

# REPORT DIGEST

## TEACHERS' RETIREMENT SYSTEM

### COMPLIANCE AUDIT

For the Year Ended:  
June 30, 1997

#### Summary of Findings:

Total this audit	2
Total last audit	2
Repeated from last audit	0

Release Date:



State of Illinois  
Office of the Auditor General

**WILLIAM G. HOLLAND**  
AUDITOR GENERAL

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### SYNOPSIS

- ◆ The System failed to properly calculate investment manager fees in accordance with contractual terms. We identified an instance where the System calculated an investment manager's fee incorrectly. The error resulted in an overpayment of \$11,489.

In addition, the System's internal auditor examined 35 additional management fee calculations during the fiscal year and noted three fees were incorrectly calculated. These three incorrectly calculated fees resulted in cumulative overpayments of \$713,604.

- ◆ The System decided to conclude its risk management overlay program in November 1996, and terminated its contract with its former Chief Investment Officer.

{Financial Data and Activity Measures are summarized on the reverse page.}

**TEACHERS' RETIREMENT SYSTEM OF ILLINOIS**  
**INFORMATION FROM FINANCIAL AND COMPLIANCE AUDITS**  
**YEAR ENDED JUNE 30, 1997**

<b>OPERATING STATEMENT ANALYSIS</b>	<b>FY 1997</b>	<b>FY 1996</b>
Revenues:		
Contributions - Members.....	\$ 416,739,369	\$ 399,084,381
Contributions - State of Illinois.....	385,129,987	330,073,976
Contributions - School Districts.....	36,049,201	59,291,489
Total Contributions.....	<u>\$ 837,918,557</u>	<u>\$ 788,449,846</u>
Investment Income - Net Appreciation in Fair Value.....	1,929,166,394	1,355,250,868
Investment Income - Income From Investments.....	859,322,775	850,754,198
Total Investment Income.....	2,788,489,169	2,206,005,066
Investment Expense.....	(143,862,693)	(110,089,834)
Total Revenues.....	<u>\$3,482,545,033</u>	<u>\$2,884,365,078</u>
Expenses:		
Total Benefits.....	\$1,160,917,183	\$1,121,593,949
Other Expenses.....	32,446,824	33,122,599
Total Expenses.....	<u>\$1,193,364,007</u>	<u>\$1,154,716,548</u>
Revenues in Excess of Expenses.....	<u>\$2,289,181,026</u>	<u>\$1,729,648,530</u>
<b>INVESTMENT PORTFOLIO ANALYSIS - Fair Value</b>	<b>JUNE 30, 1997</b>	<b>JUNE 30, 1996</b>
Total Government Obligations.....	\$2,718,749,692	\$ 2,534,531,640
Total Corporate Obligations.....	1,718,215,909	1,890,646,368
International Notes.....	1,317,103,023	1,209,308,337
Preferred Stock (U.S. & International Combined).....	106,809,956	49,911,072
Common Stock - U.S.....	5,498,625,628	4,652,473,730
Common Stock - International.....	1,736,440,411	1,517,675,938
Short Term Investments.....	2,213,381,354	1,092,509,094
Real Estate Investments.....	2,348,125,078	2,221,387,769
Alternative Investments.....	364,577,923	195,765,872
Currency Investment.....	69,333,815	50,156,459
Total Investment Portfolio.....	<u>\$18,091,362,789</u>	<u>\$15,414,366,279</u>
<b>ADMINISTRATIVE EXPENSES</b>	<b>FY 1997</b>	<b>FY 1996</b>
Personal Services.....	\$ 7,617,459	\$7,205,149
Professional Services.....	543,217	613,801
Postage.....	374,413	307,589
Machine Repair and Rental.....	261,311	267,877
Other Contractual Services.....	525,198	459,959
Commodities.....	226,453	235,657
Occupancy Expense.....	240,032	393,039
Provision for Depreciation.....	532,828	545,580
Total Administrative Expenses.....	<u>\$10,320,911</u>	<u>\$ 10,028,651</u>
<b>SELECTED ACCOUNT BALANCES</b>	<b>JUNE 30, 1997</b>	<b>JUNE 30, 1996</b>
Cash.....	\$ 6,706,525	\$ 4,057,245
Receivables.....	230,947,823	336,452,411
Accrued Investment Income Receivable.....	228,713,016	212,281,126
Investments, at cost.....	17,862,649,773	15,202,085,153
Collateral from Securities Lending.....	1,349,674,873	1,518,696,814
Prepaid Expenses.....	701,819	-
Property and Equipment.....	3,426,543	3,755,982
Total Assets.....	<u>\$19,682,820,372</u>	<u>\$17,277,328,731</u>
Total Liabilities.....	2,289,712,457	2,173,401,842
Net Assets Held in Trust for Pension Benefits.....	\$17,393,107,915	\$15,103,926,889
Actuarial Accrued Liability.....	26,951,585,000	26,141,794,000
Unfunded Actuarial Accrued Liability.....	<u>\$(9,558,477,085)</u>	<u>\$(11,037,867,111)</u>
<b>SUPPLEMENTARY INFORMATION</b>	<b>FY 1997</b>	<b>FY 1996</b>
Total investment manager fees.....	\$65,217,816	\$62,982,366
Total time weighted return on investments.....	18.3%	16.9%
Average Number of System Employees.....	156	156
Number of Retirement Annuitants.....	51,955	52,532
Number of Survivor Benefit Annuitants.....	6,449	6,240
Number of Disability Benefit Recipients.....	948	892
<b>EXECUTIVE DIRECTOR</b>		
During Audit Period: Mr. Robert Daniels through August 15, 1997		
Currently: Mr. John Day, Interim Executive Director, effective August 18, 1997		

## **INTRODUCTION**

This digest covers our State compliance audit of the System for the year ended June 30, 1997. A financial audit covering the year ended June 30, 1997 is issued under a separate cover.

## **FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS**

### **INCORRECT INVESTMENT MANAGER FEES**

The System failed to ensure investment manager fees were properly calculated in accordance with contractual terms. The System contracts with investment management companies for portfolio management services. We reviewed 15 investment manager quarterly fee calculations totaling \$6,371,012, noting one quarterly fee was incorrectly calculated, resulting in an overpayment of \$11,489.

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**Investment manager was overpaid \$11,489**

In addition, the System's internal auditor examined 35 additional management fee calculations during the fiscal year and noted three fees were incorrectly calculated. These three incorrectly calculated fees resulted in cumulative overpayments of \$713,604.

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**Internal auditor identified \$713,604 in overpayments**

Sound internal controls require that payments be made according to contractual terms and should only be for services received and benefits derived. The System's current process puts it at risk of making overpayments when compensating their investment managers. (Finding 2, page 15)

We recommended the System:

- Calculate all fees in accordance with the terms and conditions of the investment management agreements;
- Standardize the manager fee payment process;
- Design spreadsheets to facilitate the review and recalculation process;
- Show all the necessary calculations on the face of the spreadsheet;
- Document reviews, recalculations and benchmark confirmations to ensure they are proper and timely.

## **OTHER FINDING**

The remaining finding was less significant and the System's response indicates that it is addressing the condition. We will review the System's progress in implementing our recommendations in our next audit.

Mr. John Bauman, Chief Operating Officer, provided responses to our recommendations on January 12, 1998.

## **RELATED TRANSACTION**

On September 1, 1994, the System entered into a contract with Zimmerman Investment Management Company (ZIMCO). The president of ZIMCO is the former Chief Investment Officer of the System who resigned his position effective August 31, 1994. While employed by the System, the former Chief Investment Officer was responsible for overseeing the entire System investment program, including development of currency hedging and risk management overlay programs which were managed "in-house." The fiscal year 1995 and 1996 audits disclosed this related transaction.

The System paid ZIMCO approximately \$872,000 in FY97, \$2.9 million in FY96 and \$2.5 million in FY95. During this time, ZIMCO was responsible for hedging domestic equity, domestic fixed income and international equity investments. In addition, ZIMCO ran a currency overlay program and an enhanced equity index program.

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**The System concluded its risk management program in November 1996. The System terminated its contract with ZIMCO on November 15, 1997.**

The services ZIMCO provided to the System during fiscal year 1997 involved hedging domestic equity and international equity portfolios. The System decided to conclude its risk management overlay program in November 1996, at the recommendation of its external investment consultant. The System terminated its contract with ZIMCO on November 15, 1996. According to

information provided by the System, losses on the three programs managed by ZIMCO during FY97 totaled \$33,796,000. This figure is derived from the information on page 52 of the report.

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WILLIAM G. HOLLAND, Auditor General

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**SPECIAL ASSISTANT AUDITORS**

KPMG Peat Marwick, LLP were our special assistant auditors for this audit.

