

**STATE OF WISCONSIN
DEPARTMENT OF EMPLOYEE TRUST FUNDS
801 West Badger Road
Madison, WI 53702**

CORRESPONDENCE MEMORANDUM

DATE: April 10, 2002

TO: Deferred Compensation Board Members

FROM: Mary Willett, Director
Supplemental Retirement Plans

SUBJECT: Annual Investment Performance Review and Recommendations

The **2001 Annual Investment Performance Report** is presented to the Deferred Compensation Board to monitor the investment options that are made available to participants of the Wisconsin Deferred Compensation Program (WDC). The Investment Committee met on March 27, 2002 to review a draft of the 2001 report. Staff and committee members concur that further review of the Dreyfus Third Century Fund, T Rowe Price International Stock Fund and Janus Fund is warranted because of their failure to meet performance benchmarks.

A portfolio manager from each of the above funds has been asked to attend the May 14th Board meeting (in person or via conference call) to provide an explanation of the fund's recent performance and its future outlook. Staff recommends that no action be taken on closing or removing these funds from the WDC until further review has occurred and additional analysis is completed on possible alternative options for the core spectrum.

Overview of 2001

For the second year in a row, the plan experienced an aggregate investment loss of 7% in the core options. This has resulted in negative net growth in total plan assets, which totaled \$1.15 billion on January 1st, and \$1.12 billion on December 31, 2001. Participant contributions for the year totaled \$94 million.

Changes that were made to the WDC core investment spectrum during 2001 include:

- Three passively managed index options were added in February. These are commingled funds managed by Barclays Global Investors (BGI). By the end of the year, there were 1,749 participant accounts and assets totaling \$7.4 million in these three options.
- The assets in the Vanguard Long Term Corporate Fund and the Vanguard Wellington Fund were transferred from Investor Class shares to Admiral Shares in October 2001. The internal management fees for the Admiral shares are slightly lower, which will result in better long-term performance returns assigned to participant accounts.

A separate report on plan statistics will be presented to the Board at the May meeting to demonstrate participant activity during 2001.

Performance Review

The investment options that are included in the WDC core spectrum had a reasonably good year as compared to their performance benchmarks. All of the equity funds, with the exception of the DFA U.S. Micro Cap Portfolio and the Wellington Fund (which is a balanced fund) experienced negative returns for the year.

This report illustrates the returns of the WDC funds compared to their established benchmarks for the one, three, five and ten year periods. All of the core options met or exceeded at least one benchmark in one or more of the time periods that are reviewed. The Board's established investment guidelines state that actions to change (remove or add) investment options in the spectrum are based on the five year return period. This is because the five year return is less likely to be affected by short-term market fluctuations and better represents the longer-term performance of the fund.

This year, the annual report identifies three funds that need further examination, as noted below.

- The Dreyfus Third Century Fund failed to meet all of its performance benchmarks, including its peer group of socially responsible investment options, for the one, three and five year review periods and met only one benchmark for the ten year return. This option is included in the WDC spectrum because of its socially responsible investment style and, as a result, is not held to the same performance standards as the other WDC offerings.

As background, the 1994 review of funds resulted in Board action to close this option to new participant deferrals on August 1, 1995 because of poor performance demonstrated in two consecutive annual reports. Further action to remove this option from the spectrum was halted, however, because of the significant improvements to the returns in 1995 and 1996. As a result, Dreyfus Third Century was reopened to all participants in August 1997. This fund has continued to meet performance benchmarks since from that date until the 2001 review period.

- The T Rowe Price International Fund failed to meet all benchmarks for the five year review period, but has exceeded one or more benchmarks in its one, three and ten year returns. This fund has closely tracked the MSCI EAFE index in the one, three and five year periods (differences are less than .50%). Because of this close tracking and the fact that an international index fund (managed by BGI) was added in 2001, a question was raised at the Investment Committee meeting regarding this fund's management style and its continued appropriateness for the WDC's core spectrum as an actively managed international option.
- The Janus Fund exceeded one benchmark for the five year review period, but for the second year in a row has significantly underperformed all of its benchmarks for the one year period. [It exceeded all benchmarks for the three year return and two for the ten year period.] The two year performance of this fund will likely have a negative effect on longer-term returns unless this year's performance significantly improves.

The management of this fund (as well as the Janus family of funds) has experienced many changes over the last two years. Concern has been raised regarding how this may be affecting the fund's investment management and long-term performance opportunities.

Recommendations

Staff and the Investment Committee members concurred that additional review of the Dreyfus Third Century Fund, T Rowe Price International Fund and Janus Fund is necessary to ensure these options continue to be acceptable long-term investment opportunities for WDC participants. Specific recommendations for actions to close or remove any option from the WDC core spectrum is deferred until information to be presented by the fund managers at the May Board meeting has been considered.

Should there be a decision at this meeting, however, to take action regarding one or more of the above funds, staff recommends that it be delayed until review and analysis can be completed on alternative investments for the core spectrum. Additionally, since the WDC now offers the self-directed brokerage option (and all three of the above funds are included in the fund selections) the process for removing options from the core spectrum needs to be reexamined.

If the Board concludes that action on one or more of the above options is warranted, staff recommends that analysis of alternative choices for the core spectrum and the process for removing options be examined and presented to the Investment Committee this summer. Recommendations for final action to remove or add funds would then be presented to the Board at its November meeting, with implementation of approved changes to occur in 2003.