Advisory Council held ten regular meetings during the 2004-2005 fiscal year. Some of the actions/activities, which occurred during the 2004-2005 fiscal year, follow:

- Selected a new Private Equity consultant.

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- Issued a request for proposal for a master custodian. Selected the existing master custodian from a group of four compliant responders.
- Attended training seminar on Asset Allocation.
- Reviewed and approved the IAC budget for the 2004-2005 fiscal year.

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 Funds 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 Funds.

Information concerning the Combined Investment Funds and the results of their operations during the audited period, together with recent developments follow.

### **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 seven pension funds and seven trust funds having total net assets of more than \$21,300,000,000, as of June 30, 2005. The Division invests the assets of these funds in accordance with an investment program through the purchase of ownership interests in the Combined Investment Funds. Each asset class (i.e., Fixed Income, Mutual Equity, etc.) within the Fund holds investments of the Combined Investment Funds. During the audited fiscal years, and as of June 30, 2005, the Combined Investment Funds (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, 2005, the Division employed 83 external advisors to manage and invest the assets of the Combined Investment Funds.

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 Funds. 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 \$9,000,000 for the 2003-2004 fiscal year and \$6,000,000 for the 2004-2005 fiscal year.

During the fiscal year ended June 30, 2005, the Combined Investment Funds realized an annual total return of 10.46 percent, according to the Annual Report. The fund return of 10.46 percent is slightly higher than the calculated benchmark of the Connecticut Multiple Market Index of 10.02 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, 2004, the Combined Investment Funds realized an annual total return of 15.23 percent which was lower than that year's calculated benchmark of the Connecticut Multiple Market Index of 16.27 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, 2005 and 2004 are presented below.

| <b><u>Combined Investment Funds:</u></b>       | <b><u>Percentage Return</u></b> |                         |
|--|---------------------------------|-------------------------|
|  | <b><u>2004-2005</u></b>         | <b><u>2003-2004</u></b> |
| Net Total Combined Investment Funds            | 10.46 %                         | 15.23 %                 |
| Mutual Equity                    MEF           | 8.06 %                          | 20.84 %                 |
| International Stock            ISF             | 19.23 %                         | 29.69 %                 |
| Real Estate                      REF           | 27.74 %                         | 0.67 %                  |
| Mutual Fixed Income          MFIF              | 7.70 %                          | 2.79 %                  |
| Commercial Mortgage        CMF                 | 6.95 %                          | 7.87 %                  |
| Private Investment            PIF              | 9.58 %                          | 20.21 %                 |
| Cash Reserve                    CRF            | 2.38 %                          | 1.30 %                  |
| <br><b><u>Retirement and Trust Funds:</u></b>  |                                 |                         |
| Net Total Return Retirement and Trust Funds    | 10.46 %                         | 15.23 %                 |
| Teachers' Retirement Fund (TRF)                | 10.49 %                         | 15.34 %                 |
| State Employees' Retirement Fund (SERF)        | 10.44 %                         | 15.06 %                 |
| Municipal Employees' Retirement Fund (MERF)    | 10.10 %                         | 14.28 %                 |
| Probate Court Retirement Fund (Probate)        | 10.50 %                         | 14.49 %                 |
| Judges' Retirement Fund (Judges')              | 9.77 %                          | 13.42 %                 |
| State's Attorneys' Retirement Fund (St. Atty.) | 7.16 %                          | 12.71 %                 |
| Trust Funds                                    | 7.64 %                          | 5.09 %                  |

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 Funds. 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 and the Andrew Clark Fund.

**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,</u> |             |
|------------------------------------|----------------------------|----------------------|--------------------------------|-------------|
|                                    |                            |                      | <u>2005</u>                    | <u>2004</u> |
| <i>U.S. Equity</i>                 | <i>36%: MEF</i>            | 36%                  | 38%                            | 38%         |
| <i>International Equity</i>        | <i>18%: ISF</i>            | 18%                  | 20%                            | 20%         |
| Developed Markets                  | 15% ISF                    |                      |                                |             |
| Emerging Markets                   | 3% ISF                     |                      |                                |             |
| <i>Fixed Income</i>                | <i>30%: MFIF, CRF, CMF</i> | 30%                  | 33%                            | 31%         |
| 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%                  | 9%                             | 11%         |
| Equity Real Estate                 | 5% REF                     |                      |                                |             |
| Alternative 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 Real Estate Fund which is below the intended lower range as of June 30, 2004 and the Fixed Income Fund which is over the intended upper range as of June 30, 2005.

**Investment Mix:**

A summary of the Retirement Funds' investment activity in the Combined Investment Funds for the 2003-2004 fiscal year is presented below. This information is presented in detail in the Treasurer's Annual Report, Supplemental Information Section. The amounts below are presented in millions of dollars.

| <b>Participant Funds</b> | <b>6/30/03</b>         | <b>Share Transactions</b> |                       |                      |                     | <b>Realized Gain on</b> | <b>Change in Mkt. Value</b> | <b>6/30/04</b>     | <b>Percent Holdings</b> | <b>Inv. Income</b> |
|--------------------------|------------------------|---------------------------|-----------------------|----------------------|---------------------|-------------------------|-----------------------------|--------------------|-------------------------|--------------------|
|                          | <b>Market Values</b>   | <b>Purch</b>              | <b>Redemp</b>         | <b>Net</b>           | <b>Redemp</b>       | <b>Value</b>            | <b>Mkt. Values</b>          |                    |                         |                    |
|                          | \$                     | \$                        | \$                    | \$                   | \$                  | \$                      | \$                          |                    | \$                      |                    |
| TRF                      | 9,846                  | 1,555                     | 1,584                 | (29)                 | 67                  | 976                     | 10,860                      | 54 %               | 440                     |                    |
| SERF                     | 6,987                  | 1,064                     | 1,065                 | (1)                  | 50                  | 674                     | 7,710                       | 39 %               | 312                     |                    |
| MERF                     | 1,175                  | 224                       | 209                   | 15                   | 8                   | 106                     | 1,304                       | 7 %                | 52                      |                    |
| Probate                  | 61                     | 9                         | 9                     | 0                    | 0                   | 6                       | 67                          | 0 %                | 2                       |                    |
| Judges'                  | 125                    | 28                        | 24                    | 4                    | 0                   | 11                      | 140                         | 0 %                | 6                       |                    |
| St. Atty.                | 1                      | 0                         | 0                     | 0                    | 0                   | 0                       | 1                           | 0 %                | 0                       |                    |
| All Other                | 106                    | 8                         | 8                     | 0                    | 1                   | 1                       | 108                         | 0 %                | 5                       |                    |
| <b>Totals</b>            | <b><u>\$18,301</u></b> | <b><u>\$2,888</u></b>     | <b><u>\$2,899</u></b> | <b><u>\$(11)</u></b> | <b><u>\$126</u></b> | <b><u>\$1,774</u></b>   | <b><u>\$20,190</u></b>      | <b><u>100%</u></b> | <b><u>\$817</u></b>     |                    |

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 Funds' activity is presented below. This information is presented in detail in the Treasurer's Annual Report, Supplemental Information Section. The amounts below are presented in millions of dollars.

| <b>Combined Investment Fund</b> | <b>6/30/03</b>         | <b>Participant Fund Activity</b> |                       |                       |                       | <b>Invest Return</b>  | <b>6/30/04</b>         |                         |
|---------------------------------|------------------------|----------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|------------------------|-------------------------|
|                                 | <b>Net Assets</b>      | <b>Purch</b>                     | <b>Redemp</b>         | <b>Income Distrib</b> | <b>Net Contrib</b>    |                       | <b>Net Assets</b>      | <b>Percent Holdings</b> |
| CRF                             | \$1,853                | \$ 4,882                         | \$ 5,335              | \$ 21                 | \$(474)               | \$ 21                 | \$1,400                | 7 %                     |
| MEF                             | 6,599                  | 0                                | 65                    | 108                   | (173)                 | 1,356                 | 7,782                  | 38 %                    |
| ISF                             | 2,034                  | 1200                             | 83                    | 54                    | 1,063                 | 906                   | 4,003                  | 20 %                    |
| MFIF                            | 6,610                  | 379                              | 979                   | 280                   | (880)                 | 120                   | 5,850                  | 29 %                    |
| REF                             | 426                    | 2                                | 25                    | 37                    | (60)                  | 3                     | 369                    | 2 %                     |
| CMF                             | 72                     | 0                                | 28                    | 11                    | (39)                  | 3                     | 36                     | 1 %                     |
| PIF                             | 1,848                  | 29                               | 94                    | 320                   | (385)                 | 322                   | 1,785                  | 9 %                     |
| Elim. Entry*                    | (1,141)                | (3,603)                          | (3,709)               | (15)                  | 121                   | (15)                  | (1,035)                | (6)%                    |
| <b>Totals</b>                   | <b><u>\$18,301</u></b> | <b><u>\$2,889</u></b>            | <b><u>\$2,900</u></b> | <b><u>\$816</u></b>   | <b><u>\$(827)</u></b> | <b><u>\$2,716</u></b> | <b><u>\$20,190</u></b> | <b><u>100%</u></b>      |

\*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.

A summary of the Retirement Funds' investment activity in the Combined Investment Funds for the 2004-2005 fiscal year is presented below. This information is presented in detail in the

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Treasurer's Annual Report, pages S-2 through S-6. The amounts below are presented in millions of dollars.

| <b>Participant Funds</b> | <b>6/30/04</b>         | <b>Share Transactions</b> |                       |                      | <b>Realized</b>       | <b>Change</b>         | <b>Mkt. Values</b>     | <b>6/30/05</b>          | <b>Inv. Income</b>  |
|--------------------------|------------------------|---------------------------|-----------------------|----------------------|-----------------------|-----------------------|------------------------|-------------------------|---------------------|
|                          | <b>Market Values</b>   | <b>Purch</b>              | <b>Redemp</b>         | <b>Net</b>           | <b>Gain on Redemp</b> | <b>in Mkt. Value</b>  |                        | <b>Percent Holdings</b> |                     |
|                          | \$                     | \$                        | \$                    | \$                   | \$                    | \$                    | \$                     | %                       | \$                  |
| TRF                      | 10,860                 | 945                       | 1,060                 | (115)                | 2                     | 645                   | 11,392                 | 53 %                    | 460                 |
| SERF                     | 7,710                  | 556                       | 547                   | 9                    | 2                     | 454                   | 8,175                  | 38 %                    | 329                 |
| MERF                     | 1,304                  | 108                       | 91                    | 17                   | 0                     | 73                    | 1,394                  | 6 %                     | 56                  |
| Probate                  | 67                     | 6                         | 5                     | 1                    | 0                     | 4                     | 72                     | 1 %                     | 2                   |
| Judges'                  | 140                    | 10                        | 5                     | 5                    | 0                     | 7                     | 152                    | 1 %                     | 6                   |
| St. Atty.                | 1                      | 0                         | 0                     | 0                    | 0                     | 0                     | 1                      | 0 %                     | 0                   |
| All Other                | 108                    | 7                         | 8                     | (1)                  | 0                     | 6                     | 113                    | 1 %                     | 6                   |
| <b>Totals</b>            | <b><u>\$20,190</u></b> | <b><u>\$1,632</u></b>     | <b><u>\$1,716</u></b> | <b><u>\$(84)</u></b> | <b><u>\$4</u></b>     | <b><u>\$1,189</u></b> | <b><u>\$21,299</u></b> | <b><u>100%</u></b>      | <b><u>\$859</u></b> |

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 Funds' 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.

| <b>Combined Investment Funds</b> | <b>6/30/04</b>         | <b>Participant Fund Activity</b> |                       |                     |                       | <b>Invest Return</b>  | <b>6/30/05</b>         |                         |
|----------------------------------|------------------------|----------------------------------|-----------------------|---------------------|-----------------------|-----------------------|------------------------|-------------------------|
|                                  | <b>Net Assets</b>      | <b>Purch</b>                     | <b>Redemp</b>         | <b>Distrib</b>      | <b>Net Contrib</b>    |                       | <b>Net Assets</b>      | <b>Percent Holdings</b> |
| CRF                              | \$1,400                | \$ 3,532                         | \$ 3,354              | \$ 36               | \$ 142                | \$ 36                 | \$1,578                | 7 %                     |
| MEF                              | 7,782                  | 0                                | 0                     | 127                 | (127)                 | 620                   | 8,275                  | 39 %                    |
| ISF                              | 4,003                  | 81                               | 270                   | 82                  | (271)                 | 757                   | 4,489                  | 21 %                    |
| MFIF                             | 5,850                  | 261                              | 0                     | 279                 | (18)                  | 448                   | 6,280                  | 29 %                    |
| REF                              | 369                    | 18                               | 49                    | 27                  | (58)                  | 89                    | 400                    | 2 %                     |
| CMF                              | 36                     | 0                                | 14                    | 3                   | (17)                  | 2                     | 21                     | 1 %                     |
| PIF                              | 1,785                  | 74                               | 214                   | 331                 | (471)                 | 127                   | 1,441                  | 6 %                     |
| Elim. Entry*                     | <u>(1,035)</u>         | <u>(2,334)</u>                   | <u>(2,185)</u>        | <u>(25)</u>         | <u>(124)</u>          | <u>(26)</u>           | <u>(1,185)</u>         | <u>(5)%</u>             |
| <b>Totals</b>                    | <b><u>\$20,190</u></b> | <b><u>\$1,632</u></b>            | <b><u>\$1,716</u></b> | <b><u>\$860</u></b> | <b><u>\$(944)</u></b> | <b><u>\$2,053</u></b> | <b><u>\$21,299</u></b> | <b><u>100%</u></b>      |

\*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, 2004 and 2005, 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 2004-2005 and 2003-2004 fiscal years are summarized below:

| <u>CIF</u>   | <u># of Advisors-<br/>June 30, 2005</u> | <u>Expenses<br/>2004-2005</u> | <u># of Advisors-<br/>June 30, 2004</u> | <u>Expenses<br/>2003-2004</u> |
|--------------|---|-------------------------------|---|-------------------------------|
| MFIF         | 11                                      | \$ 6,734,104                  | 8                                       | \$ 8,384,224                  |
| MEF          | 6                                       | 22,668,229                    | 6                                       | 6,459,864                     |
| ISF          | 10                                      | 23,670,373                    | 13                                      | 17,336,519                    |
| CRF          | 1                                       | 298,665                       | 1                                       | 313,350                       |
| CMF          | 1                                       | 249,911                       | 1                                       | 327,489                       |
| PIF          | 44                                      | 29,929,307                    | 37                                      | 36,936,260                    |
| REF          | 10                                      | 4,757,757                     | 8                                       | 4,692,019                     |
| <b>Total</b> | <b><u>83</u></b>                        | <b><u>\$88,308,346</u></b>    | <b><u>74</u></b>                        | <b><u>\$ 74,449,725</u></b>   |

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 30. 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, 2004, included three findings with recommendations concerning the Pension Fund Management Division's administration of the Combined Investment Funds. In one finding we disclosed that investment advisor fees amounting to \$31,250 had been incurred and paid without a contract. Another finding disclosed that \$522,675 of advisor fees paid during the 2003-2004 fiscal year were actually related to services to be rendered during the 2004-2005 fiscal year. The third finding concerned our suggestion that realized losses on impaired assets be recognized in the year in which the losses are apparent.

Our State Treasurer – State Financial Operations Audit Report for the Fiscal Year Ended June 30, 2005, has not been issued as of the date of this report. This report has been delayed because final book cash balances for civil list funds are not yet available from the State Comptroller. We have

certified the Combined Investment Funds financial statements for the fiscal year ended June 30, 2005 with our Auditors' letter dated December 15, 2005 which contained no qualifications regarding this financial statement presentation.

**Subsequent Events:**

The following subsequent events were disclosed in the Combined Investment Funds' Notes to Financial Statements for the year ended June 30, 2005.

Subsequent to June 30, 2005, net proceeds of \$36,200,000 were received from the sale of one Real Estate Fund investment. The cost basis of this investment at the time of the sale was \$25,000,000 resulting in a realized gain of \$11,200,000.

One of the Private Investment Fund partnerships entered into an Assignment and Liquidation Agreement after June 30, 2005. Net proceeds received were \$18,500,000. The cost basis of this investment at the time of liquidation was \$49,900,000 resulting in a realized loss of \$31,400,000.

**Investment Advisory Council Meetings:**

Between July 1, 2005 and December 14, 2005, four meetings were held. Matters covered by the IAC at those meetings, in addition to those mentioned earlier follow.

The IAC agreed to make commitments to four investment advisors in the alternative investments group, and terminated an investment agreement with one Mutual Equity Fund advisor.

## **RECOMMENDATIONS**

*Status of Prior Audit Recommendations:*

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

**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