

# State of Wisconsin Investment Board



Fiscal Year 2003  
Annual Report

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*"Excellent performance;  
effective management;  
efficient service;  
through educated,  
ethical employees."*

## **State of Wisconsin Investment Board**

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Madison, WI 53707-7842

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121 East Wilson Street  
Madison, WI 53702

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[info@swib.state.wi.us](mailto:info@swib.state.wi.us)

This document includes a brief overview of the assets under management by the Investment Board and the comparative financial statements and related notes for the fiscal years ending June 30, 2003 and June 30, 2002. A complete listing of the Board's investments held as of June 30, 2003 is available on the Internet at [www.swib.state.wi.us](http://www.swib.state.wi.us) or by contacting the State of Wisconsin Investment Board.

# Vision

To be a premier public investment organization, a place where professional excellence and public service thrive. Superior investment returns, the highest ethical and professional standards, teamwork to support the investment process and a rewarding work environment will make SWIB the investment management organization of choice.

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# INTRODUCTION

# Message from the Chair

It has been a privilege for me to serve as a member of the Investment Board of Trustees for the past two and a half years and an honor to be named chair in 2003.

The best way to sum up the past year is that it has been a time of key transitions.

First, we experienced the third consecutive year of down markets in 2002, making this period one of the worst on record for stocks. Being diversified meant that several portfolios which earned strong positive returns eased the poor performance of domestic stocks. Fortunately, reductions in Fixed (balanced) Retirement Fund annuity payments were averted this year.

We added two new portfolios in early 2003 as a result of our annual asset allocation review. They are expected to add value as we continue to face volatile markets in the future. As the fiscal year drew to a close, we began to see a turnaround in the mood of the marketplace and the stock market began to rebound.

Second, we experienced a major change in the membership of our Board. During fiscal year 2003, six of the nine board members departed. We now have five new members and one vacancy.

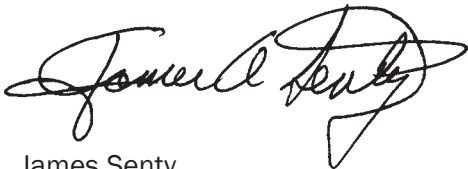
Departing trustees helped guide the Investment Board through some major strategic challenges and organizational changes. We thank them – and especially want to recognize the leadership of former chair Jon Hammes.

I look forward to working with our new members and with those whose service continues.

Changes in board membership provide a natural opportunity for a fresh look at our responsibilities. And we do face many new challenges.

- The first is to select the mix of assets that will provide solid investment returns with an appropriate level of risk.
- The second is to ensure that SWIB is well-positioned as an organization to be successful in a highly competitive global marketplace.

Even with many new faces you can be assured that the Board remains dedicated to doing its best for the people we serve.



James Senty  
Chair  
June 30, 2003



*"Every Trustee comes to the Board with the same basic responsibility: to serve on behalf of the interests of all participants in the funds we manage."*

# From the Executive Director

I am pleased to present the Annual Financial Report on behalf of the State of Wisconsin Investment Board for the fiscal year ending June 30, 2003. Total assets under management at fiscal year end were \$61.2 billion, with 90% or \$55.3 billion, in the Wisconsin Retirement System (WRS).

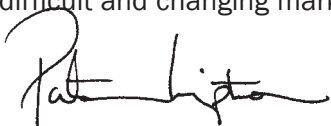
The US equity market has begun to show signs of recovery; however, there has been a substantial weakening in the US bond market. As a result, the Fixed (balanced) Trust Fund reported a 4.6% return for the fiscal year. On a ten-year basis, the 8.5% average annual rate of return for the Fixed Fund is ahead of the 8% actuarial benchmark. The Variable Trust Fund returned -1.9% for the year compared to -0.4% for the benchmark.

Annually, the Board reviews the asset allocation for both retirement funds and considers changes based upon expected returns under a variety of possible economic conditions. Given the large size of the WRS trust funds, it is not possible to effectively "time the markets" based on possible geopolitical events or short-term economic developments.

Our asset allocation process determines how investments are divided among broad asset classes, such as stocks, bonds and other types of investments. It is the starting point and key element for achieving successful investment returns. With the help of outside consultants, each year the Board and staff conduct a formal asset allocation review that results in policy and funding recommendations. In 2003, this review concluded that stocks and other equities are likely to outperform most other forms of investments over the next several market cycles. This resulted in the following changes to our asset allocation:

- Fixed Fund allocations for the fixed income investment targets were decreased from 34% to 31% of assets. US stocks, international stocks and alternative investments were each increased by 1% to 40%, 19% and 6% respectively. Real estate remained at 4%. Variable Fund targets remained the same: 80% US stocks and 20% international stocks.
- The \$250 million global tactical asset allocation portfolio was added to the Fixed Fund. This globally diversified portfolio integrates asset allocation strategies across world capital markets. It invests primarily in stocks, debt and money market instruments in developed and emerging market sectors around the world, in addition to real estate, natural resources and private equity.
- A \$300 million allocation to emerging market equities was added to the Fixed and Variable Funds. Based on relatively stronger growth expectations and current valuation levels, experts forecast strong returns for emerging markets.

The asset allocation process is a fundamental way in which SWIB works to ensure that the WRS will continue to meet participants' pension needs. By following this disciplined approach we are more likely to achieve success in difficult and changing market conditions.



Patricia Lipton  
Executive Director  
June 30, 2003



*"While there has been a steady increase in stock market returns since March, global economic and other events, continued to impact the market and cause volatility."*

# Overview

The State of Wisconsin Investment Board (SWIB) is a state agency responsible for investing the assets of the Wisconsin Retirement System, the State Investment Fund and five smaller trust funds established by the State. Investments are made according to the purpose and risk profile of each trust.

SWIB is directed by a nine-person, independent Board of Trustees and staffed with professional money managers and support personnel. The Board of Trustees appoints the Executive Director of the Investment Board. The Executive Director oversees the staff, develops and recommends agency and investment policies for Board adoption, and ensures adherence to state law and policies.

## Assets Under Management - June 30, 2003

<u>Fund</u>	<u>\$ in Millions</u>	<u>% of Total</u>
<i>Fixed Retirement Trust Fund</i>	\$ 50,272	82%
<i>Variable Retirement Trust Fund</i>	<u>5,051</u>	<u>8</u>
Wisconsin Retirement System	55,323	90
State Investment Fund*	5,130	9
Various Funds		
Patients Compensation Fund	666	1
State Life Insurance Fund	82	0
Local Gov't Property Insurance Fund	24	0
Historical Society Trust Fund	10	0
Tuition Trust Fund	<u>13</u>	<u>0</u>
	<u><b>\$ 61,248</b></u>	<u><b>100%</b></u>

*\*Excludes deposits from Fixed Retirement Trust Fund, Variable Retirement Trust Fund and Various Funds.*

## Guidelines

Investments must be within guidelines established for each specific fund.

Investments must qualify as prudent under SWIB's standard of fiduciary responsibility.

## Goals

Diversify investments to manage risk and minimize large exposure to unpredictable events.

Invest in organizations that adhere to prevailing laws and generally accepted conduct standards.

Invest in organizations that respect the basic human rights of their employees and clientele.



# Management Costs

Total costs of the State of Wisconsin Investment Board include agency operating expenses as well as fees paid to outside suppliers of investment services. In fiscal year 2003, agency operating expenses for staff compensation, overhead and equipment were \$16.4 million. Compared to the average value of assets managed, the cost per \$100 of securities managed was 2.57 cents. Total costs also include external management and advisory fees paid to outside advisors. Costs of other support services include custodial banking services, investment research, and legal services. These fees are charged directly to the current income accounts of funds managed by SWIB.

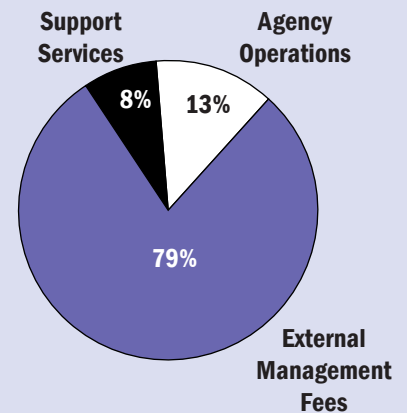
Annually, SWIB participates in an independent review of costs compared to other investment managers with similar objectives. An analysis by Cost Effectiveness Measurement, Inc. concluded that SWIB's total cost to manage the Fixed Fund in calendar year 2002 was 27 cents per \$100 managed, which is comparable to other managers with a similar mix of assets.

## Cost of Management - June 30, 2003

	Fiscal Year Ended June 30, 2003	Fiscal Year Ended June 30, 2002
<b>PROGRAM REVENUE AVAILABLE</b>		
Prior Year Balance	\$ 1,355,400	\$ 2,739,500
<b>RECEIPTS FROM:</b>		
State Investment Fund	\$ 908,000	\$ 811,500
Fixed Retirement Trust Fund	14,235,100	14,124,000
Variable Retirement Trust Fund	1,195,400	1,609,600
Local Gov't Property Ins. Fund	35,300	20,000
State Life Insurance Fund	46,000	41,100
Historical Society Trust Fund	15,400	5,800
Patients Compensation	52,100	53,300
Tuition Trust Fund	17,000	10,800
Act II Retirement Credit	0	141,200
Miscellaneous	100	15,300
<b>Total Receipts</b>	<b>\$ 16,504,400</b>	<b>\$ 16,832,600</b>
<b>TOTAL REVENUE AVAILABLE</b>	<b>\$ 17,859,800</b>	<b>\$ 19,572,100</b>
<b>DISBURSEMENTS:</b>		
Salaries	\$ 10,124,200	\$ 10,520,100
Fringe Benefits	2,768,900	2,857,000
Supplies & Equipment	3,511,500	4,839,600
<b>AGENCY OPERATING EXPENSES</b>	<b>\$ 16,404,600</b>	<b>\$ 18,216,700</b>
<b>CLOSING BALANCE</b>	<b>\$ 1,455,200</b>	<b>\$ 1,355,400</b>

## Calendar Year 2002

Total Costs = \$144.8 million



## Management Costs

- Total costs for all funds were 24¢ per \$100 managed.
- All management costs are funded with earnings of the funds managed.
- Based on an analysis of over 209 pension funds, SWIB's Fixed Fund costs (27¢ per \$100 managed) are normal for a fund managing a similar mix of assets.\*

\* *Cost Effectiveness Measurement, Inc.*



# Board of Trustees



**James Senty, Chair**  
Public Member  
President, Midwest  
Gas Companies,  
La Crosse



**Allen Samson**  
**Vice-Chair**  
Public Member  
Milwaukee



**Eric Stanchfield**  
**Secretary**  
WRS, Wisc. Retirement  
Board Appointee  
Secretary, Department  
of Employee Trust Funds



**Thomas Boldt**  
Public Member  
President, The Boldt  
Group, Inc./CEO, The  
Boldt Co., Appleton



**William Levit, Jr.**  
Public Member  
Attorney, Godfrey  
& Kahn S.C.,  
Milwaukee



**Marc Marotta**  
Department of  
Administration  
Department Secretary



**Laura Engan**  
DOA Designee  
Deputy Secretary



**Wayne McCaffery**  
WRS, Teacher Retirement  
Board Appointee  
Teacher,  
Stevens Point



**Deloris Sims**  
Public Member  
President & CEO,  
Legacy Bank Inc.,  
Milwaukee

**Position Vacant**  
Local Government  
Public Member

## Board Membership

- Six public members appointed by the Governor and confirmed by the State Senate including:
  - Four with at least 10 years investment experience.
  - One with at least 10 years financial experience and who works for a local government in the LGIP.
- Teacher participant in the WRS appointed by the Teacher Retirement Board.

- Non teacher participant in WRS appointed by the Wisconsin Retirement Board.
- Secretary of the Department of Administration or designee.

*(Appointed Board members serve six-year terms.)*

## Board Responsibilities Include:

- Establish long-term investment policies.
- Set guidelines for each investment portfolio.
- Monitor investment performance.

# Agency Management

## Senior Management

Executive Director - Patricia Lipton

Chief Investment Officer - Public Fixed Income - Jon R. Traver

Chief Investment Officer - Public Equities - Jean C. Ledford

Chief Investment Officer - Private Markets - Robert H. Severance

Managing Director, Alternative Investments - Franz Pool\*

Chief Operating Officer - Kenneth W. Johnson

Chief Legal Officer - Keith L. Johnson

Director of Human Resources - Ledell Zellers

Director of Internal Audit - James W. Kaellner

## Investment Managers

### Domestic Equities

Jackie S. Doeler

Steven F. Hilmer

William A. McCorkle

John F. Nelson

Chad A. Neumann

Trisha L. Reopelle

### International Equities

Charles D. Saunders

### Real Estate

Robert H. Severance

Charles R. Carpenter

### Domestic Fixed Income

Laurel A. Butler

Sally J. Lee

### Global Fixed Income

J. Alain Hung

### Alternative Investments

Monica A. Jaehnig

Thomas P. Olson

Jon R. Vanderploeg\*

Michael A. Wagner

\* No longer on staff

### SWIB Staff Quick Facts

- 104.5 authorized positions.
- A majority of the investment staff holds or is pursuing the Chartered Financial Analyst (CFA) designation.
- Top investment staff average between 17 and 27 years of experience.
- The Board adheres to the industry standards of the Association for Investment Management Research.
- Professional standards and continuing education are stressed for staff.

# Investor Responsibility

SWIB's Investor Responsibility Program began in 1986. Our goal is to enhance long-term prospects and investment potential through proxy voting, social responsibility activities, and corporate governance. SWIB's legal staff and investment groups identify program strategies within parameters approved by the Trustees.

SWIB's Corporate Governance Program has two primary goals:

- (a) to protect and increase SWIB's long-term returns,
- (b) to meet SWIB's fiduciary obligation to manage shareholder rights as an asset of the trust funds.

Each year, we identify key corporate governance issues based on investment staff's recommendations and national trends.

SWIB determines ways to work with company management, corporate board of directors and other shareholders to make changes that should have a positive impact. Our first approach is to withhold votes from director candidates with poor records. In addition, SWIB will work with companies to resolve concerns. When necessary, SWIB will offer shareholder resolutions and use its proxy vote if companies fail to act in the interests of shareholders. SWIB's proxy votes are posted on the website.

If a governance failure creates a legal claim, SWIB considers legal action - often class action suits with other investors - to uphold shareholder rights. In some cases, we work with other large pension funds to protect shareholders through regulatory changes and other actions.

Our policies for voting social issue resolutions reinforce our investment goals to enhance returns. Making investments or using proxy votes for the sole purpose of promoting social or political causes or goals is contrary to our fiduciary duties. However, some special issues could impact a company's long-term viability.

We believe companies with socially unacceptable products or services will feel the economic consequences of public disapproval or imposition of liability under laws protecting the public health and welfare. The result: negative aspects of a company's behavior will be felt on the economic bottom line. These issues are considered when evaluating investments. Most social responsibility concerns fall into two areas: the environment and human rights. Other social issues are brought to the attention of the Trustees if they have a significant financial impact on the companies involved.

## Corporate Concerns

The two major concerns of SWIB's corporate governance program, follow a nationwide focus.

### **1. Establishing effective corporate boards with independent directors.**

Company boards should represent shareholders. SWIB supports boards that consist of a majority of directors who are independent and willing to act in the best interest of shareholders. An independent director's only connection to the corporation is that person's directorship. In addition, key committees, such as nominating, compensation, and audit committees should consist solely of independent directors.

### **2. Prudently limiting stock options, or the right to buy company stock at a set price, used for employee compensation.**

SWIB believes that there is a cost to awarding stock options and that cost should be reflected in the corporate financial records. Employee options can cause other shareholders to experience an erosion of stock value. SWIB believes that a company should be required to receive shareholder approval before repricing options or setting aside blocks of stock for company insiders.

## Corporate Governance Resources

To be successful, a corporate governance program must be strong. SWIB works with other groups as part of the Council of Institutional Investors (CII). SWIB is a founding member of CII, which consists of 250 pension funds and investment related firms. Council members work together on corporate governance measures to protect plan assets and increase return on their investments.

# Wisconsin Retirement System

The Wisconsin Retirement System (WRS) makes up 90% of the assets managed by SWIB. As fiduciary for the funds, SWIB is dedicated to earning the best possible rate of return within acceptable risk parameters and “prudent expert” standards in all investment matters. As of June 30, 2003, the total assets of the WRS were \$55.3 billion.

The WRS includes the pension funds available through most public employers in Wisconsin other than the City of Milwaukee and Milwaukee County. Participants include current and former employees of Wisconsin’s state agencies and local governments. Contributions made to the WRS by these employees and their employers are invested by the Investment Board to finance retirement benefits.

More than 500,000 people participate in the WRS. Investment earnings account for the majority of the annuities paid, thus lowering the costs paid by taxpayers. Over \$2.6 billion was paid in 2002 to 115,000 annuitants in the WRS.

The WRS is comprised of two trust funds. The larger of the two is the Fixed (balanced) Trust Fund, which is a broadly diversified portfolio of stocks, bonds, real estate and other holdings. The second fund is the Variable Trust Fund, which is invested in stocks.

The process for determining the effect of investment returns on employee accounts (the “effective rate”) and changes in benefits for retirees differs between the Variable and Fixed Funds.

The Department of Employee Trust Funds (ETF) is responsible for administering the benefits of the WRS. ETF computes those amounts based on the December 31 rate of return for each of the two trust funds to determine the impact on participants. Most employees who retire receive a pension annuity initially determined by a formula (calculated by ETF) using years of service, salary, and job type.

## WRS Quick Facts

- The Wisconsin Retirement System includes over 500,000 participants.
- It is the 10th largest public pension fund in US.
- 23rd largest pension fund in the world.
- WRS is comprised of the Fixed Trust Fund, a balanced fund, and the Variable Trust Fund, a stock fund.
- The Fixed Fund gains and losses are spread over five years to smooth the effect on participants’ accounts.
- The Variable Fund annuities fully reflects the prior year gains and losses of the investments.
- More than 105,000 people participate in the Variable Trust Fund.

### Annualized Performance Ending 6/30/03

Retirement Funds	1-Year Return	5-Year Return	10-Year Return
<b>Fixed Fund</b>	<b>4.6%</b>	<b>3.1%</b>	<b>8.5%</b>
Benchmark	5.1	2.6	8.1
<b>Variable Fund</b>	<b>-1.9%</b>	<b>-0.4%</b>	<b>8.5%</b>
Benchmark	-0.4	-2.0	7.8
S&P 500	0.3	-1.6	10.0

# State Investment Fund

The State Investment Fund (SIF) is a pool of cash balances of various state and local governmental units. It makes up about 9% of the assets managed by SWIB. The objectives of this fund are to provide liquidity, safety of principal, and a reasonable rate of return. The Fixed Income Group manages the State Investment Fund.

The State Investment Fund includes retirement trust funds cash balances pending longer-term investment by SWIB's other investment groups. This fund also functions as the State's cash management fund. By pooling the idle cash balances of all 58 state funds, it provides the State's general fund with the needed liquidity for operating expenses.

Over 1,100 local units of government also deposit revenues in the SIF until they are needed. These funds are commingled in the Local Government Investment Pool (LGIP).

The cash balances available for investment vary daily as cash is accumulated or withdrawn from the agency funds. The SIF is invested primarily in obligations of the US government and its agencies, and high quality commercial bank and corporate debt obligations. Net assets of the State Investment Fund as of June 30, 2003, were \$5.6 billion.

Portfolio Characteristics as of June 30, 2003:

- 86% of Fund invested in US Government Securities.
- Average maturity 51 days versus iMoneyNet\* at 54 days.
- Short term liquidity (0 - 3 months) equal to 133% of LGIP and 84% of SIF.
- 34% of portfolio assets change rates overnight, 82% in three months.

To achieve safety of principal and liquidity, the SIF adheres to rigorous quality standards, careful attention to maturity schedules and emphasis on high marketability. Enhanced return is sought through intensive portfolio management, which considers probable changes in the general structure of interest rates.

Earnings for the State Investment Fund are calculated and distributed monthly, based on the participant's average daily balance as a percent of the total pool.

## SIF Quick Facts

- SIF provided a superior rate of return, ranking 1st out of 235 government money market funds.\*
- SIF also ranked 9th out of 1,207 money market funds (top 1%).\*

## State Investment Fund Annualized Time-Weighted Returns

<u>Fiscal Year</u>	<u>Return</u>
1994	3.9%
1995	5.4
1996	5.4
1997	5.3
1998	5.4
1999	5.0
2000	5.5
2001	6.0
2002	2.5
2003	1.5

*\*Source: The iMoneyNet financial company money fund statistics.*

\* iMoneyNet All Taxable Money Market Index

# Various Funds

SWIB manages five funds for various state agencies. These funds make up just over 1% of the total assets managed. Each is invested to meet specific objectives.

## **HISTORICAL SOCIETY TRUST FUND**

The State Historical Society of Wisconsin is both a state agency and a private membership organization. SWIB is responsible for investing the endowment funds of the Society to help with its goal to promote a wider appreciation of the American heritage, with an emphasis on the collection, advancement, and dissemination of knowledge of the history of Wisconsin and the region.

## **LOCAL GOVERNMENT PROPERTY INSURANCE FUND**

The purpose of the Fund is to make reasonably priced property insurance available for tax-supported local government property such as government buildings, schools, libraries, and motor vehicles. The Fund provides policy and claim service to the policyholders.

## **STATE LIFE INSURANCE FUND**

The Fund is a state-sponsored life insurance program for the residents of Wisconsin. The applicant must be a state resident at the time of application for coverage through the Fund. The Fund operates on a nonprofit basis and receives no subsidies from the state.

## **PATIENTS COMPENSATION FUND**

The Fund was created by statute in 1975 to provide excess medical malpractice coverage for Wisconsin health care providers. Health care providers obtain primary medical malpractice insurance from private insurance companies in an amount required by law. Coverage in excess of the primary insurance is provided by the Fund. The program is administered by the Office of the Commissioner of Insurance.

## **TUITION TRUST FUND**

The Tuition Trust Fund was created to invest the funds for EdVest Wisconsin, a state-sponsored way to save for the cost of college expenses. It offers an investment opportunity designed to help families keep up with rising college tuition expenses. Participants purchase “tuition units” which can be redeemed and applied toward undergraduate tuition and fees at most public and private schools nationwide. SWIB is responsible for investing assets of the program, which are managed in the Tuition Trust Fund. This Fund is currently closed to new participants.

### **For More Information:**

#### **State Historical Society**

(608) 264-6400

#### **Local Gov’t Property Insurance**

Office of Commissioner of  
Insurance

(608) 266-3585 (Madison) or  
(800) 236-8517 (toll-free)

#### **State Life Insurance Fund**

Office of Commissioner of  
Insurance

(608) 266-0107 (Madison) or  
(800) 562-5558 (toll-free)

#### **Patients Compensation Fund**

Office of Commissioner of  
Insurance

(608) 266-6830 (Madison) or  
(800) 562-5558 (toll-free)

#### **EdVest**

Office of the State Treasurer  
(608) 264-7899 (Madison) or  
(888) 338-3789 (toll-free)

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# Financial Section



## INDEPENDENT AUDITOR'S REPORT

Senator Carol Roessler and  
Representative Suzanne Jeskewitz, Co-chairpersons  
Joint Legislative Audit Committee

Members of the Board of Trustees and  
Ms. Patricia Lipton, Executive Director  
State of Wisconsin Investment Board

We have audited the accompanying Statement of Net Assets for the State Investment Fund of the State of Wisconsin as of June 30, 2003 and 2002, and the related Statement of Operations and Changes in Net Assets for the years then ended. These financial statements are the responsibility of the State of Wisconsin Investment Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The financial statements present only the investment activity of the State Investment Fund and do not purport to, and do not, present fairly the financial position and results of operations of the Investment Board or of the State of Wisconsin in conformity with accounting principles generally accepted in the United States of America.

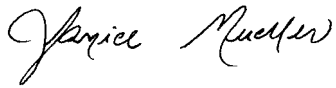
In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the net assets of the State Investment Fund as of June 30, 2003 and 2002, and the results of its investment operations and changes in net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the financial statements of the State Investment Fund of the State of Wisconsin. The Management's Discussion and Analysis preceding the financial statements is presented for purposes of additional analysis and supplementary information and is not a required part of the financial statements referred to in the first paragraph. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and, accordingly, we express no opinion on it. The introduction section of the annual report was not audited by us and, accordingly, we express no opinion on it.

In accordance with *Government Auditing Standards*, we also issued a report dated August 28, 2003, on our consideration of the Investment Board's internal control over financial reporting for the State Investment Fund and on our tests of its compliance with certain provisions of laws and regulations. That report, which was included in a management letter to the Investment Board, is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

LEGISLATIVE AUDIT BUREAU

August 28, 2003

by   
Janice Mueller  
State Auditor

Management Discussion and Analysis provides general information on the financial activities of the State Investment Fund (SIF). The SIF invests the excess operating funds of: 1) State of Wisconsin agencies, 2) the State's public retirement funds, and 3) the Wisconsin Local Government Investment Pool (LGIP). At June 30th the ownership of the SIF was as follows:

	<u>2003</u>	<u>2002</u>
1. Various State of Wisconsin agencies	28%	22%
2. Wisconsin public retirement funds	9%	12%
3. Local Government Investment Pool	63%	66%

Following this section are the financial statements and footnotes. The Statement of Net Assets provides information on the types of investments and the liabilities of the SIF. The Statement of Operations and Changes in Net Assets provides information on the investment income of the fund and its net assets at year end. The Notes to the Financial Statements provide additional information that is essential to a full understanding of the data provided in the fund financial statements. Condensed SIF financial information for the fiscal years ended June 30, 2003 and 2002 is as follows:

SIF Condensed Financial Information			
Fiscal Year Ended:	<u>2003</u>	<u>2002</u>	<u>% Change</u>
Total Assets	\$ 5,946,141,114	\$ 6,290,330,252	( 5.5 )
Total Liabilities	301,194,092	354,060,222	( 14.9 )
Net Assets	<u>\$ 5,644,947,022</u>	<u>\$ 5,936,270,030</u>	( 4.9 )
Investment Revenue	\$ 100,647,744	\$ 165,449,893	( 39.2 )
Expenses	1,309,314	1,179,810	( 11.0 )
State Working Bank	2,819,260	3,944,525	( 28.5 )
Net Investment Income	<u>\$ 96,519,170</u>	<u>\$ 160,325,558</u>	( 39.8 )
Average Daily Cash Balance	\$ 6,521,867,789	\$ 6,695,835,985	( 2.6 )
Time Weighted Annual Yield	1.49%	2.51%	( 40.6 )

Because SIF investment balances are used to fund participants' operating cash flows, it invests in highly liquid, short-term domestic fixed income securities. At June 30, 2003, SIF Net Assets had decreased slightly, by \$291,323,008 from the prior year, due to participant withdrawals exceeding contributions. The Average Daily Cash Balance was also slightly lower than the previous year and peaked at \$7.466 billion in February 2003.

The Net Investment Income decrease of 39.8% was largely due to the Federal Open Markets Committee cutting the Fed Funds Target rate twice in fiscal year 2003, from 1.75% to 1.00%. This also caused the Time Weighted Annual Yield to drop from 2.51% to 1.49%.

**STATE INVESTMENT FUND**  
**Statement of Net Assets**  
**As of June 30, 2003 and June 30, 2002**

	<u>June 30, 2003</u>	<u>June 30, 2002</u>
<b>Assets</b>		
Investments (At fair value):		
Repurchase Agreements	\$ 1,777,000,000	\$ 992,000,000
Government and Agency	3,328,181,066	4,915,096,950
Commercial Paper	455,091,011	0
Certificates of Deposit (CDs)	400,000,000	396,820,000
Asset Backed Securities	0	1,983,870
Mortgage Backed Securities	1,277,259	1,924,166
Yankee/Euro Issues	0	0
Swap(s)	(22,933,004)	(26,806,525)
Total Net Investments (At fair value)	\$ 5,938,616,332	\$ 6,281,018,461
Other Assets:		
Accrued Interest Receivable	7,524,782	9,311,791
Total Assets	<u>\$ 5,946,141,114</u>	<u>\$ 6,290,330,252</u>
<b>Liabilities</b>		
Check Float Invested	\$ 294,206,252	\$ 344,397,323
Earnings Distribution Payable	6,397,351	9,151,955
Accrued Swap Payments	520,489	449,944
Accrued Expenses	70,000	61,000
Total Liabilities	<u>\$ 301,194,092</u>	<u>\$ 354,060,222</u>
<b>NET ASSETS</b>	<u>\$ 5,644,947,022</u>	<u>\$ 5,936,270,030</u>
Net Assets consist of:		
Participating Shares	\$ 5,652,998,000	\$ 5,948,004,000
Undistributed Unrealized Gains (Losses)	(8,050,978)	(11,733,970)
<b>NET ASSETS</b>	<u>\$ 5,644,947,022</u>	<u>\$ 5,936,270,030</u>

*The accompanying notes, on pages 21 through 25, are an integral part of this statement.*

**STATE INVESTMENT FUND****Statement of Operations and Changes in Net Assets  
For the Fiscal Years Ended June 30, 2003 and 2002**

	June 30, 2003	June 30, 2002
<b>Investment Revenue</b>		
Investment Income	\$ 113,735,036	\$ 177,186,177
Net Swaps Revenue (Expense)	(13,087,292)	(11,736,284)
Total Investment Revenue	\$ 100,647,744	\$ 165,449,893
<b>Expenses</b>		
Management Operating Expense Allocation	\$ 907,989	\$ 811,515
Custodial Bank Charges	202,431	203,236
State Treasurer Costs	40,549	39,572
Electronic Services	115,505	75,349
Legal and Consulting Fees	42,840	50,138
Total Expenses	\$ 1,309,314	\$ 1,179,810
NET INVESTMENT REVENUE	\$ 99,338,430	\$ 164,270,083
State Working Bank Charges Allocation	2,819,260	3,944,525
<b>Net Investment Income</b>	\$ 96,519,170	\$ 160,325,558
Distributions Paid and Payable	92,836,178	160,054,074
Change in Undistributed Unrealized Gains (Losses)	\$ 3,682,992	\$ 271,484
Beginning of Period Undistributed Unrealized Gains (Losses)	(11,733,970)	(12,005,454)
End of Period Undistributed Unrealized Gains (Losses)	\$ (8,050,978)	\$ (11,733,970)
Participant Transactions		
Receipts by Transfer to Fund	\$ 25,565,361,000	\$ 24,678,495,000
Disbursements by Transfer from Fund	(25,860,367,000)	(24,783,360,000)
Net Change in Participating Shares	\$ (295,006,000)	\$ (104,865,000)
Beginning of Period Participating Shares	5,948,004,000	6,052,869,000
End of Period Participating Shares	\$ 5,652,998,000	\$ 5,948,004,000
<b>Net Assets</b>	\$ 5,644,947,022	\$ 5,936,270,030

The accompanying notes, on pages 21 through 25, are an integral part of this document.

## 1. Description of Fund

The State Investment Fund (SIF) pools the excess cash of the State of Wisconsin and its Agencies, certain retirement funds, and various local government units (Local Government Investment Pool – LGIP) into a commingled fund with the investment objective of safety of principal and liquidity while earning a competitive rate of return. Only State of Wisconsin agencies are required to invest their excess cash in the SIF. In the State's Comprehensive Annual Financial Report, each State agency's pro rata portion of the SIF is reported in their GAAP fund as cash and cash equivalents while the funds of various local governments are reported as a separate fiduciary investment trust fund entitled "Local Government Pooled Investment Fund." The staff of the State of Wisconsin Investment Board (SWIB) manages the SIF with oversight by the Board of Trustees as authorized in Wisconsin Statutes 25.14 and 25.17. SWIB is not registered with the SEC as an investment company.

Wisconsin Statutes 25.17(3)(b), (ba) and (bd) enumerate the various types of securities that can be invested in, which include direct obligations of the United States and Canada, securities guaranteed by the United States, securities of federally chartered corporations such as the African Development Bank, the unsecured notes of financial and industrial issuers, Yankee/Euro issues, certificates of deposit issued by banks in the United States and solvent financial institutions in this state and bankers acceptances. The Board of Trustees may approve other prudent investments. The Board of Trustees has given standing authority to SWIB staff to invest in resale agreements, financial futures contracts, options and interest rate swaps on behalf of the SIF.

## 2. Significant Accounting Policies

### A. Basis of Presentation

The accompanying financial statements of the investment activity of the SIF are prepared in accordance with generally accepted accounting principles (GAAP) for governments as prescribed by the Governmental Accounting Standards Board (GASB).

### B. Basis of Accounting

The accompanying statements are prepared based upon the flow of economic resources measurement focus and the full accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized in the accounting period in which they are earned and become measurable, and expenses are recognized in the period incurred, if measurable. Security transactions and the related gains and losses are recorded on a trade date basis. Dividend income is recorded on the ex-dividend date and interest income is accrued as earned.

SWIB applies all applicable GASB pronouncements and those Financial Accounting Standards Board (FASB) pronouncements issued on or before November 30, 1989, which do not conflict with or contradict GASB pronouncements.

### C. Valuation of Securities

Investments are valued at fair value for financial statement purposes and amortized cost for purposes of calculating income to participants (See Footnote 3). The Bank of New York, as custodial bank, has compiled fair value information for all securities by utilizing third party pricing services. Government and agency securities and commercial paper are priced using matrix pricing. This method estimates a security's fair value by using quoted market prices for securities with similar interest rates, maturities, and credit ratings. Repurchase agreements and certificates of deposit are valued at cost because they are nonparticipating contracts that do not capture interest rate changes in their value. Swaps are valued at



Summary Information by Investment Classification						
	June 30, 2003				June 30, 2002	
	Interest Rates	Maturity Dates	Fair Value	Book Value (Amort. Cost)	Fair Value	Book Value (Amort. Cost)
Repurchase Agreements	1.10-1.25	07/01/03-07/01/03	\$ 1,777,000,000	\$ 1,777,000,000	\$ 992,000,000	\$ 992,000,000
Government and Agency	0.89-7.02	07/01/03-02/15/05	3,328,181,066	3,313,284,035	4,915,096,950	4,900,030,949
Commercial Paper	0.94-1.31	07/01/03-08/06/03	455,091,011	455,106,016	0	0
Certificates of Deposit	1.10-7.27	07/15/03-06/15/06	400,000,000	400,000,000	396,820,000	396,820,000
Asset Backed Securities	N/A	N/A	0	0	1,983,870	1,977,316
Mortgage Backed Securities	2.12	04/27/05	1,277,259	1,277,259	1,924,166	1,924,166
Yankee/Euro Issues	N/A	N/A	0	0	0	0
Swap(s)	N/A	03/16/05	(22,933,004)	0	(26,806,525)	0
Total Investments			<u>\$ 5,938,616,332</u>	<u>\$ 5,946,667,310</u>	<u>\$ 6,281,018,461</u>	<u>\$ 6,292,752,431</u>
Ratio of Fair Value to Book Value				<u>99.8646%</u>		<u>99.8135%</u>

the net present value of estimated expected future cash flows using discount rates commensurate with the risk involved. In addition, a bond issued by a State of Wisconsin agency, having a par value at June 30, 2003 of \$1.3 million, is valued at par, which management believes approximates fair value. The fair value of investments is determined at the end of each month.

#### *D. Management Operating Expenses*

Management operating expenses are SWIB's administrative costs that are allocated, in advance, to the SIF participants. Also, certain related costs of the Office of the State Treasurer have been allocated to the fund.

### **3. Pool Earnings and Pool Shares**

For purposes of calculating earnings to each participant, all investments are valued at amortized cost. Specifically, the SIF distributes income to pool participants monthly based on their average daily share balance. Distributed income includes realized investment gains and losses calculated on an amortized cost basis, interest income based on stated rates (both paid and accrued), amortization of discounts and premiums on a straight-line basis, and investment and administrative expenses. This method differs from the fair value method used to value investments in these financial statements, because the amortized cost method is not designed to distribute to participants all unrealized gains and losses in the fair values of the pool's investments. The total difference between the fair values of the investments in the pool and the values distributed to the pool participants using the amortized cost method described above is reported in the equity section of the statement of net assets as undistributed unrealized gains (losses).

Pool shares are bought and redeemed at \$1.00 based on the amortized cost of the investments in the fund. The State of Wisconsin does not provide any legally binding guarantees to support the value of pool shares. However, LGIP investments, except for investments in U.S. Government/Agencies, State of Wisconsin Agencies, and Wisconsin Banks, are insured against credit loss by Financial Security Assurance

Corporation. Further, the Federal Deposit Insurance Corporation (FDIC) insures the prorata share of Certificates of Deposit held by the LGIP. Finally, the State of Wisconsin's Public Deposit Guarantee Fund protects a depositing municipality up to \$400,000 if the local governing body has designated the LGIP as a public depository.

#### 4. Deposits and Investments

*Deposits* – As of June 30, 2003, the SIF held certificates of deposit with an estimated fair value of \$400.0 million invested pursuant to the Wisconsin Certificate of Deposit Program implemented in July 1987. Banks that are accepted into this program must be located in Wisconsin and meet credit-screening criteria designed to assure the safety of the deposits.

The GASB Statement No. 3 requires deposits with financial institutions to be categorized to indicate the level of risk assumed by the SIF as defined in GASB Statement No. 3. Category 1 consists of deposits that are insured or collateralized with securities held by the State or by its agent in the State's name. Approximately \$354.2 million falls under this category through FDIC insurance, the Wisconsin State Deposit Guarantee Fund, and Financial Securities Assurance Corporation insurance. The remaining \$45.8 million are considered Category 3 uncollateralized deposits. The actual coverage of these deposits fluctuates daily based on the allocable share of participants' accounts.

*Investments* – The GASB Statement also requires investments to be categorized to indicate the level of risk assumed by the SIF at year-end. The categories are:

1. Insured or registered, or securities which are held by the Fund in the Fund's name or its agent in the Fund's name.
2. Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the Fund's name.
3. Uninsured and unregistered, with the securities held by the counterparty or by its trust department or agent, but not in the Fund's name.

Securities Categorized by Level of Risk				
	Category			Fair and Carrying Value
	1	2	3	
<u>Deposits:</u>				
CDs (Nonnegotiable)	\$ 354,209,884	\$ 0	\$ 45,790,116	\$ 400,000,000
<u>Investments:</u>				
Repurchase Agreements	\$ 1,777,000,000	\$ 0	\$ 0	\$ 1,777,000,000
Government and Agency	3,328,181,066	0	0	3,328,181,066
Commercial Paper	455,091,011	0	0	455,091,011
CDs (Negotiable)	0	0	0	0
Asset Backed Securities	0	0	0	0
Mortgage Backed	1,277,259	0	0	1,277,259
Yankee/Euro Issues	0	0	0	0
Subtotal	\$ 5,561,549,336	\$ 0	\$ 0	\$ 5,561,549,336
<u>Not Categorized:</u>				
Swap				\$ (22,933,004)
Total Investments				\$ 5,938,616,332

## 5. Derivative Financial Instruments

As of June 30, 2003, the only derivative financial instrument held by the SIF was the March 16, 1995 restructured interest rate swap which required periodic payments over ten years, as discussed in detail in Footnote 6. Each swap transaction involves the exchange of interest rate payment obligations without the exchange of underlying principal amounts. The notional amounts used to express the volume of these transactions do not represent the amounts subject to risk, but represent the amount on which both parties calculate interest rate obligations. The settlement of the interest rate exchange occurs at predetermined dates, with the net difference between the interest paid and interest received reflected as an increase in income. Entering into interest rate swap agreements subjects the investor to the possibility of financial loss in the event of adverse changes in market rates or nonperformance by the counterparty to the swap agreement. Selecting creditworthy counterparties mitigates credit risks arising from derivative transactions.

For fiscal years 2003 and 2002, the cash outflow for the restructured interest rate swap was (\$13,016,747) and (\$11,602,273) respectively.

## 6. Restructured Investments – March 16, 1995

During fiscal year 1995, SWIB became aware of the existence of market exposure in certain swap agreements and structured bonds, which could impair the earnings of the SIF. In one case, a \$10 million notional value swap agreement, which contained exposure to Mexican interest rates, included a leverage factor, which caused a very high rate of market volatility. In another case, structured bonds with a par value of \$58 million were found to have a potential loss of principal because the redemption values were linked to foreign currency rates.

In March 1995, SWIB entered into agreements with two counterparties that resulted in the counterparties' assumption of all future market risk associated with ten swap agreements and two structured bonds. At the time of the agreement, the counterparties assigned a market value to these investments of negative \$95,321,000. Within this restructuring, one swap agreement requires SWIB to make periodic payments over a period of ten years, while the other agreement requires periodic payment of the loss over a period of five years. Interest cost associated with the periodic payment of the loss over time is estimated to be \$24.8 million. Future earnings will be charged as payments are made.

Various parties, under the direction of the Board of Trustees, evaluated the appropriateness of the original derivatives that were considered high risk, and determined that several of the positions were not in compliance with the Board of Trustees investment guidelines. SWIB has suspended the use of nonrisk reducing derivatives in the SIF and the Board of Trustees adopted investment guidelines prohibiting the use of such instruments on November 2, 1995. The following schedules provide more analysis of the restructured investments.

Restructured Investments Analysis			
	Fair Value		
	June 30, 2003	June 30, 2002	March 16, 1995
<u>Restructured Interest Rate Mirror Swaps</u>			
USD Libor Swap	\$ 0	\$ 0	\$ (1,380,000)
ESP Libor Swap	0	0	(2,960,000)
ITL Libor versus ESP Libor Swap	0	0	(1,537,000)
SWK CMS Swap	0	0	(4,160,000)
CMT Two-Year Spread Swap	0	0	(889,000)
Ten-Year Swap Spread Swap	0	0	(4,720,000)
DEM Libor Swap	0	0	(6,570,000)
FFR Pibor Swap	0	0	(5,710,000)
Subtotal	\$ 0	\$ 0	\$ (27,926,000)
<u>Restructured Asset Amortizing Swaps</u>			
SLMA Currency Linked NZ\$ vs. Yen	\$ 0	\$ 0	\$ (4,995,000)
Grantor Trust Crncy Linked C\$ vs. Lira vs. Yen	0	0	(27,400,000)
Subtotal	\$ 0	\$ 0	\$ (32,395,000)
<u>Mexican - Spread Restructuring Swap</u>			
10.74% - 1m USD Libor	\$ (22,933,004)	\$ (26,806,525)	\$ (35,000,000)
US Treas. 7.50% 2/15/05 Hedge-Unreal. Gain	13,510,388	13,911,884	0
Subtotal	\$ (9,422,616)	\$ (12,894,641)	\$ (35,000,000)
Total Fair Value	\$ (9,422,616)	\$ (12,894,641)	\$ (95,321,000)

As of June 30, 2003, anticipated cash requirements for deferred loss principal and interest payments are as follows:

Deferred Loss Cash Requirements			
Fiscal Year Ended:	Principal	Interest	Total
June 30, 2004	\$ 4,778,983	\$ 584,417	\$ 5,363,400
June 30, 2005	3,816,569	143,331	3,959,900
June 30, 2006	0	0	0
June 30, 2007	0	0	0
June 30, 2008	0	0	0
Thereafter	0	0	0
Total	\$ 8,595,552	\$ 727,748	\$ 9,323,300

## 7. Related Party Transactions

The SIF held one bond issued by a State of Wisconsin agency with a remaining par and carrying value of \$1.3 million at June 30, 2003. Management believes the rate of interest received is comparable to rates for bonds with similar characteristics issued by an unaffiliated third party.



# State of Wisconsin \ LEGISLATIVE AUDIT BUREAU

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## INDEPENDENT AUDITOR'S REPORT

Senator Carol Roessler and  
Representative Suzanne Jeskewitz, Co-chairpersons  
Joint Legislative Audit Committee

Members of the Board of Trustees and  
Ms. Patricia Lipton, Executive Director  
State of Wisconsin Investment Board

We have audited the accompanying Statements of Net Investment Assets for the Retirement Trust Funds (Fixed Retirement Trust Fund and Variable Retirement Trust Fund) of the State of Wisconsin, as of June 30, 2003 and 2002, and the related Statements of Changes in Net Investment Assets for the years then ended. These financial statements are the responsibility of the State of Wisconsin Investment Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the investment activity of the Retirement Trust Funds attributable to the transactions of the State of Wisconsin Investment Board. The financial statements do not purport to, and do not, present the financial activity of the Retirement Trust Funds attributable to the Department of Employee Trust Funds. Further, they do not purport to, and do not, present fairly the financial position and results of operations of the Investment Board or of the State of Wisconsin in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the net investment assets of the Retirement Trust Funds as of June 30, 2003 and 2002, and the changes in net investment assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As explained in Note 2, the financial statements include investments that do not have readily ascertainable market prices and are valued based on a variety of third-party pricing methods. We have reviewed the procedures used by the Investment Board in arriving at estimates of the values of such investments and have inspected underlying documentation, and, given the circumstances,

we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ from the values that would have been used had a ready market for the investments existed.

As discussed in Note 8, during fiscal year 2001-02, the Investment Board changed the method by which it estimates fair values for its private placement portfolios. The new valuation method resulted in a net decrease in value of \$167.1 million during the fiscal year because it recognizes the investment return more gradually over the life of the investment than the previous method had.

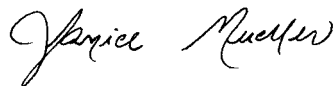
Our audits were conducted for the purpose of forming an opinion on the financial statements of the Retirement Trust Funds of the State of Wisconsin. The Management's Discussion and Analysis preceding the financial statements is presented for purposes of additional analysis and supplementary information and is not a required part of the financial statements referred to in the first paragraph. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it. The introduction section of the annual report was not audited by us and, accordingly, we express no opinion on it.

In accordance with *Government Auditing Standards*, we will also issue a report dated November 24, 2003, on our consideration of the Investment Board's internal control over financial reporting and our tests of its compliance with certain provisions of laws and regulations. That report, which will be included in a management letter to the Investment Board, is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

LEGISLATIVE AUDIT BUREAU

November 24, 2003

by



Janice Mueller  
State Auditor

The State of Wisconsin Retirement Funds' narrative discussion and analysis of the financial activities for the fiscal year ended June 30, 2003 is presented by management as an introduction to the financial statements. It is meant to assist the reader in understanding the financial statements by providing an overall review of the financial activities during the year as well as provide a comparison of the prior year's activity and results.

## Overview of Basic Financial Statements

Following this section are the financial statements and footnotes which reflect only the investment activity of these funds. Retirement reserves, contribution revenue and benefit expense are excluded from presentation in these statements.

-The **Statement of Net Investment Assets** provides information on the financial position of the Funds at year-end. It indicates the investment assets available for payment for future benefits and any current liabilities related to the investments.

-The **Statement of Changes in Net Investment Assets** presents the results of the investing activities during the year. The changes reflected on this statement support the overall change that has occurred to the prior year's net assets on the Statement of Net Investment Assets.

-The **Notes to the Financial Statements** offer additional discussion that is essential to the full understanding of the data presented in the financial statements. The notes give more detail about accounting policies, significant account balances and activities, material risks, obligations, contingencies and subsequent events, if any.

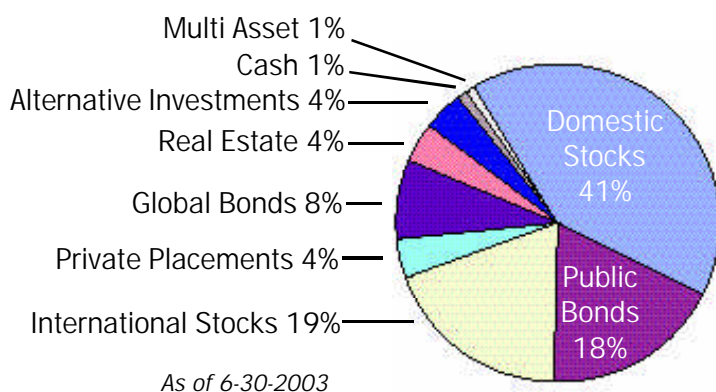
The financial statements and related notes are prepared in accordance with Governmental Accounting Standards Board Pronouncements.

## Retirement Trust Funds

More than 500,000 people participate in the Wisconsin Retirement System (WRS), including current and former employees of Wisconsin's state agencies and most local governments. Contributions made to the WRS by these employees and their employers are invested by the State of Wisconsin Investment Board to finance retirement and other benefits. The WRS is comprised of the Fixed Retirement Trust Fund and the Variable Retirement Trust Fund whose combined net investment assets total \$55.3 billion as of June 30, 2003.

### Fixed Retirement Trust Fund

The larger of the two trust funds comprising the Wisconsin Retirement System is the Fixed Retirement Trust Fund (FRTF) totaling \$50.3 billion. All WRS members have at least half - if not all - of their pension



account in the FRTF. It is a fully diversified, balanced fund invested for the long-term needs of the WRS. It includes a mixture of holdings, such as stocks, bonds, and real estate. Diversification helps to stabilize the effects of market changes. The basic investment objective of this trust fund is to achieve an average 8% annual return over the long-term and a rate of return of 3.5% a year above wage-rate growth. This objective is based on market rate of return and actuarial assumptions needed to meet obligations of the pension system.



The FRTF Net Investment Assets increased approximately \$1 billion or an increase of 2.03%. This was primarily due to a rise in fund level investment returns of 4.6% offset by the net outflow of benefit payments. The fixed income portfolios returned 14.0% over the fiscal year, while real estate portfolios returned 8.1% and alternative investment portfolios earned 4.8%. The equity investments, after a tumultuous year, produced an annualized rate of return down slightly at negative 1.6%. Net investment assets were further reduced over the fiscal year by net benefit payments exceeding contribution revenues by \$1 billion. Net benefit outflows slowed somewhat from the previous year because FY 2002 payments included several large retroactive benefit payments due to the enactment of 1999 Wisconsin Act 11.

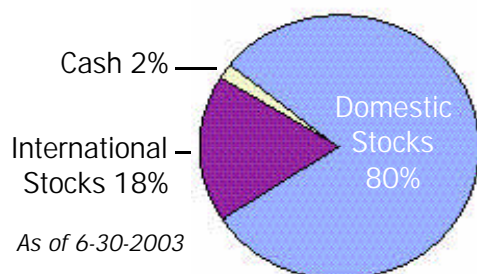
Both the Other Current Assets and Other Current Liabilities balances decreased significantly from June 30, 2002 to June 30, 2003. The bulk of the reduction in balances was caused by a large reallocation of assets that occurred over the June 30, 2002 year end. Since a restructuring of this magnitude was not underway at June 30, 2003, other current assets and other current liabilities, which reflect pending transactions, were approximately 80% lower than the prior year.

Fixed Retirement Trust Fund Condensed Financial Information			
Fiscal Year Ended:	2003	2002	% Change
Cash and Cash Equivalents	\$ 889,700,794	\$ 1,360,148,648	-34.59%
Other Current Assets	250,563,827	1,352,828,342	-81.48%
Invested Securities Lending Collateral	3,053,566,720	2,233,869,161	36.69%
Other Assets	5,550,905	20,493,952	-72.91%
Investments	49,365,424,960	47,743,069,210	3.40%
Total Assets	<u>\$ 53,564,807,206</u>	<u>\$ 52,710,409,313</u>	1.62%
Current Liabilities	\$ 239,470,409	\$ 1,205,217,430	80.13%
Securities Lending Collateral Liability	3,053,566,720	2,233,869,161	-36.69%
Total Liabilities	<u>\$ 3,293,037,129</u>	<u>\$ 3,439,086,591</u>	4.25%
Net Investment Assets	<u><u>\$ 50,271,770,077</u></u>	<u><u>\$ 49,271,322,722</u></u>	2.03%
Investment Revenue (Loss)	\$ 2,205,818,984	\$ (2,531,335,286)	187.14%
Investment Expense	(145,873,414)	(135,272,310)	-7.84%
Net Investment Income (Loss)	<u>\$ 2,059,945,570</u>	<u>\$ (2,666,607,596)</u>	177.25%
Net Receipt (Disbursements)	(1,059,498,215)	(1,475,978,402)	-28.22%
Net Increase (Decrease)	<u><u>\$ 1,000,447,355</u></u>	<u><u>\$ (4,142,585,998)</u></u>	124.15%

Expenses increased 7.84% over fiscal year 2002. Most of this increase can be attributed to a rise management fees. During this time period, SWIB allocated more assets to external managers, thus increasing base management fees. In addition, the FRTF moved assets from portfolios where traditional flat fees based on the market value of assets managed are earned to portfolios where performance based management fees are earned. Performance fees are earned by an external manager when the portfolio's performance meets or exceeds an agreed upon performance objective. The \$38.8 million paid in performance fees in fiscal year 2003 were more than offset by the \$119.9 million by which they outperformed their benchmarks.

### Variable Retirement Trust Fund

The Wisconsin Legislature passed, and the Governor signed into law, 1999 Wisconsin Act 11 which reopened the VRTF, effective January 1, 2001. Act 11 allows active employees participating in the WRS to put half of their pension fund contributions into this stock fund. Approximately 21% of WRS members participate in the Fund, which totaled \$5.1 billion at the end of fiscal year 2003. It is 98% invested in equities with the remaining in cash. Employees who choose this fund accept a higher degree of risk for the potential of greater long-run returns. The investment objective of the VRTF is to exceed similar equity-oriented portfolios over a full market cycle.



The VRTF net investment assets decreased by approximately \$400 million, or negative 7.62%. A portion of this reduction was due to the downturn in the equities market. VRTF equity investments earned an annualized rate of return of negative 1.9%.

The other factor affecting the decline in net investment assets was net benefit payments exceeding contribution revenue by \$267 million over the fiscal year. This net outflow of funds resulted in less assets to be invested. The Net Receipts (Disbursements) is comprised mainly of the contribution revenue and benefit payments. When the two fiscal years are compared, net receipts (disbursements) fell by 9.52%. While contribution rates remained relatively constant, benefit payments made in fiscal year 2003 amounted to significantly less than benefits payments made during fiscal year 2002. Benefit payments made over most of the past fiscal year reflected a negative 14% dividend adjustment due to the difficult market conditions experienced in calendar year 2001.

Variable Retirement Trust Fund Condensed Financial Information			
Fiscal Year Ended:	2003	2002	% Change
Cash and Cash Equivalents	\$ 135,659,884	\$ 102,292,292	32.62%
Other Current Assets	10,093,762	278,574,373	-96.38%
Invested Securities Lending Collateral	155,904,058	101,784,031	53.17%
Other Assets	566,607	802,332	-29.38%
Investments	4,931,515,965	5,371,106,389	-8.18%
Total Assets	\$ 5,233,740,276	\$ 5,854,559,417	-10.60%
Current Liabilities	\$ 27,327,250	\$ 285,831,087	90.44%
Securities Lending Collateral Liability	155,904,058	101,784,031	-53.17%
Total Liabilities	\$ 183,231,308	\$ 387,615,118	52.73%
Net Investment Assets	\$ 5,050,508,968	\$ 5,466,944,299	-7.62%
Investment Revenue (Loss)	\$ (136,017,499)	\$ (983,028,610)	86.16%
Investment Expense	(10,425,558)	(11,827,145)	11.85%
Net Investment Income (Loss)	\$ (146,443,057)	\$ (994,855,755)	85.28%
Net Receipt (Disbursements)	(269,992,274)	(298,396,532)	-9.52%
Net Increase (Decrease)	\$ (416,435,331)	\$ (1,293,252,287)	67.80%

The VRTF was also undergoing a large shift in asset allocation at June 30, 2002. At June 30, 2003 no major reallocation was taking place. As a result other current assets and other current liabilities balances, which reflect pending transactions, decreased by more than 90%.

Expenses decreased 11.85% over fiscal year 2002. This decrease can be attributed to a decrease in management fee expense, resulting from 11.93% less assets under external management.

### Total Rate of Return – As of June 30, 2003

Total rate of return (time-weighted) is widely accepted for comparing investment results. It combines current yield plus changes in current market value.

Fiscal Year	Fixed Trust Fund	Variable Trust Fund
1994	3.8 %	6.1 %
1995	16.7	19.6
1996	14.8	20.1
1997	18.9	25.0
1998	17.6	20.6
1999	9.8	15.1
2000	12.5	17.8
2001	-5.4	-13.5
2002	-4.8	-14.7
2003	4.6	-1.9
10 Yr. Avg.	8.5 %	8.5 %

# RETIREMENT FUNDS

## Statement of Net Investment Assets

### June 30, 2003

	Fixed Retirement Trust Fund	Variable Retirement Trust Fund
<b>Assets</b>		
Cash and Cash Equivalents	\$ 889,700,794	\$ 135,659,884
Receivables:		
State Investment Fund Earnings	749,744	92,996
Accrued Interest & Dividends Receivables	167,989,869	3,418,102
Sales Receivables	81,824,214	6,582,664
Invested Securities Lending Collateral	3,053,566,720	155,904,058
Foreign Currency Contracts	2,397,054	566,607
Other Assets	3,153,851	0
Investments (at fair value):		
Fixed Income	14,489,276,071	24,856
Stocks	30,734,715,564	4,931,491,109
Limited Partnerships	2,693,112,962	0
Mortgages	726,725,125	0
Real Estate Owned	436,628,080	0
Multi Asset	284,967,158	0
<b>Total Investment Assets</b>	<b>\$ 53,564,807,206</b>	<b>\$ 5,233,740,276</b>
<b>Liabilities</b>		
Purchases Payable	217,840,434	24,561,166
Mortgage Escrow Account	75,975	0
Vouchers Payable	21,554,000	2,766,084
Securities Lending Collateral Liability	3,053,566,720	155,904,058
<b>Total Investment Liabilities</b>	<b>\$ 3,293,037,129</b>	<b>\$ 183,231,308</b>
<b>Net Investment Assets Held in Trust</b>	<b>\$ 50,271,770,077</b>	<b>\$ 5,050,508,968</b>

The accompanying notes, on pages 36 through 43, are an integral part of this statement.

**RETIREMENT FUNDS****Statement of Changes in Net Investment Assets  
For the Fiscal Year Ended June 30, 2003**

	<b>Fixed Retirement Trust Fund</b>	<b>Variable Retirement Trust Fund</b>
<b>Additions:</b>		
Investment Income:		
Net Increase (Decrease) in the Fair Value of Investments	\$ 1,179,730,145	\$ (176,967,019)
Interest	681,869,790	1,359,343
Dividends	237,523,874	38,872,619
Securities Lending Commissions	40,237,989	1,746,246
Other Income	98,467,890	0
Less:		
Investment Expense	(145,873,414)	(10,425,558)
Securities Lending Rebates	(29,856,650)	(871,653)
Securities Lending Fees	(2,154,054)	(157,035)
 Total Investment Income (Loss)	 \$ 2,059,945,570	 \$ (146,443,057)
<b>Deductions:</b>		
Net Receipts (Disbursements) - Department of Employee Trust Funds	(1,059,498,215)	(269,992,274)
 <b>Net Increase (Decrease)</b>	 \$ 1,000,447,355	 \$ (416,435,331)
<b>Net Investment Assets Held in Trust:</b>		
Beginning of Year	49,271,322,722	5,466,944,299
 End of Year	 \$ 50,271,770,077	 \$ 5,050,508,968

*The accompanying notes, on pages 36 through 43, are an integral part of this statement.*

# RETIREMENT FUNDS

## Statement of Net Investment Assets

### June 30, 2002

	Fixed Retirement Trust Fund	Variable Retirement Trust Fund
<b>Assets</b>		
Cash and Cash Equivalents	\$ 1,360,148,648	\$ 102,292,292
Receivables:		
State Investment Fund Earnings	887,677	74,290
Accrued Interest & Dividends Receivables	200,814,022	3,328,109
Sales Receivables	1,151,126,643	275,171,974
Invested Securities Lending Collateral	2,233,869,161	101,784,031
Foreign Currency Contracts	17,453,303	802,332
Other Assets	3,040,649	0
Investments (at fair value):		
Fixed Income	15,111,071,428	196,425
Stocks	28,885,893,981	5,370,734,216
Limited Partnerships	2,598,401,452	173,712
Mortgages	685,784,188	0
Real Estate Owned	461,911,678	0
Financial Futures Contracts	6,483	2,036
<b>Total Investment Assets</b>	<b>\$ 52,710,409,313</b>	<b>\$ 5,854,559,417</b>
<b>Liabilities</b>		
Purchases Payable	1,178,839,674	282,633,734
Mortgage Escrow Account	975	0
Vouchers Payable	26,376,781	3,197,353
Securities Lending Collateral Liability	2,233,869,161	101,784,031
<b>Total Investment Liabilities</b>	<b>\$ 3,439,086,591</b>	<b>\$ 387,615,118</b>
<b>Net Investment Assets Held in Trust</b>	<b>\$ 49,271,322,722</b>	<b>\$ 5,466,944,299</b>

The accompanying notes, on pages 36 through 43, are an integral part of this statement.

**RETIREMENT FUNDS****Statement of Changes in Net Investment Assets  
For the Fiscal Year Ended June 30, 2002**

	<b>Fixed Retirement Trust Fund</b>	<b>Variable Retirement Trust Fund</b>
<b>Additions:</b>		
Investment Income:		
Net Increase (Decrease) in Fair Value of Investments	\$ (3,639,335,505)	\$ (1,020,302,298)
Interest	768,257,476	2,405,822
Dividends	202,019,086	33,869,820
Securities Lending Commissions	71,425,796	2,763,743
Other Income	125,802,337	0
Less:		
Investment Expense	(135,272,310)	(11,827,145)
Securities Lending Rebates	(55,533,635)	(1,433,026)
Securities Lending Fees	(3,970,841)	(332,671)
<b>Total Investment Income (Loss)</b>	<b>\$ (2,666,607,596)</b>	<b>\$ (994,855,755)</b>
<b>Deductions:</b>		
Net Receipts (Disbursements) - Department of Employee Trust Funds	(1,475,978,402)	(298,396,532)
<b>Net Increase (Decrease)</b>	<b>\$ (4,142,585,998)</b>	<b>\$ (1,293,252,287)</b>
<b>Net Investment Assets Held in Trust:</b>		
<b>Beginning of Year</b>	<b>53,413,908,720</b>	<b>6,760,196,586</b>
<b>End of Year</b>	<b>\$ 49,271,322,722</b>	<b>\$ 5,466,944,299</b>

*The accompanying notes, on pages 36 through 43, are an integral part of this statement.*



## 1. Description of Funds

The State of Wisconsin Investment Board (SWIB) has exclusive control of the investment and collection of principal, interest, and dividends of all monies invested of the Fixed Retirement Trust Fund and the Variable Retirement Trust Fund. The statements presented here reflect only the investment activity of these funds. Excluded from presentation in the statements are, for example, retirement reserves, contribution revenue, and benefit expense. The investment expense account on the retirement fund financial statements represents the expenses that are allowed to be charged directly to the trust funds per s. 25.18(1)(a) and (m) Wis. Stats. and SWIB's administrative receipts and disbursements. The directly charged expenses include external management fees, legal fees, custodial bank fees, bond insurance fees, and investment consulting fees. SWIB's administrative receipts and disbursements related to the investment function are appropriated under the state's General Fund. The administrative receipts and disbursements allocated to each of the Funds is then billed back to the respective Fund and included in the Statement of Changes in Net Investment Assets as "Investment Expense."

### A. Fixed Retirement Trust Fund

The Fixed Retirement Trust Fund consists mainly of retirement contributions for the participants in the Wisconsin Retirement System (WRS). The WRS is administered by the Department of Employee Trust Funds (DETF) in accordance with Chapter 40 of the Wisconsin Statutes. All retirement fund contributions are invested in this trust fund unless participants had elected to have part of the contributions invested in the Variable Retirement Trust Fund. In addition to the retirement contributions, the assets of various other benefit programs are invested as part of the Fixed Retirement Trust Fund as listed in the table below.

Other Benefit Programs Within the Fixed Retirement Fund	
Accumulated Sick Leave	\$ 537,140,310
Long Term Disability Insurance	221,897,278
Police and Firefighters	129,541,076
Duty Disability	125,141,262
Income Continuation Insurance	75,176,648
Milwaukee Retirement System	49,866,655
Special Death Benefits	5,429
Total	<u>\$ 1,138,768,658</u>

The Fixed Retirement Trust Fund is managed by SWIB with oversight by a Board of Trustees as authorized in Wisconsin Statutes 25.14 and 25.17. It is not registered with the Securities and Exchange Commission as an investment company. The investments of the Fixed Retirement Trust Fund consist of a highly diversified portfolio of securities. Wisconsin Statutes 25.17(3)(a) allow investments in loans, securities and any other investments as authorized by s. 620.22. Permitted classes of investments include bonds of governmental units or of private corporations, loans secured by mortgages, preferred or common stock, real property and other investments not specifically prohibited by statute.

### B. Variable Retirement Trust Fund

The Variable Retirement Trust Fund also consists mainly of retirement contributions for the participants in the WRS. In addition, the Milwaukee Retirement System had \$18.2 million invested in the Variable Retirement Trust Fund at June 30, 2003.

Participation in the Variable Retirement Trust Fund is at the option of the employee. Participants have elected to credit one half of their retirement contributions and matching amounts of employer contributions to this fund, and have the remainder credited to the Fixed Retirement Trust Fund. Individual participants in the variable program may elect to terminate their variable participation and transfer their account to the Fixed Retirement Trust Fund.

The Variable Retirement Trust Fund is managed by SWIB with oversight by a Board of Trustees as authorized by Wisconsin Statutes 25.14 and 25.17. It is not registered with the Securities and Exchange Commission. Wisconsin Statute 25.17(5) states assets of the Variable Retirement Trust Fund shall be invested primarily in equity securities which shall include common stocks, real estate or other recognized forms of equities whether or not subject to indebtedness, including securities convertible into common stocks and securities of corporations in the venture capital stage. The Variable Retirement Trust Fund consists primarily of common stock and bonds convertible into common stock, although, because of existing conditions in the securities market, there may temporarily be other types of investments.

## 2. Significant Accounting Policies

### A. Basis of Presentation

The accompanying financial statements were prepared in conformity with generally accepted accounting principles (GAAP) for governments as prescribed by the Governmental Accounting Standards Board (GASB).

### B. Basis of Accounting

The accompanying statements are prepared based upon the flow of economic resources measurement focus and the full accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized in the accounting period in which they are earned and become measurable, and expenses are recognized in the period incurred, if measurable. Security transactions and the related gains and losses are recorded on a trade date basis. Dividend income is recorded on the ex-dividend date, and interest income is accrued as earned.

SWIB applies all applicable GASB pronouncements and those Financial Accounting Standards Board (FASB) pronouncements issued on or before November 30, 1989, which do not conflict with or contradict GASB pronouncements.

### C. Valuation of Securities

The investments of the Fixed Retirement Trust Fund and the Variable Retirement Trust Fund are valued at fair value, per s. 25.17(14), Wis. Stats. Monthly, the investments are adjusted to fair value, with unrealized gains and losses reflected in the Statement of Changes in Net Investment Assets as "Net Increase (Decrease) in Fair Value of Investments."

Generally, fair value is based on quoted market prices but a number of other pricing methods are used for various types of investments.

Mortgages are priced via a matrix pricing system. The traditional discounted cash flow methodology is employed, where discounted rates, based on current yields in the base Treasury, consider factors such as coupon rates, term to maturity, Moody's and S&P ratings, and sector/industry information.

Private placements are priced using a multi-tiered approach, which is discussed further in Note 8.

Limited partnerships' fair value is estimated based on periodic reports from the limited partnerships' management. Annually, the reports are audited by independent auditors.

The basis for valuing real estate is appraisals, which are prepared once every three years. In years when appraisals are not performed the asset managers are responsible for providing market valuations.

A limited number of securities are carried at cost. Certain non-public or closely held stock are not reported at fair value, but are carried at cost since no independent quotation is available to price these securities.

All derivative financial instruments are reported at fair value in the Statement of Net Investment Assets. The instruments are marked to fair value monthly, with valuation changes recognized in income, regardless of whether the instruments are held for hedging or trading purposes. Gains and losses are recorded in the Statement of Changes in Net Investment Assets as "Net Increase (Decrease) in Fair Value of Investments" during the period the instruments are held and when the instrument is sold or expires. The nature and use of derivative instruments is discussed in Note 5.

#### *D. Use of Estimates*

The preparation of financial statements in accordance with GAAP requires management to make estimates that affect amounts reported herein. Due to the inherent uncertainty involved, actual results could differ from those estimates.

### **3. Deposits, Investments, and Securities Lending Transactions**

*Deposits* – GASB Statement 3 requires deposits with financial institutions to be categorized to indicate the level of custodial risk assumed. Bank deposits as of June 30, 2003 were \$123,934,343. A portion of the deposits, totaling \$61,189,613 are covered by federal depository insurance. The remaining uninsured and uncollateralized deposits were held in foreign currencies in SWIB's custodian's nominee name. In addition, SWIB held a number of US denominated time deposits with foreign financial institutions with a fair value of \$214 million, all of which was uncollateralized and uninsured.

*Investments* – The following tables present the investments held by SWIB as of June 30, 2003, categorized to give an indication of the level of risk assumed by SWIB at year-end. The categories are:

1. Insured or registered, or securities which are held by SWIB in SWIB's name or its agent in SWIB's name.
2. Uninsured and unregistered, with the securities held by the counterparty's trust department or agent in SWIB's name.
3. Uninsured and unregistered, with the securities held by the counterparty, or by its trust department or agent, but not in SWIB's name.

Fixed Retirement Trust Fund				
June 30, 2003	Category			Fair and Carrying Value
	1	2	3	
Stocks	\$ 11,633,824,435	\$ 0	\$ 0	\$ 11,633,824,435
Fixed Income	9,307,416,969	0	0	9,307,416,969
Repurchase Agreements	182,724,395	0	0	182,724,395
Bankers Acceptances	47,565,428	0	0	47,565,428
<b>Subtotal</b>	<b>\$ 21,171,531,227</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 21,171,531,227</b>
Limited Partnerships				2,693,112,962
Pooled Multi Asset Fund				284,967,158
Pooled Equities				18,062,658,716
Pooled Bonds				5,260,868,947
Mortgages				726,725,125
Real Estate Owned				436,628,080
State Investment Fund				402,357,469
Pooled Cash and Cash Equivalents				298,970,098
Investments held by broker dealers under securities loans:				
Fixed Income				1,914,874,527
Equities				1,038,232,413
Securities lending cash collateral pooled investments				713,567,812
<b>Total</b>				<b>\$ 53,004,494,534</b>

Variable Retirement Trust Fund				
June 30, 2003	Category			Fair and Carrying Value
	1	2	3	
Stocks	\$ 2,286,602,864	\$ 0	\$ 0	\$ 2,286,602,864
Fixed Income	101,825,370	0	0	101,825,370
Repurchase Agreements	9,329,246	0	0	9,329,246
Bankers Acceptances	2,428,519	0	0	2,428,519
<b>Subtotal</b>	<b>\$ 2,400,185,999</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 2,400,185,999</b>
Pooled Equities				2,495,581,936
State Investment Fund				91,541,884
Pooled Cash and Cash Equivalents				37,063,066
Investments held by broker dealers under securities loans:				
Equities				149,306,309
Securities lending cash collateral pooled investments				36,432,188
<b>Total</b>				<b>\$ 5,210,111,382</b>

Fair value information represents actual bid prices or the quoted yield equivalent at the end of the fiscal year for securities of comparable maturity, quality and type as obtained from one or more major investment brokers. If quoted market prices are not available, a variety of third party pricing methods are used, including appraisals, certifications, pricing models and other methods deemed acceptable by industry standards. See Note 2(C).

#### **4. Securities Lending Transactions**

State statutes and board policies permit SWIB to use investments of the two funds to enter into securities lending transactions. These transactions involve the lending of securities to broker-dealers and other entities for collateral, in the form of cash or securities, with the simultaneous agreement to return the collateral for the same securities in the future. SWIB's securities custodian is an agent in lending the funds' domestic and international securities for collateral of 102 percent and 105 percent, respectively, of the loaned securities' fair value. The cash collateral is reinvested by the lending agent in accordance with contractual investment guidelines which are designed to insure the safety of principal and obtain a moderate rate of return. The investment guidelines include very high credit quality standards and also allow for a portion of the collateral investments to be invested with short-term securities. The earnings generated from the collateral investments, less the amount of rebates paid to the dealers, results in the gross earnings from lending activities, which is then split on a percentage basis with the lending agent.

Securities on loan at June 30, 2003 are presented as unclassified in the preceding schedule of custodial risk. At year end, SWIB had no credit risk exposure to borrowers because the amounts SWIB owed the borrowers exceeded the amounts that the borrowers owed SWIB. The contract with the lending agent requires them to indemnify SWIB if the borrowers fail to return the loaned securities and the collateral is inadequate to replace the securities lent.

The majority of securities loans can be terminated on demand by SWIB or the borrower, although the average term of the loans is approximately one week. The term to maturity of the securities loans is somewhat shorter than the weighted average maturity of 22 days for investments made with the cash collateral.

The ability to pledge or sell collateral securities cannot be made without a borrower default. In addition, no restrictions on the amount of loans exist.

SWIB also earns securities lending income as part of total net earnings from the investment in several commingled funds. These earnings are automatically reinvested in the commingled fund and as a result the earnings are combined with all other earnings, and gains and losses for these funds and reported in the Statement of Changes in Net Investment Assets as "Net Increase (Decrease) in the Fair Value of Investments." The securities lending income earned on the commingled funds totaled \$9.1 million for the fiscal year ended June 30, 2003.

#### **5. Derivative Financial Instruments**

##### *A. Foreign Currency Forwards and Options*

SWIB's derivative activities primarily involve forward contracts and foreign currency options. Generally foreign currency forwards and options are held to hedge foreign exchange risk. Market risk is controlled by holding substantially offsetting purchase and sell positions. At June 30, 2003 the fair value of foreign currency forward contract assets totaled \$1.230 billion, while the liabilities totaled \$1.227 billion.

### *B. Futures Contracts*

One outside investment manager has used futures contracts to manage its exposure to the stock market during the fiscal years presented. This manager is authorized to utilize futures up to 25% of the fair value of the portfolio. Upon entering into a futures contract, the outside manager is required to deposit with the broker, in SWIB's name, an amount of U.S. government obligations in accordance with the initial margin requirements of the broker. Futures contracts are marked to market daily with gains and losses being recognized. The variation margin is settled daily until the contracts expire or are closed. Futures contracts involve, to varying degrees, risk of loss in excess of the variation margin disclosed in the Statement of Net Investment Assets. Losses may arise from the changes in the value of the underlying instrument, illiquidity in the secondary market for the contracts, or if the counterparties do not perform under the terms of the contract. Futures contracts are valued each day at the settlement price established by the board of trade or exchange on which they are traded. During the fiscal years presented in these financial statements futures contracts have been utilized, but as of June 30, 2003, SWIB held no futures contracts.

### *C. Collateralized Mortgage Obligations*

Collateralized mortgage obligations (CMO's) are bonds that are collateralized by whole loan mortgages, mortgage pass-through securities or stripped mortgage-backed securities. Income is derived from payments and prepayments of principal and interest generated from collateral mortgages. Cash flows are distributed to different investment classes or tranches in accordance with each CMO's established payment order. Some CMO tranches have more stable cash flows relative to changes in interest rates while others are significantly more sensitive to interest rate fluctuations. In a declining interest rate environment, some CMO's may be subject to a reduction in interest payments as a result of prepayments of mortgages which make up the collateral pool. A reduction in interest payments causes a decline in cash flows and thus a decline in the fair value of the security. Rising interest rates may cause an increase in interest payments, thus an increase in fair value of the security. CMO's are held to maximize yields and in part to hedge against a rise in interest rates.

At June 30, 2003 and June 30, 2002, SWIB held CMO's valued at \$90 million and \$374 million, respectively. SWIB holds only high quality, senior tranches, resulting in minimal risks of default and prepayment.

### *D. Principal Only Strips*

Principal only strips are securities that derive cash flow from the payment of principal on underlying debt securities. SWIB holds principal only strips for yield enhancing purposes. The majority of the underlying securities are United States Treasury obligations; therefore the credit risk is low. On the other hand, principal only strips are more volatile in terms of pricing, and thus the market risk is higher than traditional United States Treasury obligations. During fiscal year 2003, principal only strips with a combined total cost of \$376.6 million were sold for a net gain of \$212 million. As of June 30, 2003, and June 30, 2002, SWIB held principal only strips valued at \$337,500 and \$491.5 million, respectively.

## **6. Milwaukee Retirement Systems**

The Milwaukee Retirement Systems (MRS), consisting of two separate funds within the Milwaukee Public School Retirement System, invests in the Fixed and Variable Retirement Trust Funds through the WRS. Since the MRS is a separate legal entity from the WRS, both the Fixed Retirement Trust Fund and the Variable Retirement Trust Fund qualify as external investment trust funds. Participation by the MRS in the Fixed and Variable Retirement Trust Fund is described in the DETF Administrative Code, Chapter 10.12. MRS provides assets to DETF for investment in the Fixed and Variable Retirement Trust Funds which are managed by SWIB. Each month the DETF distributes the pro-rata share of the total Fixed Retirement Trust

Fund's earnings less administrative expenses as well as, the Variable Retirement Trust Fund's earnings less administrative expenses. The MRS accounts are adjusted to fair value and gains/losses are recorded directly in the accounts per DETF Administrative Code 10.12(2). Neither State statute, a legal provision, nor a legally binding guarantee exist to support the value of MRS's portion of the Fixed Retirement Trust Fund or the Variable Retirement Trust Fund.

As of June 30, 2003, the Fixed Retirement Trust Fund held \$49,365 million of investments, as well as, \$3,054 million of securities lending collateral, and the Variable Retirement Trust Fund held \$4,932 million of investments, as well as \$156 million of securities lending collateral. The tables included in Note 3 present investments of the Fixed and Variable Retirement Trust Funds at June 30, 2003, categorized in accordance with the level of risk requirements of GASB Statement No. 3.

The following schedules provide summary information by investment classification for the Fixed Retirement Trust Fund and the Variable Retirement Trust Fund at June 30, 2003.

Fixed Retirement Trust Fund				
June 30, 2003				
Classification	Interest/Coupon Rates	Maturity Dates	Cost	Fair Value
Common and Preferred Stock	N/A	N/A	\$ 31,621,935,365	\$ 30,734,715,564
Fixed Income	Variable and .10 to 24.00	7/03 to 11/49	13,146,466,250	14,489,276,071
Limited Partnerships	N/A	N/A	2,908,360,020	2,693,112,962
Mortgages	6.77 to 12.25	08/04 to 06/22	629,232,196	726,725,125
Real Estate	N/A	N/A	344,553,911	436,628,080
Multi Asset	N/A	N/A	250,000,000	284,967,158
			<u>\$ 48,900,547,742</u>	<u>\$ 49,365,424,960</u>

Variable Retirement Trust Fund				
June 30, 2003				
Classification	Interest/Coupon Rates	Maturity Dates	Cost	Fair Value
Common and Preferred Stock	N/A	N/A	\$ 5,179,165,765	\$ 4,931,491,109
Fixed Income	N/A	10/03	24,856	24,856
			<u>\$ 5,179,190,621</u>	<u>\$ 4,931,515,965</u>

## 7. Unfunded Capital Commitments

Partnership agreements generally set a limit on the total dollar amount that limited partners must commit to funding when entering the partnership. Over the life of the partnership, the general partner will request capital contributions totaling the agreed upon limit. As of June 30, 2003, unfunded capital commitments totaled \$1.5 billion.



## 8. Private Placements Pricing Method Change

During the fiscal year ended June 30, 2002, SWIB completed a review of valuation practices for the private placement portfolios. Since quoted market prices are not available for a substantial portion of these assets, fair values are typically estimated by investors or broker/dealers using financial models or evaluations based on security and market characteristics.

Prior to April 2002, SWIB utilized a financial model to calculate the fair value of assets held in the private placement portfolios. A matrix model from CMS BondEdge provided prices based on corporate yield spread over treasury securities with comparable durations. The spread was based on a matrix of factors including credit rating, sector, average life or cashflow and any call features.

Since that time, SWIB has moved to a multi-tiered method of pricing assets held in private placement portfolios. The method prices each holding based on the best available information using the following hierarchy of pricing sources:

1. Custodian supplied prices for assets that are in the Lehman Aggregate Bond Index
2. Prices provided by a contracted third party with expertise in the bond market
3. Modeled prices utilizing CMS BondEdge where spreads are supplied by the same contracted third party

In a few instances securities cannot be priced by one of the above three sources. In these circumstances the investment is priced using an alternative bond index price or if no independent quotation exists, the investment is priced by SWIB management, usually at cost.

The change in methods of estimating fair values for the private placement portfolios resulted in a net decrease of \$167.1 million in fiscal year 2002. The new valuation method is more conservative in that it recognizes the investment return gradually over the life of the investment. The valuation process does not, however, alter the expected receipt of coupon and final principal, or alter the security's economic value or risk of default to SWIB. The adjustment in fair value is presented in the financial statements in the Statement of Net Investment Assets as a reduction to "Fixed Income," and in the Statement of Changes in Net Investment Assets as a decrease to "Net Increase (Decrease) in Fair Value of Investments."





# State of Wisconsin \ LEGISLATIVE AUDIT BUREAU

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## INDEPENDENT AUDITOR'S REPORT

Senator Carol Roessler and  
Representative Suzanne Jeskewitz, Co-chairpersons  
Joint Legislative Audit Committee

Members of the Board of Trustees and  
Ms. Patricia Lipton, Executive Director  
State of Wisconsin Investment Board

We have audited the accompanying Statements of Net Investment Assets for the Various Funds (Local Government Property Insurance Fund, State Life Insurance Fund, Patients Compensation Fund, Historical Society Trust Fund, EdVest Tuition Trust Fund, and Tobacco Permanent Endowment Fund) of the State of Wisconsin as of June 30, 2003 and 2002, and the related Statements of Changes in Net Investment Assets for the years then ended. These financial statements are the responsibility of the State of Wisconsin Investment Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the investment activity of the Various Funds attributable to the transactions of the State of Wisconsin Investment Board. The financial statements do not purport to, and do not, present the financial activity of the Various Funds attributable to other state agencies. Further, they do not purport to, and do not, fairly present the financial position and results of operations of the Investment Board or of the State of Wisconsin in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the net investment assets of the Various Funds as of June 30, 2003 and 2002, and the changes in net investment assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As explained in Note 2, the financial statements include investments that do not have readily ascertainable market prices and are valued based on a variety of third-party pricing methods. We have reviewed the procedures used by the Investment Board in arriving at estimates of the values

of such investments and have inspected underlying documentation, and, given the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ from the values that would have been used had a ready market for the investments existed.

As discussed in Note 5, during fiscal year 2001-02, the Investment Board changed the method by which it estimates fair values for its private placement portfolios. The new valuation method resulted in a net decrease in value of \$0.9 million in the State Life Insurance Fund during the fiscal year because it recognizes the investment return more gradually over the life of the investment than the previous method had.

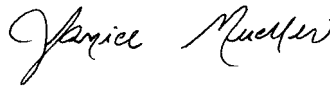
Our audits were conducted for the purpose of forming an opinion on the financial statements of the Various Funds of the State of Wisconsin. The Management's Discussion and Analysis preceding the financial statements is presented for purposes of additional analysis and supplementary information and is not a required part of the financial statements referred to in the first paragraph. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it. The introduction section of the annual report was not audited by us and, accordingly, we express no opinion on it.

In accordance with *Government Auditing Standards*, we will also issue a report dated November 24, 2003, on our consideration of the Investment Board's internal control over financial reporting and our tests of its compliance with certain provisions of laws and regulations. That report, which will be included in a management letter to the Investment Board, is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

LEGISLATIVE AUDIT BUREAU

November 24, 2003

by



Janice Mueller  
State Auditor

Management Discussion and Analysis provides general information on the investment financial activities of the Various Funds. The State of Wisconsin Investment Board (SWIB) has exclusive control of the investment and collection of principal, interest, and dividends of all monies invested of the Local Government Property Insurance Fund (LGPIF), State Life Insurance Fund (SLIF), Patients Compensation Fund (PCF), Historical Society Trust Fund, EdVest Tuition Trust Fund (EdVest), and Tobacco Permanent Endowment Fund (Tobacco).

Following this section are the financial statements and footnotes. The Statement of Net Assets provides information on the types of investments and the liabilities of the Various Funds. The Statement of Operations and Changes in Net Assets provides information on the investment income of the Various Funds and their net assets at year-end. The Notes to the Financial Statements provide additional information that is essential to a full understanding of the data provided in the fund financial statements. Condensed Various Funds financial information for the fiscal years ended June 30, 2003 and 2002 is as follows:

Various Funds Condensed Financial Information			
Fiscal Year Ended:	2003	2002	% Change
<u>Net Assets:</u>			
Local Govt Property Ins Fund	\$ 24,115,262	\$ 27,779,712	(13.2%)
State Life Insurance Fund	82,212,946	73,123,968	12.4%
Patients Compensation Fund	665,963,611	588,346,567	13.2%
Historical Society Trust Fund	9,905,909	10,019,995	(1.1%)
EdVest Tuition Trust Fund	13,392,180	14,770,185	(9.3%)
Tobacco Permanent Endowment	0	595,154,873	(100.0%)
<u>Net Investment Income:</u>			
Local Govt Property Ins Fund	\$ 922,416	\$ 1,685,402	(45.3%)
State Life Insurance Fund	11,825,253	4,634,174	155.2%
Patients Compensation Fund	74,522,263	21,021,991	254.5%
Historical Society Trust Fund	507,307	(925,730)	154.8%
EdVest Tuition Trust Fund	2,110,768	1,099,900	91.9%
Tobacco Permanent Endowment	3,353,278	1,152,473	191.0%

Changes in the Net Assets of the Various Funds were relatively small, except for the Tobacco Permanent Endowment Fund, which in November 2002, used its net assets to make State of Wisconsin shared revenue payments to county and municipal governments, as authorized by Wisconsin Statute 20.855(4)(rb).

Net Investment Income was lower in the Local Government Property Insurance Fund due to higher coupon bonds maturing and not being replaced and it was significantly higher in the other Various Funds primarily due to increases in the fair value of bonds as a result of falling interest rates. In addition, the Patients Compensation Fund held two indexed stock funds, representing 11.9% of net assets, which experienced a \$9.5 million unrealized increase in fair value over the prior year.

# VARIOUS FUNDS

## Statement of Net Investment Assets

### June 30, 2003

	Local Gov't. Property Ins. Fund	State Life Insurance Fund	Patients Compensation Fund	Historical Society Trust Fund	EdVest Tuition Trust Fund	Tobacco Permanent Endowment Fund
<b>Assets</b>						
Cash and Cash Equivalents	\$ 11,440,713	\$ 3,787,759	\$ 4,774,598	\$ 111,103	\$ 35,564	\$ 0
Receivables						
Investment Income Receivable	256,654	1,204,665	8,404,308	141	67,653	0
Investment Sales Receivable	0	7,236	0	0	0	0
Investments						
Fixed Income	12,417,895	77,213,286	573,861,350	3,423,937	13,288,963	0
Stocks	0	0	78,927,021	6,371,132	0	0
<b>Total Investment Assets</b>	<b>\$ 24,115,262</b>	<b>\$ 82,212,946</b>	<b>\$ 665,967,277</b>	<b>\$ 9,906,313</b>	<b>\$ 13,392,180</b>	<b>\$ 0</b>
<b>Liabilities</b>						
Payables	0	0	3,666	404	0	0
Due to Other Funds	0	0	0	0	0	0
<b>Total Liabilities</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 3,666</b>	<b>404</b>	<b>\$ 0</b>	<b>\$ 0</b>
<b>Net Investment Assets</b>	<b>\$ 24,115,262</b>	<b>\$ 82,212,946</b>	<b>\$ 665,963,611</b>	<b>\$ 9,905,909</b>	<b>\$ 13,392,180</b>	<b>\$ 0</b>

The accompanying notes, on pages 49 through 53, are an integral part of this document.

# VARIOUS FUNDS

## Statement of Changes in Net Investment Assets

### For the Fiscal Year Ended June 30, 2003

	Local Gov't. Property Ins. Fund	State Life Insurance Fund	Patients Compensation Fund	Historical Society Trust Fund	EdVest Tuition Trust Fund	Tobacco Permanent Endowment Fund
<b>From Investment Activities:</b>						
Investment Income						
Net Increase (Decrease) in Fair Value of Investments	\$ (18,490)	\$ 7,290,460	\$ 44,810,991	\$ 524,885	\$ 1,271,297	\$ 0
Interest	944,310	4,540,691	29,747,742	2,191	839,471	3,353,278
Dividends	0	0	0	0	0	0
Investment Expenses	(3,404)	(5,898)	(36,470)	(19,769)	0	0
Increase (Decrease) in Net Investments Derived from Investment Activities	\$ 922,416	\$ 11,825,253	\$ 74,522,263	\$ 507,307	\$ 2,110,768	\$ 3,353,278
<b>From Participant Transactions:</b>						
Net Receipts (Disbursements) - Non-Investment Activity	(4,586,866)	(2,736,275)	3,094,781	(621,393)	(3,488,773)	(598,508,151)
Net Increase (Decrease) in Net Investment Assets	\$ (3,664,450)	\$ 9,088,978	\$ 77,617,044	\$ (114,086)	\$ (1,378,005)	\$ (595,154,873)
<b>Net Investment Assets</b>						
Beginning of Period	27,779,712	73,123,968	588,346,567	10,019,995	14,770,185	595,154,873
End of Period	<b>\$ 24,115,262</b>	<b>\$ 82,212,946</b>	<b>\$ 665,963,611</b>	<b>\$ 9,905,909</b>	<b>\$ 13,392,180</b>	<b>\$ 0</b>

The accompanying notes, on pages 49 through 53, are an integral part of this document.

# VARIOUS FUNDS

## Statement of Net Investment Assets

### June 30, 2002

	Local Gov't. Property Ins. Fund	State Life Insurance Fund	Patients Compensation Fund	Historical Society Trust Fund	EdVest Tuition Trust Fund	Tobacco Permanent Endowment Fund
<b>Assets</b>						
Cash and Cash Equivalents	\$ 11,999,450	\$ 3,294,757	\$ 16,899,604	\$ 144,162	\$ 2,840,102	\$ 826,154,873
Receivables						
Investment Income Receivable	327,108	1,228,801	10,545,737	8,624	147,455	0
Investment Sales Receivable	0	3,743,016	0	0	0	0
Investments						
Fixed Income	15,453,404	68,578,641	491,523,086	3,722,504	11,782,628	0
Stocks	0	0	69,383,719	6,145,231	0	0
<b>Total Investment Assets</b>	<b>\$ 27,779,962</b>	<b>\$ 76,845,215</b>	<b>\$ 588,352,146</b>	<b>\$ 10,020,521</b>	<b>\$ 14,770,185</b>	<b>\$ 826,154,873</b>
<b>Liabilities</b>						
Payables	250	3,721,247	5,579	526	0	0
Due to Other Funds	0	0	0	0	0	231,000,000
<b>Total Liabilities</b>	<b>\$ 250</b>	<b>\$ 3,721,247</b>	<b>\$ 5,579</b>	<b>\$ 526</b>	<b>\$ 0</b>	<b>\$ 231,000,000</b>
<b>Net Investment Assets</b>	<b>\$ 27,779,712</b>	<b>\$ 73,123,968</b>	<b>\$ 588,346,567</b>	<b>\$ 10,019,995</b>	<b>\$ 14,770,185</b>	<b>\$ 595,154,873</b>

The accompanying notes, on pages 49 through 53, are an integral part of this document.

# VARIOUS FUNDS

## Statement of Changes in Net Investment Assets

### For the Fiscal Year Ended June 30, 2002

	Local Gov't. Property Ins. Fund	State Life Insurance Fund	Patients Compensation Fund	Historical Society Trust Fund	EdVest Tuition Trust Fund	Tobacco Permanent Endowment Fund
<b>From Investment Activities:</b>						
Investment Income						
Net Increase (Decrease) in Fair Value of Investments	\$ 295,716	\$ (93,576)	\$ (11,585,648)	\$ (1,225,665)	\$ 275,251	\$ 0
Interest	1,393,156	4,745,298	32,652,621	239,700	824,649	1,152,473
Dividends	0	0	0	68,221	0	0
Investment Expenses	(3,470)	(17,548)	(44,982)	(7,986)	0	0
Increase (Decrease) in Net Investments Derived from Investment Activities	\$ 1,685,402	\$ 4,634,174	\$ 21,021,991	\$ (925,730)	\$ 1,099,900	\$ 1,152,473
<b>From Participant Transactions:</b>						
Net Receipts (Disbursements) - Non-Investment Activity	(5,149,755)	(2,656,296)	(8,743,832)	(474,150)	3,841,722	594,002,400
Net Increase (Decrease) in Net Investment Assets	\$ (3,464,353)	\$ 1,977,878	\$ 12,278,159	\$ (1,399,880)	\$ 4,941,622	\$ 595,154,873
<b>Net Investment Assets</b>						
Beginning of Period	31,244,065	71,146,090	576,068,408	11,419,875	9,828,563	0
End of Period	<b>\$ 27,779,712</b>	<b>\$ 73,123,968</b>	<b>\$ 588,346,567</b>	<b>\$ 10,019,995</b>	<b>\$ 14,770,185</b>	<b>\$ 595,154,873</b>

The accompanying notes, on pages 49 through 53, are an integral part of this document.

## 1. Description of Funds

The State of Wisconsin Investment Board (SWIB) has exclusive control of the investment and collection of principal, interest, and dividends of all monies invested of the Local Government Property Insurance Fund, State Life Insurance Fund, Patients Compensation Fund, Historical Society Trust Fund, EdVest Tuition Trust Fund, and Tobacco Permanent Endowment Fund (collectively known as the "Various Funds"). The schedules presented here reflect only the investment activity of the Various Funds. Excluded from the presentation in the schedules are, for example, claim reserves, reserves for life policies and contracts, contribution revenue, premiums earned, benefit expense, and expenditures from endowment income. Also excluded from the statements are SWIB's administrative receipts and disbursements related to the investment function.

The State Investment Fund (SIF) is used to invest idle cash of the Various Funds, except for the Tobacco Permanent Endowment Fund. The State of Wisconsin Investment Board manages the SIF with oversight by a Board of Trustees, as authorized in Wisconsin Statutes 25.14 and 25.17. It is not registered with the Securities and Exchange Commission (SEC) as an investment company.

### *A. Local Government Property Insurance Fund*

The Local Government Property Insurance Fund (LGPIF) provides property insurance protection to local government units on an optional basis. The Office of the Commissioner of Insurance (OCI) is responsible for administering the operations of the LGPIF, while SWIB performs the investment activities for the fund. SWIB's investment objective is to maintain a high quality portfolio that provides for a high degree of liquidity, a relatively moderate degree of risk, and a high rate of return consistent with the priorities of liquidity and protection of principal. Wisconsin Statute 25.17(3)(b) allows investments in direct obligations of the United States and Canada, securities guaranteed by the United States, unsecured notes of financial and industrial issuers, Yankee/Euro dollar issues, certificates of deposit issued by banks in the United States, and solvent financial institutions in this state.

### *B. State Life Insurance Fund*

The State Life Insurance Fund (SLIF) offers low cost life insurance protection to Wisconsin residents in amounts up to \$10,000 per person. The Office of the Commissioner of Insurance is responsible for administering the operations of the SLIF. SWIB's investment objective is to maintain a diversified portfolio of high quality income obligations that will preserve principal, maximize income while minimizing costs to policyholders, and approximate the expected life of the Fund's insurance contracts. Wisconsin Statute 25.17(3)(a) allows investments in loans, securities and any other investments as authorized by s. 620.22, Wis. Stats. Permitted classes of investments include bonds of government units or of private corporations, loans secured by mortgages, preferred or common stocks, real property and other investments not specifically prohibited by statute.

### *C. Patients Compensation Fund*

The Patients Compensation Fund (PCF) provides medical malpractice insurance protection to health care providers permanently practicing or operating in Wisconsin. The Office of the Commissioner of Insurance is responsible for administering the operations of the PCF. Since September 1990, SWIB has been responsible for investing the securities held by this Fund. SWIB's investment objective is to maintain a portfolio of investments with maturities and liquidity levels that are appropriate for the needs of the PCF. Wisconsin Statute 25.17(3)(a) allows investments in loans, securities and any other investments as authorized by s. 620.22, Wis. Stats. Permitted classes of investments include bonds of governmental units or of private corporations, loans secured by mortgages, preferred or common stock, real property and other investments not specifically prohibited by statute.

### *D. Historical Society Trust Fund*

The State Historical Society of Wisconsin collects and preserves historical and cultural resources relating to the history of Wisconsin and the western United States, conducts historical research, facilitates and encourages education in Wisconsin history, and serves as the Trustee of the State for the preservation and

care of government records. In addition to state and federal funds, the Historical Society receives gifts, grants, and bequests to assist it in carrying out its mission. The gifts, grants and bequests are deposited into the Historical Society Trust Fund. SWIB is responsible for managing and supervising the fund's investments. Any income earned, except where reinvestment is required by the terms of the gift or bequest, may be expended by the Historical Society in accordance with provisions of the gift, grant or bequest. The Historical Society funds available for investment are authorized to be invested in "every kind of property, real, personal or mixed, and every kind of investment, specifically including but not by the way of limitation, bonds, debentures, and other corporate obligations, stocks, preferred or common, and shares of investment companies and investment trusts, which persons of prudence, discretion, and intelligence acquire or retain for their own account."

#### *E. EdVest Tuition Trust Fund*

The EdVest Wisconsin program offers families a way to prepare for future higher education costs through the purchase of tuition units. These units, plus investment earnings, are expected to equal one percent of the projected average annual cost of tuition at University of Wisconsin campuses in the year of their use. The Office of State Treasurer is responsible for the administration of the EdVest Wisconsin program. Wisconsin Statute 14.63(10)(b) directs SWIB to invest moneys held in the Tuition Trust Fund in investments with maturities and liquidity that are appropriate for the needs of the fund as reported by the State Treasurer in his or her quarterly reports. All income derived from such investments shall be credited to the fund.

#### *F. Tobacco Permanent Endowment Fund*

The Tobacco Permanent Endowment Fund was established as a separate non-lapsable trust fund consisting of all of the proceeds from the sale of the state's right to receive payments under the Attorneys General Master Tobacco Settlement Agreement of November 23, 1998 and all investment earnings on the proceeds. Wisconsin Statute 25.18(1)(o) authorizes SWIB to invest the assets of the Tobacco Permanent Endowment Fund in any investment that is an authorized investment for assets in the Fixed or Variable Retirement Trust Fund. All assets were expended during the fiscal year ended June 30, 2003.

## **2. Significant Accounting Policies**

### *A. Basis of Presentation*

The accompanying financial statements of the investment activity of the Various Funds are prepared in accordance with generally accepted accounting principles (GAAP) for governments as prescribed by the Governmental Accounting Standards Board (GASB).

The Local Government Property Insurance Fund, the State Life Insurance Fund, and the Patients Compensation Fund operate similar to insurance enterprises and are reported by the State as proprietary funds. In reporting the investment activity of proprietary funds, SWIB applies all applicable GASB pronouncements and those Financial Accounting Standards Board (FASB) pronouncements issued on or before November 30, 1989, which do not conflict with or contradict GASB pronouncements. The Historical Society Trust Fund and the Tobacco Permanent Endowment Fund are reported by the State as governmental funds and the EdVest Tuition Trust Fund is reported by the State as a fiduciary fund.

### *B. Basis of Accounting*

The accompanying statements are prepared based upon the flow of economic resources measurement focus and the full accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized in the accounting period in which they are earned and become measurable, and expenses are recognized in the period incurred, if measurable. Security transactions and the related gains and losses are recorded on a trade date basis. Dividend income is recorded on the ex-dividend date, and interest income is accrued as earned.

### *C. Valuation of Securities*



As required by Governmental Accounting Standards Board Statement No. 31, the investments of the Various Funds are valued at fair value, with unrealized gains and losses reflected in the Statement of Changes in Net Investment Assets as "Net Increase (Decrease) in Fair Value of Investments."

Generally, fair value is based on quoted market prices. Private placements are priced via a multi-tiered method. This method prices each holding based on the best available information using a hierarchy of pricing sources (See Note 5).

#### *D. Use of Estimates*

The preparation of financial statements in accordance with GAAP requires management to make estimates that affect amounts reported herein. Due to the inherent uncertainty involved, actual results could differ from those estimates.

### 3. Deposits and Investments

*Deposits* – Governmental Accounting Standards Board Statement No. 3 requires deposits with financial institutions to be categorized to indicate the level of risk assumed. Deposits, as of June 30, 2003, included \$4,438 deposited in a single financial institution in the State Treasury account covered by federal depository insurance.

*Investments* – The following table presents investments held as of June 30, 2003, categorized to give an indication of the level of risk assumed by the Funds at year-end. The categories are as follows:

1. Insured or registered, or securities held by a Fund in the Fund's name or its agent in the Fund's name.
2. Uninsured and unregistered, with the securities held by the counterparty's trust department or agent in the Fund's name.
3. Uninsured and unregistered, with the securities held by the counterparty, or by its trust department or agent, but not in the Fund's name.

Securities Categorized by Level of Risk				
	Category			Fair and Carrying Value
	1	2	3	
Fixed Income	\$ 680,205,431	\$ 0	\$ 0	\$ 680,205,431
Stocks	85,298,153	0	0	85,298,153
<b>Subtotal</b>	<b>\$ 765,503,584</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 765,503,584</b>
Pooled Cash and Equivalents				0
State Investment Fund				20,145,299
<b>Total</b>				<b>\$ 785,648,883</b>

### 4. Derivative Financial Instruments

#### *A. Collateralized Mortgage Obligations*

Collateralized mortgage obligations (CMO's) are bonds that are collateralized by whole loan mortgages, mortgage pass-through securities or stripped mortgage-backed securities. Income is derived from payments and prepayments of principal and interest generated from collateral mortgages. Cash flows are distributed to different investment classes or tranches in accordance with each CMO's established payment order.



Some CMO tranches have more stable cash flows relative to changes in interest rates while others are significantly more sensitive to interest rate fluctuations. In a declining interest rate environment, some CMO's may be subject to a reduction in interest payments as a result of prepayments of mortgages, which make up the collateral pool. A reduction in interest payments causes a decline in cash flows and thus a decline in the fair value of the security. Rising interest rates may cause an increase in interest payments, thus an increase in fair value of the security. CMO's are held to maximize yields and in part to hedge against a rise in interest rates.

As of June 30, 2003 and 2002, the State Life Insurance Fund held a CMO valued at \$7,540 and \$20,409, representing approximately 0.01% and 0.04% of portfolio assets, respectively. The SLIF holds only high quality, senior tranches, resulting in minimal risks of default and prepayment.

#### *B. Principal Only Strips*

Principal only strips are securities that derive cash flow from the payment of principal on underlying debt securities. The Various Funds hold several principal only strips for yield enhancing purposes. The majority of the underlying securities are United States Treasury obligations; therefore the credit risk is low. On the other hand, principal only strips are more volatile in terms of pricing, and thus the market risk is higher than traditional United States Treasury obligations.

As of June 30, 2003 and 2002, the EdVest Tuition Trust Fund held principal only strips valued at \$9.7 and \$8.4 million, representing approximately 73.0% and 71.7% of portfolio assets, respectively. As of June 30, 2002, the Patients Compensation Fund held a principal only strip valued at \$15.5 million, representing approximately 2.8% of portfolio assets.

### **5. Private Placements Pricing Method Change**

During the fiscal year ended June 30, 2002, SWIB completed a review of valuation practices for private placements. Since quoted market prices are not available for a substantial portion of these assets, fair values are typically estimated by investors or broker/dealers using financial models or evaluations based on security and market characteristics.

Prior to April 2002, SWIB utilized a financial model to calculate the fair value of private placements. A matrix model from CMS BondEdge provided prices based on corporate yield spread over treasury securities with comparable durations. The spread was based on a matrix of factors including credit rating, sector, average life or cash flow and any call features.

Since that time, SWIB has moved to a multi-tiered method of pricing private placements. The method prices each holding based on the best available information using the following hierarchy of pricing sources:

1. Custodian supplied prices for assets that are in the Lehman Aggregate Bond Index.
2. Prices provided by a contracted third party with expertise in the bond market.
3. Modeled prices utilizing CMS BondEdge where spreads are supplied by the same contracted third party.

In a few instances securities cannot be priced by one of the above three sources. In these circumstances the investment is priced using an alternative bond index or if no independent quotation exists, the investment is priced by SWIB management, usually at cost.

The change in methods of estimating fair values for private placements resulted in a net decrease of \$0.9 million in fiscal year 2002 in the State Life Insurance Fund. The adjustment in fair value is presented in the financial statements in the Statement of Net Investment Assets as a reduction to "Fixed Income," and in the Statement of Changes in Net Investment Assets as a decrease to "Net Increase (Decrease) in Fair Value of Investments."