

PERFORMANCE AUDIT REPORT

Kansas Public Employees Retirement System: An Overview of Investment Manager Compensation Practices

**A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
June 1991**

Legislative Post Audit Committee

Legislative Division of Post Audit

THE LEGISLATIVE POST Audit Committee and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about \$6 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of governmental agencies. The audit work performed by Legislative Post Audit helps provide that information.

We conduct our audit work in accordance with applicable government auditing standards set forth by the U.S. General Accounting Office. These standards pertain to the auditor's professional qualifications, the quality of the audit work, and the characteristics of professional and meaningful reports. The standards also have been endorsed by the American Institute of Certified Public Accountants and adopted by the Legislative Post Audit Committee.

The Legislative Post Audit Committee is a bipartisan committee comprising five senators and five representatives. Of the Senate members, three are appointed by the President of the Senate and two are appointed by the Senate Minority Leader. Of the Representatives, three are appointed by the Speaker of the House and two are appointed by the Minority Leader.

Audits are performed at the direction of the Legislative Post Audit Committee. Legislators or

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PERFORMANCE AUDIT REPORT

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM: AN OVERVIEW OF INVESTMENT MANAGER COMPENSATION PRACTICES

OBTAINING AUDIT INFORMATION

This audit was conducted by Mary Beth Green, Senior Auditor, Randy Tongier, Financial-Compliance Audit Manager, and Cindy Denton, Rakesh Mohan, Murlene Priest and Tom Vittitow, Auditors, of the Division's staff. If you need any additional information about the audit's findings, please contact Ms. Green or Mr. Tongier at the Division's offices.

TABLE OF CONTENTS

SUMMARY OF AUDIT FINDINGS

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM: AN OVERVIEW OF INVESTMENT MANAGER COMPENSATION PRACTICES

Overview of the Kansas Public Employees Retirement System	3
How Are the Kansas Public Employees Retirement System's Investment Managers Compensated?	6
Conclusion	13
Recommendation	14
What Are the Generally Accepted Accounting Principles Applicable To Valuation of Direct Placement Investments of Government Retirement Systems, and How Does the Kansas Public Employees Retirement System Apply These Principles?	15
APPENDIX A: Kansas Public Employees Retirement System Summary of Investment Management Firms As of May 1, 1991.....	19
APPENDIX B: Kansas Public Employees Retirement System Summary of Assets Managed by and Fees Paid to Investment Management Firms Fiscal Years 1986 - 1990.....	21
APPENDIX C: Kansas Public Employees Retirement System Summary of Investment Manager Fee Terms As of May 1, 1991.....	25
APPENDIX D: Agency Response.....	33
APPENDIX E: An Overview of Investment Manager Compensation Practices: An Example.....	37
APPENDIX F: Losses on Direct Placement Investments: Fiscal Years 1989 and 1990.....	41

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM: AN OVERVIEW OF INVESTMENT MANAGER COMPENSATION PRACTICES

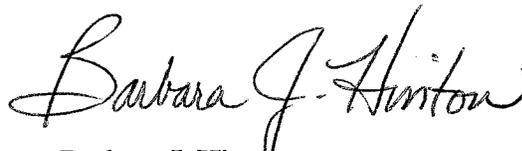
Summary of Legislative Post Audit's Findings

Under State law, the Kansas Public Employees Retirement System's Board of Trustees is responsible for managing the Kansas Public Employees Retirement Fund. The Board has delegated its authority to make investments to numerous outside investment managers under contract with the Retirement System. A number of legislative concerns have been raised recently about some of the Retirement System's investment practices. To address those concerns, the Joint Committee on KPERS Investment Practices was established by the 1991 Legislature to review some of the Retirement System's practices and procedures. To facilitate the Joint Committee's review, the Legislative Post Audit Committee authorized this audit.

How are the Kansas Public Employees Retirement System's investment managers compensated? During fiscal year 1990, the Retirement System paid outside investment managers more than \$10 million to handle its investments. All of the Retirement System's investment managers are paid a management fee based on the value of the assets managed. Five investment managers are also paid additional fees based on the performance of the managed investments. Finally, the two direct placement managers and a real estate manager can receive additional fees if investments managed by them are sold at a profit. We also found that Retirement System staff did not always adequately monitor investment manager compensation payments to ensure that the amounts billed were accurate. Retirement System staff also authorized some expense reimbursements to managers without verifying that the claimed expenses complied with the contract provisions.

What are the generally accepted accounting principles applicable to valuation of direct placement investments of government retirement systems, and how does the Kansas Public Employees Retirement System apply these principles? Generally accepted accounting principles call for reporting direct placement investments at either original cost or current market value, whichever is lower, and for reporting an investment loss whenever the investments have experienced a permanent decline in market value. The Kansas Public Employees Retirement System applies these principles by reporting estimated declines in market value and resulting investment losses at the end of each fiscal year, even if those losses cannot be identified with particular investments.

This report includes a recommendation for improving the Retirement System's procedures for handling investment manager compensation payments and expense reimbursements. We would be happy to discuss the findings presented in this report with any legislative committees, individual legislators, or other State officials.

A handwritten signature in black ink that reads "Barbara J. Hinton". The signature is written in a cursive style with a large, prominent initial "B".

Barbara J. Hinton
Deputy Legislative Post Auditor

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM: AN OVERVIEW OF INVESTMENT MANAGER COMPENSATION PRACTICES

Under State law, the Kansas Public Employees Retirement System's Board of Trustees is responsible for managing the Kansas Public Employees Retirement Fund. The Board is allowed to make various types of investments for the Fund, including direct placement investments in certain companies and real estate ventures. Direct placement investments are investments arranged directly with companies whose securities are not publicly traded. Direct placement investments generally involve a higher degree of risk than other types of investments but also have the potential to produce higher returns than more traditional investments.

The Retirement System's Board has delegated its authority to make investments to numerous private investment managers under contract with the Retirement System, including two direct placement investment managers. A number of legislative concerns have been raised about some of the Retirement System's investment practices. It was recently revealed that the Retirement System had lost \$65 million on an investment made by one of the direct placement investment managers in Home Savings Association. There are also concerns about potential losses on other direct placements.

To address these concerns, the Joint Committee on KPERS Investment Practices was established by the 1991 Legislature. The Joint Committee is conducting a broad review of the Retirement System's investment practices, especially direct placement and real estate investments. To facilitate the Joint Committee's review, the Legislative Post Audit Committee authorized this audit examining some of the Retirement System's policies and procedures. Specifically, the audit addressed these questions:

- 1. How are the Kansas Public Employees Retirement System's investment managers compensated?**
- 2. What are the generally accepted accounting principles applicable to valuation of direct placement investments of government retirement systems, and how does the Kansas Public Employees Retirement System apply these principles?**

To answer these questions, we interviewed staff members from the Retirement System and reviewed the System's records concerning investment manager compensation and certain financial statement information. We also examined the Retirement System's investment manager contracts and reviewed samples of recent compensation payments and expense reimbursements to investment managers. In addition, we reviewed authoritative publications to identify generally accepted accounting principles applicable to direct placement investments of government retirement systems.

Finally, we reviewed the Kansas Public Employees Retirement System's financial reporting practices to determine how the System applied those principles.

In conducting this audit, we followed the applicable government auditing standards set forth by the U.S. General Accounting Office. One of those standards states that individual auditors should be free from impairments to independence, and should maintain an independent attitude and appearance. Although all members of the Division's staff are members of the Retirement System, we are confident that no impairment to independence occurred. We also made every possible effort to provide for and maintain an independent attitude and appearance while conducting this audit.

In general, we found that investment managers under contract with the Retirement System are paid fees based on the amount of the funds they manage. Some managers, including the direct placement and real estate managers, are paid additional fees based on the performance of their investments for the System. The direct placement managers and one real estate manager are also paid a fee for selling an investment at a profit if the profit amount exceeds cumulative losses from earlier transactions. We also found that the Retirement System did not always verify that fee billings and expense reimbursement claims from the individual managers were accurate. For example, we identified an instance when one of the direct placement managers had overcharged the Retirement System \$74,500 over a one-year period and Retirement System staff had not noticed the error.

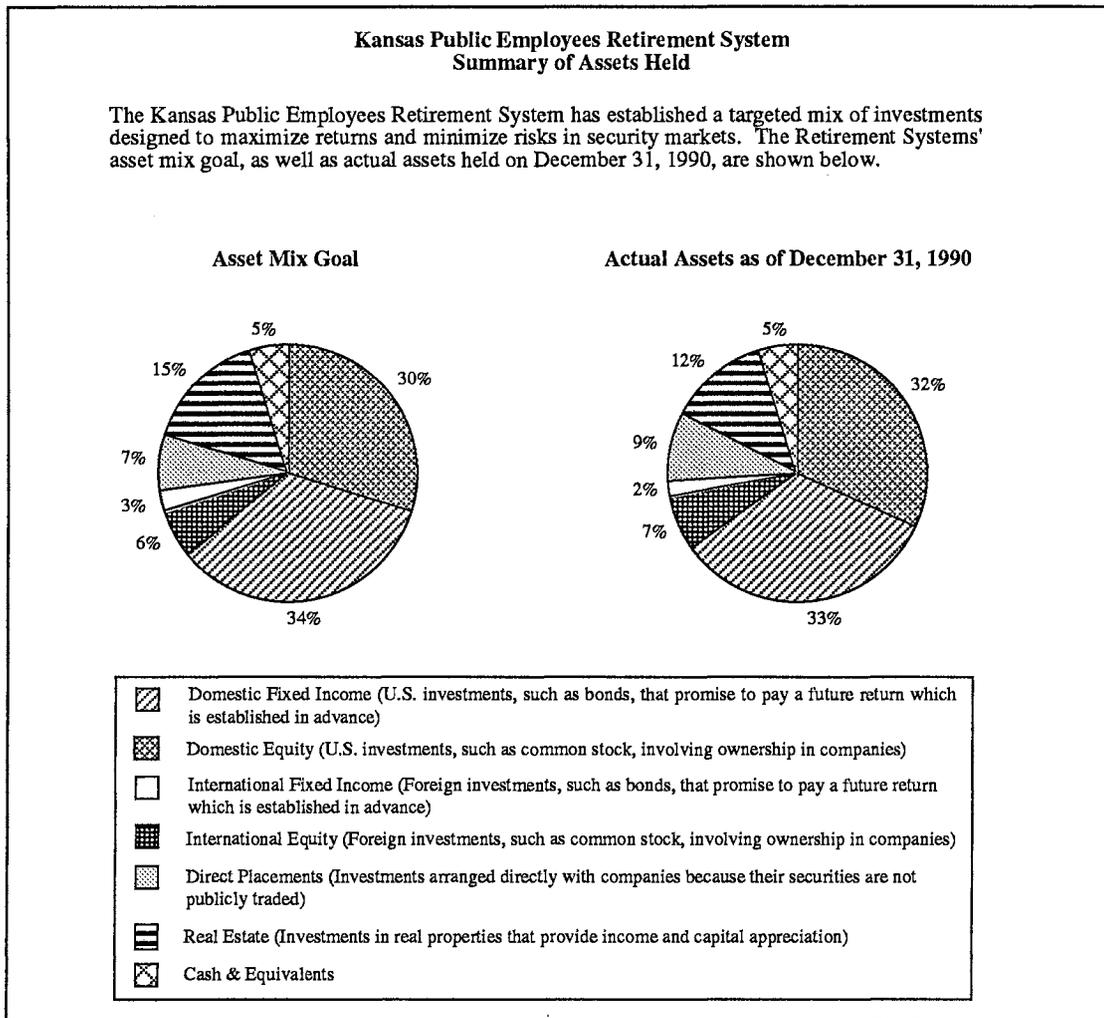
Finally, we found that generally accepted accounting principles call for reporting direct placement investments at either original cost or current market value, whichever is lower, and for reporting an investment loss whenever the investments have experienced a permanent decline in market value. We also found that the Kansas Public Employees Retirement System applies these principles by reporting estimated declines in market value and resulting investment losses at the end of each fiscal year, even if those losses cannot be identified with particular investments. These findings will be discussed in more detail after the following overview of the Retirement System.

Overview of the Kansas Public Employees Retirement System

The Kansas Public Employees Retirement System was established in 1961 to provide a systematic retirement plan for public employees in Kansas. In addition to the retirement plan, the System provides group life and disability insurance coverage for its members.

The Retirement System is actually an umbrella organization that is made up of three separate membership groups—the Kansas Public Employees Retirement System, the Kansas Police and Firemen’s Retirement System, and the Kansas Retirement System for Judges. The System covers most public employees in Kansas, such as state and local government employees. On June 30, 1990, the System had 118,042 active members and 1,188 participating employers.

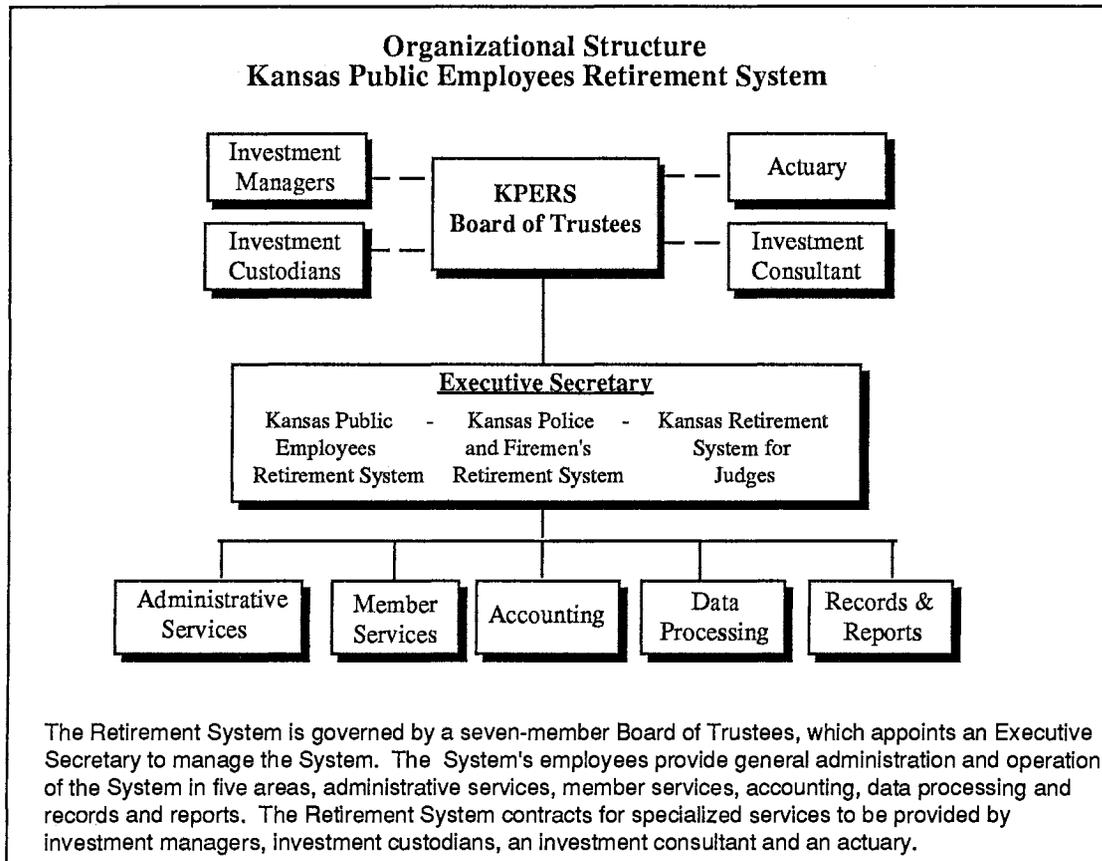
To pay the various retirement, disability, and death benefits to eligible members and beneficiaries, the Retirement System accumulates assets by receiving em-



employee and employer contributions and receiving earnings on its investments. As of June 30, 1990, the System's investments were valued at approximately \$4 billion. Those investments included corporate stocks and bonds, government notes, real estate, and direct placement investments in certain companies. The investments provide income to the System through interest, dividends, and profits from sales. The System also holds interest-producing short-term investments, such as treasury bills and certificates of deposit. The portion of the System's funds invested in each of these different types of assets is illustrated in the graph at the bottom of the previous page.

The Retirement System is governed by a seven-member Board of Trustees. Board members are appointed by the Governor, with the advice and consent of the Senate, to overlapping four-year terms of office. The Board appoints an Executive Secretary to manage the System's daily operations. The Retirement System's organization structure is presented in the chart at the bottom of this page.

The Retirement System employs about 65 full-time staff members in five areas: member services, data processing, records and reports, accounting, and administrative services. The System's employees provide the general administration and operation of the Retirement Fund, including various activities involving employer or employee contributions and member benefits. The System's administrative expenses, including employee salaries and wages, are paid from the Kansas Public Employees Retirement Fund.



The Retirement System's employees do not actually perform many of the System's investment-related activities. Rather, the Board contracts with various outside managers and consultants to provide these services, and the System's employees monitor the performance of those managers and consultants. In general, the System contracts with the following types of consultants and investment managers:

- **Actuaries** to help determine the probable obligations of the Retirement System, the contributions required, recommended rates for employer contributions, and other factors related to the relationship between present assets and liabilities, future contributions and benefits, and investments. As of May 1, 1991, Martin E. Segal Company from New York, New York was the System's consulting actuary. This firm has been the System's actuary since its inception, and the System paid the firm \$163,500 for fiscal year 1990 services.
- **Investment managers** to select and make actual investments. Within certain guidelines established by the Board, the individual investment managers are responsible for daily decisions relating to the purchase and sale of investments and the composition of investment portfolios. Investment managers are generally hired to manage a particular type of investment, such as an equity (stock) portfolio or a fixed-income (bond) portfolio of investments. As of May 1, 1991, the System had contracted with 14 investment managers. For fiscal year 1990, the System paid these investment managers more than \$10 million. In addition, the Retirement System contracts with two short-term investment managers—one to invest idle cash and another to loan securities to brokers and institutions. In fiscal year 1990, the System paid these two managers about \$608,000 for their services.
- **Investment consultants** to recommend the Retirement System's investment mix and allocations to individual investment managers, to assist with developing investment guidelines, to evaluate the System's investment performance, and to monitor the performance of the investment managers. As of May 1, 1991, Callan Associates from San Francisco, California was the System's investment consultant. The firm's fee for fiscal year 1990 was \$360,865.
- **Investment custodians** to administer and account for the securities held by the Retirement System. The Retirement System contracts with two investment custodians—Banker's Trust Company from New York, New York (international investments) and Commerce Bank and Trust from Topeka, Kansas (domestic investments). In addition, the State Treasurer serves as custodian, at no cost to the System, for federally guaranteed small business loans. In fiscal year 1990, the System paid about \$1.5 million to its custodians.

Fees for these outside managers and consultants are generally paid from the Kansas Public Employees Retirement Fund. The investment consultant (Callan Associates) is paid through directed brokerage commissions. This means that in lieu of the System paying the fee to the consultant, the Retirement System has directed some of its investment managers to buy and sell the System's securities through a brokerage firm owned by Callan Associates.

How Are the Kansas Public Employees Retirement System's Investment Managers Compensated?

The Kansas Public Employees Retirement System's Board of Trustees contracts with various private investment managers to select and manage the System's investments. In fiscal year 1990, the Retirement System paid these investment managers more than \$10 million for their services. We found that these investment managers receive a management fee based on the amount of the System's funds they handle. Some managers, including the direct placement managers and one real estate manager, are also paid income incentive fees which are based on the performance of their investments. Finally, the direct placement managers and one real estate manager are also paid a fee for selling an investment at a profit if the profit amount exceeds any cumulative losses from earlier sales.

We also found that when investment managers submitted bills to the Retirement System, the System's staff members did not always verify that the amount billed was accurate before paying the managers. For example, we identified one instance when a direct placement manager had overcharged the Retirement System approximately \$74,500 over a one-year period. System staff had paid the manager the amounts billed and were not aware of the error until we brought it to their attention.

Finally, the direct placement and real estate managers are also reimbursed for certain expenses. In some instances, we found that Retirement System staff authorized funds for the expense reimbursements without knowing what the claimed expenses were or whether the claimed expenses complied with the contract. These findings will be discussed in more detail in the following sections.

The Retirement System's Investment Managers Are Compensated in Various Ways

During this audit, we reviewed contract documents for the 14 investment managers under contract with the Retirement System as of May 1, 1991. Because of the different nature of their activities and the limited timeframe for this audit, we generally did not include contracts and payments to the System's two short-term investment managers (for idle cash and securities lending) in our investment manager reviews. In addition, we did not determine why the various investment managers were paid at different rates or levels.

The System's 14 investment managers are listed in the box on page seven. As indicated in the box, most managers were hired to handle a particular type of investment. For example, Julius Baer Investment Management, Inc. manages international fixed income investments for the Retirement System and invests almost exclusively in securities of foreign governments. Two managers—Loomis Sayles and Co. and Peters, Gamm, West and Vincent—handle two different types of investments. Appendix A includes more detailed descriptions of each investment manager and Appendix B lists the amount of funds managed by, and fees paid to, each individual manager.

**Kansas Public Employees Retirement System
Investment Managers' Base Management Fees
As of May 1, 1991**

	Range of Base Management Fees (Annual Percent of Funds Managed)	If the firm managed... \$100 million it would be paid.....	\$200 million it would be paid.....
Domestic Equity Managers (U.S. investments, such as corporate stocks, involving ownership in companies):			
Market Research and Management Corp.	.25% to .50%	\$300,000	\$550,000
Loomis, Sayles and Co., Inc.	.10% to .30%	\$300,000	\$500,000
Wells Fargo Bank	.016% to .48%	\$ 65,600	\$ 81,600
Pilgrim, Baxter, Greig and Associates	.25% to .75%	\$437,500	\$687,500
Delaware Investment Advisers	.20% to .30%	\$300,000	\$600,000
Provident Investment Counsel, Inc.	.25% to .585%	\$437,500	\$687,500
International Equity Managers (Foreign investments, such as corporate stocks, involving ownership in companies):			
Alliance Capital Management Corp.	.09% to .425%	\$306,250	\$396,250
Nomura Capital Management, Inc.	.25% to .50%	\$425,000	\$675,000
Domestic Fixed Income Managers (U.S. investments, such as corporate and public bonds, that promise to pay a future return which is established in advance):			
Loomis, Sayles and Co., Inc.	.20% to .50%	\$320,000	\$520,000
Pacific Investment Management Co.	.25%	\$250,000	\$500,000
Peters, Gamm, West and Vincent, Inc.	.20%	\$200,000	\$400,000
International Fixed Income Managers (Foreign investments, such as corporate and public bonds, that promise to pay a future return which is established in advance):			
Pacific Investment Management Co.	.65%	\$650,000	\$1,300,000
Julius Baer Investment Management, Inc.	.10% to .60%	\$340,000	\$440,000
Real Estate Managers (Real properties that provide income and capital appreciation):			
The O'Connor Group	.375% to .50%	\$500,000	\$875,000
Lehndorff and Babson Real Estate Counsel	.65%	\$650,000	\$1,300,000
Direct Placement Managers (Investments arranged directly with companies whose securities generally are not traded through an established securities exchange):			
Reimer and Koger Associates Inc. (a)	.375% to .50%	\$500,000	\$875,000
Peters, Gamm, West and Vincent Inc. (b)	.375% to .50%	\$500,000	\$875,000

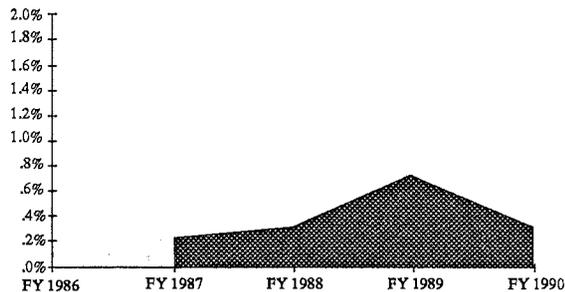
(a) The Retirement System terminated this contract effective May 29, 1991.

(b) The Retirement System terminated this contract effective June 30, 1991.

Investment Manager Compensation as a Percent of Assets Administered for the Kansas Public Employees Retirement System

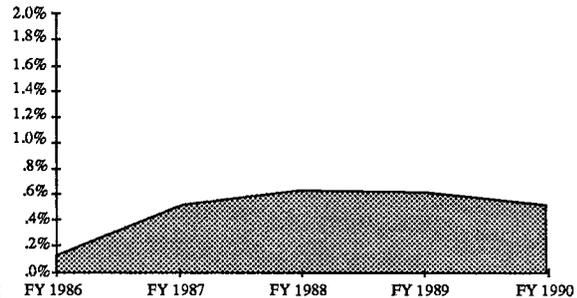
Retirement System staff prepared schedules of the fees investment managers received for 1986 through 1990, and schedules of the assets managed by the firms for the same period. The graphs presented below show how much compensation the investment managers received as a percent of the level of assets they administered for the Retirement System. The two direct placement managers and the real estate investment manager are presented as separate graphs, and all other investment managers are presented in the final graph.

Peters, Gamm, West and Vincent



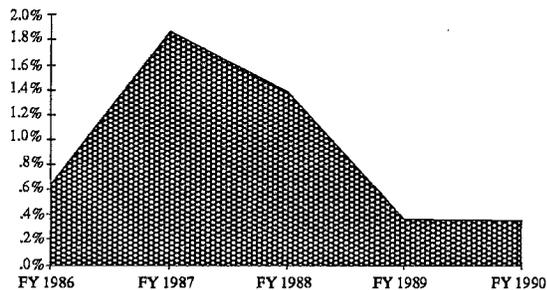
This firm began managing the Retirement System's funds in fiscal year 1987. Peters, Gamm, West, and Vincent manages direct placement and fixed income investments for the Retirement System. The firm's earnings peaked in fiscal year 1989 at over \$3 million which was .7 percent of managed assets.

Reimer and Koger Associates



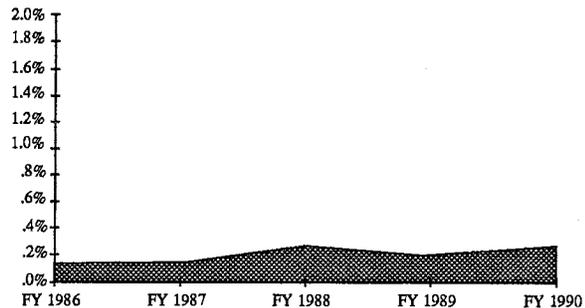
Reimer and Koger Associates manage direct placements and marketable securities for the Retirement System. Reimer and Koger's fees as a percentage of assets remained relatively stable between fiscal years 1987 and 1990. The actual amount of fees paid peaked in fiscal year 1987 at about \$3 million and declined to \$1.4 million in fiscal year 1990.

O'Connor Group



The O'Connor Group handles real estate investments for the Retirement System. In fiscal year 1989 this firm changed its name from J.W. O'Connor to the O'Connor Group. The O'Connor Group's fees as a percentage of assets peaked in fiscal year 1987. The actual amount of fees paid peaked in fiscal year 1988 at almost \$2 million and in fiscal year 1990 were still over \$1.2 million.

All Other Investment Managers



Since fiscal year 1986, investment management firms (except those handling direct placement and real estate) have shown increases in actual fees and fees as a percentage of managed assets. In fiscal year 1990, fees paid were over \$6.5 million which was .25 percent of managed assets.

In general, we found that the System's investment managers receive a management fee based on the amount of funds they manage for the System. Some managers are also paid income incentive fees, which are based on their investment performance, and gains incentive fees, which are based on profits from sales of investments. According to Retirement System staff, the fee terms for each individual manager are negotiated by the Retirement System, the investment consultant, and the manager after the System's Board of Trustees has selected a manager they would like to hire.

All of the System's investment managers are paid a management fee based on the value of the assets managed. This base management fee is generally stated as an annual percent of the amount of funds managed and may vary for different levels of funds. For example, Market Research and Management receives an annual base management fee of .5 percent of the first \$20 million managed and .25 percent of funds managed over \$20 million. Consequently, Market Research and Management would receive \$100,000 for managing \$20 million and \$150,000 for managing \$40 million in assets for the Retirement System. Base management fee terms for each investment manager are summarized briefly in the box on page seven; more detailed information about fee terms for each manager is included in Appendix C.

The Retirement System generally pays base management fees on a quarterly basis, although some are paid monthly. Most base management fees are paid in advance based on the value of the funds managed at the end of the preceding period. For example, this means that a manager who is paid quarterly received its fee for the beginning quarter of 1991 at the beginning of that quarter based on the amount of funds managed at the end of the fourth quarter of 1990. Base management fees for those managers who handle international investments are generally paid after the period.

Five investment managers are paid additional fees based on the performance of their investments. These additional fees are called "income incentive" fees. The five managers who receive income incentive fees are: Alliance Capital Management Corporation; the O'Connor Group; Peters, Gamm, West, and Vincent; Pilgrim, Baxter, Greig and Associates; and Reimer and Koger Associates, Inc. The income incentive fee terms vary from manager to manager and the fee is paid when the individual manager's Retirement System funds earn more than a predetermined amount or rate. For example, Pilgrim, Baxter, Greig and Associates is paid an income incentive fee equal to 20 percent of its funds' annual earnings in excess of the average interest rate earnings for treasury bills, with certain allowances for the manager's earnings in earlier periods. The income incentive fee terms, by individual manager, are included in Appendix C.

Under certain conditions, the direct placement managers and one real estate manager are also paid if they sell an investment at a profit. The O'Connor Group, Peters, Gamm, West, and Vincent, and Reimer and Koger Associates are all paid a "gains incentive" fee when investments are sold at a profit. Only these three investment managers receive this type of fee. The O'Connor Group receives ten percent of the gain from selling an investment less the cumulative amount of any losses incurred from earlier sales of assets. The two direct placement managers both receive

Changes in Asset Values Can Produce Mixed Results Because Those Values Affect Base Management and Income Incentive Fees Differently

In 1986, Reimer and Koger Associates (a direct placement investment manager) invested \$65 million of the Retirement System's funds in Home Savings Association. On March 15, 1991, the Resolution Trust Corporation placed Home Savings in receivership. At that time, the Retirement System's \$65 million investment probably had little or no value. During the May 1991 meetings of the Joint Committee on KPERS Investment Practices, a representative from Reimer and Koger Associates told the Joint Committee that he believed that decreasing the stated value of the Home Savings investment prior to March 1991 would have increased the amount of compensation Reimer and Koger received from the Retirement System.

To determine if this was true, we recalculated certain base management and income incentive fees paid to Reimer and Koger Associates for fiscal year 1991. In general, we found that reducing the value of the firm's assets decreases the base management fee paid but potentially increases the income incentive fee paid. This occurs because the decreased asset value lowers the minimum investment income necessary for managers to qualify for the income incentive fee. In other words, the lower asset value decreases the manager's base management fee but makes it easier to get an income incentive fee. When the increases in the income incentive fees exceed the decreases in base management fees, the total amount paid to an investment manager increases. However, we could not project exactly when this would happen because that would depend on the interaction of the firm's investment purchases and sales, and the entire portfolio over time.

We recalculated the base management and income incentive fees that would have been paid to Reimer and Koger if the value of the Home Savings investment had been reduced to \$0 as of September 30, 1990 (less than six months before the Association was placed in receivership). In this case, we estimated that Reimer and Koger's base management fees for the second and third quarters of fiscal year 1991 (October 1990 through March 1991) would have decreased from about \$275,000 to \$214,000 each quarter, for a decrease of about \$61,000 each quarter. Further, reducing the asset value would not have affected income incentive fees paid the firm during those two quarters because the firm did not have enough income to qualify for the income incentive fee.

Potentially, however, reducing the asset value could have resulted in the Retirement System actually paying the firm an income incentive fee for the last quarter of fiscal year 1991 or the first quarter of fiscal year 1992. This is possible because the income incentive fee is based on a manager's asset value. This means that the total asset value determines the minimum income needed to qualify for income incentive fees. Further, the fee calculation is cumulative, meaning that if a firm does not earn the required minimum income in one quarter, during the next quarter it must earn the usual minimum income plus enough to make up for the previous period's deficit before qualifying for an income incentive fee.

During the second and third quarters of fiscal year 1991, Reimer and Koger was carrying a rather large income deficit from earlier periods. However, reducing the firm's asset value by \$65 million would have allowed the firm to more easily meet its minimum return and would have reduced the income deficits it was required to carry over to future periods. For example, Reimer and Koger's original income incentive fee calculation for the third quarter of 1991 showed that an income deficit of more than \$400,000 would be carried to the next quarter. We estimated that if the \$65 million investment in Home Savings Association had been written off as of September 30, 1990, this deficit amount would have been about \$100,000.

It is important to note that the write down of the \$65 million investment in Home Savings Association would not act as a loss or decrease when considering the income incentive fees discussed above. It would, however, have counted as a loss to the firm's gains incentive fee and would be counted against any gains from the sale of investment assets in the future. The \$65 million would affect gains incentive fees until the entire loss—and all other losses—had been recovered in gains from the sale of other assets.

During this audit, we also recalculated the fees that would have been paid to the two direct placement managers if their asset values had been decreased according to estimates prepared by Baird, Kurtz, and Dobson, the certified public accounting firm that audited the System's fiscal year 1990 financial statements. At that time, the accounting firm estimated a range of impairment values for the System's direct placements. Using these estimates, we reduced the asset values at June 30, 1990 and recalculated fees the direct placement firms would have received for the first three quarters of fiscal year 1991. We found that both firms would have received a lower base management fee for all of the quarters, but the firms may have received income incentive fees (neither firm actually received an income incentive fee for this period).

The estimates included reducing the value of the portfolio managed by Reimer and Koger Associates, Inc. by about \$49.9 to \$84.3 million (approximately 20 to 33 percent of the entire portfolio). Using these estimates, our recalculations showed that the firm would have received about \$47,000 to \$79,000 less in base management fees for each of the three quarters. However, the firm may have received income incentive fees during the third or fourth quarter of the fiscal year if the asset values had been reduced by the highest impairment estimate.

The accounting firm estimated that Peters, Gamm, West, and Vincent's investment assets should be reduced by 8.8 to 20.7 percent—or about \$6.6 to \$15.7 million. With these reductions, we calculated that the investment manager would have received about \$8,200 to \$19,600 less in base management fees for each of the quarters. The firm, however, may have received income incentive fees as early as the second quarter of the fiscal year if the asset values had been reduced by the highest impairment estimate.

13 percent of the gains resulting from a sale less the cumulative amount of any earlier losses.

For example, Peters, Gamm, West, and Vincent purchased \$588,000 of common stock in Shepler's Inc. for the Retirement System in fiscal year 1987. When the stock was sold in July 1989 for more than \$17 million, the Retirement System made approximately \$16.5 million. The investment manager's gains incentive fee was 13 percent of the \$16.5 million, or \$2.1 million. As of June 1, 1991, this payment was the only gains incentive fee paid to Peters, Gamm, West, and Vincent since the firm began handling direct placements in fiscal year 1987. The other direct placement manager, Reimer and Koger Associates, has not received a gains incentive fee since they were paid about \$370,000 for transactions that occurred in fiscal years 1987 and 1988.

The Retirement System Did Not Always Adequately Monitor Compensation Payments to Investment Managers

During the audit, we reviewed a sample of the Retirement System's recent compensation payments to the individual investment managers. Our review included looking at payments made to each of the 14 managers for the third quarter of fiscal year 1991, as well as any supporting documentation for those payments, to determine how the Retirement System verified bills submitted by the managers. We also compared the fee terms used by the investment managers to calculate compensation to terms included in contracts between the Retirement System and individual managers.

We found that bills from the investment managers could generally be reconciled to the appropriate supporting documents and payments to investment managers generally complied with the terms of the contracts. However, we also identified some weaknesses in the Retirement System's practices in this area. In some instances, generally involving managers who withheld investment fees before remitting income to the System, Retirement System staff did not have the information necessary to determine whether the amount billed was accurate.

In another case, we found that one of the direct placement managers (Peters, Gamm, West, and Vincent) had calculated its income incentive fee incorrectly for 1990. Because of the calculation error, the Retirement System had overpaid the firm \$74,506 for that time period. Before we discussed this calculation with Retirement System staff, they apparently were not aware of the error. After we pointed the error out, Retirement System staff discussed it with the investment manager. The firm subsequently sent the System a check for \$74,506.

It was often difficult for us to determine exactly what the Retirement System did to verify billing amounts because the staff did not always document their actions. Although the Retirement System has established procedures for verifying the accuracy of investment manager fee statements, its staff did not have much documentation indicating that they verified the statements and reconciled the differences. The System's procedures for verifying bills from the investment managers include a comparison of the billed market value of the manager's assets with the market value listed

by the custodian bank. System staff indicated that they then reconcile any significant differences. System staff also indicated that they recalculate the fees. However, the staff does not document these actions in any way, except for initialing the fee statement. Consequently, it was often difficult for us to determine exactly what action Retirement System staff had taken to verify that bills from investment managers were accurate.

The Retirement System Did Not Adequately Monitor Expense Reimbursements for Certain Investment Managers

According to their contracts, the Retirement System's direct placement investment managers, and one real estate manager, are also reimbursed for certain expenses. These reimbursable expenses often include payments for professional or technical services, such as legal or accounting fees, associated with individual investments. Reimbursements for these types of fees are generally "capitalized," which means that the value of the appropriate asset is increased by the amount of the fee paid.

The direct placement and real estate managers are also reimbursed for other types of expenses. According to the contracts, reimbursable expenses are to be incurred in connection with performing the investment duties outlined in the contracts. Reimbursable expenses include travel pertaining to a specific or proposed investment, but exclude employment expenses, rent, telephone, and other general operating expenses of the investment manager. The contracts further outline that travel expenses are to be reimbursed at the same level as a State employee would receive.

In reviewing the Retirement System's records for expense reimbursements, we found that System staff authorized reimbursements to the managers without verifying that the claimed expenses complied with the appropriate contract provisions. For example, for fiscal year 1990, the Retirement System reimbursed Reimer and Koger a total of \$25,655 that was labeled only as "out-of-pocket" expenses. Retirement System staff apparently assumed that these expenses were legitimate and complied with the applicable contract terms.

Conclusion

In fiscal year 1990, the Retirement System paid various investment managers more than \$10 million to select and manage its investments. All of the System's investment managers received management fees based on the amount of the System's funds handled. Some managers also received income incentive fees based on the performance of their investments for the Retirement System or gains incentive fees based on profits from selling Retirement System assets. Finally, certain investment managers are also reimbursed for some expenses they incur while performing investment activities for the Retirement System. The Retirement System's staff, however, did not always verify that fee billings and expense reimbursement claims from the individual managers were accurate.

Recommendation

To ensure that all claims submitted by investment managers for compensation and expense reimbursements are accurate and allowable, the Retirement System should:

- a. ensure that its established procedures for monitoring investment manager compensation payments and expense reimbursements are followed,
- b. document the steps taken by Retirement System staff to verify the accuracy of fee billings and expense claims, and
- c. systematically require investment managers to provide any additional information needed to support compensation billings and expense claims.

What Are the Generally Accepted Accounting Principles Applicable to Valuation of Direct Placement Investments of Government Retirement Systems, and How Does the Kansas Public Employees Retirement System Apply These Principles?

This section of the report begins by discussing the concept of generally accepted accounting principles. Following that is a discussion of the general rule for accounting for long-term investments. Then, the report addresses generally accepted accounting principles applicable to the specific situation under consideration, the valuation of direct placement investments of government retirement systems. Finally, the report discusses how the Kansas Public Employees Retirement System applies generally accepted accounting principles to its direct placement investments.

Generally Accepted Accounting Principles

Most organizations (not only businesses but also government agencies and not-for-profit agencies) periodically provide reports on their financial status and the financial results of their operations to persons outside the organizations. The persons receiving those reports (financial statements) use the information in the reports to make a variety of decisions. These decisions can involve such activities as investment, oversight, and resource allocation.

To ensure that financial statements provide useful information for rational decision-making, the accounting profession has adopted financial reporting standards known as generally accepted accounting principles. To be responsive to the changing information needs of decision-makers, generally accepted accounting principles are under continuous review and development. At the present time, the establishment of generally accepted accounting principles is under the jurisdiction of the Financial Accounting Foundation, comprised of trustees representing organizations from both the business and the government financial communities. Examples of these organizations are the Securities and Exchange Commission and the Government Finance Officers of America. The Financial Accounting Foundation appoints the members of the two standard-setting bodies, the Financial Accounting Standards Board and the Governmental Accounting Standards Board. These two boards actually promulgate generally accepted accounting standards. The Financial Accounting Standards Board is responsible for accounting principles applicable to businesses and not-for-profit organizations, and the Governmental Accounting Standards Board is responsible for accounting principles applicable to state and local governmental entities.

In the application of generally accepted accounting principles, the reporting organization is responsible for adherence to those principles in the presentation of the financial statements. When those financial statements are audited by an independent auditor, the auditor is responsible for providing an independent, professional opinion as to whether those financial statements are presented in accordance with generally accepted accounting principles. The auditor is not responsible for the statements themselves.

The General Rule for Accounting for Long-Term Investments

The general rule for reporting on long-term investments in financial statements is to report the amount of the investments themselves at either the original cost or the current market value, whichever is lower. If the current market value is lower than the original cost, the reporting organization must make a judgment as to whether the decline in market value is permanent or temporary. If the decline is judged to be permanent, the financial statements must report a loss on those investments for the time period covered by the financial statements. Specific types of investments may require adaptations of this rule.

Applying the General Rule to Direct Placement Investments of Government Retirement Systems

Generally accepted accounting principles applicable to government retirement systems are under the jurisdiction of the Governmental Accounting Standards Board. In the area of investments, the Board has generally adopted the provisions of National Council on Governmental Accounting Statement No. 6, Pension Accounting and Financial Reporting: Public Employee Retirement Systems and State and Local Government Employers. (The National Council on Governmental Accounting was a predecessor organization to the Governmental Accounting Standards Board.) That statement closely adheres to the general rule of accounting for long-term investments discussed above. However, when dealing with direct placement investments, the current market value of those investments is not readily available. Presented below is a discussion of the amount to be reported for direct placement investments and the amount of investment loss to be reported due to permanent declines in the market value of direct placement investments.

The amount reported for direct placement investments should be either original cost or current market value, whichever is lower, if the decline in market value is judged to be permanent. Direct placement investments may be either investments in equity or ownership securities, generally stock, or investments in debt securities, such as bonds or notes. Investments in stocks are reported on the financial statements at cost, unless the market value of those stocks has experienced a decline judged to be permanent rather than temporary. If a permanent decline in their value has occurred, the stocks are reported at cost less the amount of the decline in value. Increases in market value, whether judged to be temporary or permanent, are not reported. Investments in bonds or notes are reported on the financial statements at cost adjusted to take into account the difference between the cost and the face value of the bonds or notes, unless the value of the investment in the bonds or notes has experienced a decline judged to be permanent rather than temporary. If a permanent decline in their value has occurred, the bonds or notes are reported at the adjusted cost less the amount of the decline in value. As is the case with equity securities, increases in market value are not reported.

For example, if a retirement system had made a direct placement investment costing \$1,000,000, and that investment had experienced no change in value by the

financial statement date, the investment would be reported on the financial statements at \$1,000,000. If, however, that investment had experienced a decline in market value to \$800,000, the investment would be reported on the financial statements at \$800,000. On the other hand, if the investment had experienced an increase in market value to \$1,200,000, the investment would still be reported on the financial statements at \$1,000,000.

Determination of a market value for direct placement investments is very difficult because no ready market exists for these investments. However, financial reporting in accordance with generally accepted accounting principles requires such a determination, at least to the extent of identifying any permanent declines in value. Professional guidance in this area indicates that the use of independent experts who are qualified to estimate fair value may be necessary.

Permanent declines in the market value of direct placement investments are to be reported in the financial statements as an investment loss. If a retirement system's direct placement investments have not suffered a permanent decline in market value, there is no impact on the system's investment income. If, however, the system's direct placement investments have suffered a permanent decline in market value, the investments are reported at the market value, and the amount of the decline to market value is reported as a loss. This loss reduces the system's total investment income.

For example, if a retirement system had made a direct placement investment costing \$1,000,000, and that investment had experienced a decline in market value to \$800,000, the system would have experienced a \$200,000 loss on that investment. The system's investment income would be reduced by \$200,000.

Reporting Practices of the Kansas Public Employees Retirement System for Direct Placement Investments

The Kansas Public Employees Retirement System follows generally accepted accounting principles in the following manner. At the end of each fiscal year, the System estimates the amount of permanent decline in market value for its direct placement investments. This estimate is required of the System by generally accepted accounting principles, whether or not the applicable investment managers agree with the System's judgment about the estimate. However, rather than adjusting the cost of individual investments at that time, the System reduces the total reported amount of the direct placement investments by the total amount of decline in market value below cost. The amount of that decline for the fiscal year is reported as an investment loss for that fiscal year. Based on information provided by the Retirement System, the System reported losses on direct placement investments of \$52.0 million for fiscal year 1989 and \$50.3 million for fiscal year 1990.

Later, when the investment manager indicates that a permanent decline in value has occurred for a particular investment, the Retirement System allocates a portion of the total estimated decline in market value to reduce the carrying value (the amount

reported on the financial statements) for that individual investment. This later identification of specific investments that have suffered a loss in market value has no impact on the total amount reported for direct placement investments.

For example, suppose that at the end of a fiscal year the Retirement System had four direct placement investments with a cost of \$400,000 each (\$1,600,000 in total), and the System estimated that these investments in total had experienced a permanent decline in market value of \$300,000, but did not estimate which of the four investments had experienced how much of that total loss. The System would report the estimated decline in market value in its financial statements by showing an offsetting "allowance" of \$300,000 that would be subtracted from the cost of the investments to arrive at a net amount for direct placement investments. The financial statement presentation of this would look something like the figures shown below. In addition, the Retirement System would also reflect the decline in market value as a \$300,000 loss in reporting its investment income for that fiscal year.

Direct Placement Investments (at cost)	\$1,600,000
Less: Allowance for Permanent Declines in Market Value	300,000
Net Direct Placement Investments	\$1,300,000

If during the next fiscal year, the Retirement System determined that \$200,000 of the \$300,000 decline in market value reported at the end of the previous fiscal year could be identified with one particular investment, the System would reduce the carrying value (the amount reported on the financial statements) of that investment, and also reduce the amount of the allowance amount by \$200,000 at the same time. The financial statement presentation of direct placement investments after that adjustment would appear something like the figures shown below. Because the loss now identified with a specific investment had already been reported as part of the estimated \$300,000 loss in the previous fiscal year, no additional losses would be reflected in investment income at this time.

Direct Placement Investments (at cost)	\$ 1,400,000
Less: Allowance for Permanent Declines in Market Value	100,000
Net Direct Placement Investments	\$ 1,300,000

Thus, the Retirement System reports losses from declines in market value in its financial statements at the time those losses are estimated to have occurred (even if they cannot be identified with particular investments). The amount of the allowance for permanent declines in market value represents estimated losses that have already been reflected in investment income but have not been identified with particular investments.

Appendix A

Kansas Public Employees Retirement System Summary of Investment Management Firms As of May 1, 1991

The following page shows the investment management firms contracted by the Kansas Public Employees Retirement System as of May 1, 1991 to manage the investment of the Retirement System's funds. The Appendix shows the firms' locations, the types of investments made by the firms, the dates the firms were hired by the Retirement System, the market value of the Retirement System's assets managed by the firms, and the fees paid to the firms by the Retirement System during the first half of fiscal year 1991.

**Kansas Public Employees Retirement System
Summary of Investment Management Firms
As of May 1, 1991**

<u>Investment Manager Firm</u>	<u>Type of Investments</u>	<u>Date Hired by Retirement System</u>	<u>Market Value of Assets Managed As of 12/31/90</u>	<u>Fees Paid 7/1/90 to 12/31/90</u>
Market Research and Management Corp. Hutchinson, Kansas	Higher risk growth stocks of small U.S. companies	August 1985	\$87,911,725	\$135,691
Loomis, Sayles and Co., Inc. Pasadena, California	High yield stocks of U.S. companies	April 1989	\$155,828,858	\$198,440
Wells Fargo Bank San Francisco, California	Investments match Standard & Pears 500 index	December 1989	\$202,308,735	\$40,541
Pilgrim, Baxter, Greig and Associates Wayne, Pennsylvania	Higher risk, volatile short-term returns, growth oriented stocks in U.S. companies	February 1984	\$203,805,475	\$302,695
Delaware Investment Advisers Philadelphia, Pennsylvania	Value rated stocks of U.S. companies that are expected to provide return over inflation	April 1989	\$292,861,997	\$407,013
Provident Investment Counsel, Inc. Pasadena, California	High risk, high volatility, growth oriented stock of U.S. companies	February 1984	\$300,722,091	\$555,114
Alliance Capital Management Corp. Minneapolis, Minnesota	Stocks of foreign companies in areas thought to be undervalued and with a European bias	January 1987	\$151,266,968	\$279,799
Normura Capital Management, Inc. New York, New York	Stocks of foreign companies with a Pacific Basin bias	January 1987	\$128,591,566	\$267,433
Loomis, Sayles and Co., Inc. Boston, Massachusetts	Defensive oriented investments in U.S. corporate bonds to provide superior yields relative to risk	February 1988	\$392,244,719	\$456,633
Pacific Investment Management Co. Newport Beach, California	Invests in U.S. corporate bonds with intermediate to longer-term maturities	July 1981	\$428,547,742	\$413,374
Peters, Gamm, West and Vincent, Inc. Wichita, Kansas	Long-term investments in U.S. corporate bonds	August 1983	\$454,817,901	\$450,464
Julius Baer Investment Management, Inc. New York, New York	Foreign Government securities	June 1987	\$88,289,375	\$174,534
The O'Connor Group New York, New York	Direct investments in real estate -- one-half of allocation in Kansas	August 1985	\$365,464,794	\$647,159
Lehndorff and Babson Real Estate Counsel Dallas, Texas	Commercial real estate investments managed through the Council of Real Estate Group Trust	August 1989	\$100,000,000	(a)
Peters, Gamm, West and Vincent, Inc. (b) Wichita, Kansas	Private placements, high risk investments	August 1986	\$60,633,383	\$187,487
Reimer and Koger Associates, Inc. (c) Shawnee Mission, Kansas	Private placements, high risk investments	December 1985 (d)	\$309,223,082	\$593,083

(a) Management fees are withheld by Lehndorff and Babson prior to income distributions to the Retirement System, therefore, the Retirement System has no record of the amount of fees paid to this firm.

(b) The Retirement System terminated this contract with Peters, Gamm, West and Vincent, Inc. effective June 30, 1991.

(c) The Retirement System terminated this contract with Reimer and Koger Associates, Inc. effective May 29, 1991.

(d) Reimer and Koger had a prior investment manager agreement for investing in U.S. stocks which began in May, 1973.

Appendix B

Kansas Public Employees Retirement System Summary of Assets Managed by and Fees Paid to Investment Management Firms Fiscal Years 1986 - 1990

This Appendix shows the amount of Kansas Public Employees Retirement System assets managed by each of the investment management firms during fiscal years 1986 through 1990. The Appendix also shows the amount of the fees paid to the firms by the Retirement System during the same time period.

Kansas Public Employees Retirement System

**Assets Under Management
Fiscal Years 1986 through 1990**

Investment Manager	Fiscal Year 1986		Fiscal Year 1987		Fiscal Year 1988		Fiscal Year 1989		Fiscal Year 1990	
	Assets	Percent of Total								
Alliance Capital Management Corp.			\$44,149,017	1.5%	\$100,079,207	3.4%	\$144,056,060	4.1%	\$186,312,231	4.9%
Bank IV	\$57,193,228	2.2%								
Robert C. Brown and Company	\$237,121,384	8.9%	\$236,460,215	7.8%	\$0 (a)	0.0%				
Capital Supervisors	\$426,264,030	16.1%	\$499,605,716	16.4%	\$311,144,587	10.4%	\$366,980,451	10.5%	\$0 (a)	0.0%
Delaware Investment Advisers							\$315,368,504	9.0%	\$321,565,044	8.4%
Investment and Capital Management	\$249,152,627	9.4%	\$289,161,438	9.5%	\$267,032,763	8.9%	\$0 (a)	0.0%		
Investment Management Group	\$362,328,609	13.6%								
Julius Baer Investment Management, Inc.					\$68,319,451	2.3%	\$88,972,745	2.6%	\$94,776,869	2.5%
The O'Connor Group	\$39,326,967	1.5%	\$79,177,494	2.6%	\$142,442,512	4.8%	\$249,510,408	7.2%	\$353,744,856	9.3%
Lehndorff and Babson Real Estate Counsel									\$68,935,000 (b)	1.8%
Loomis, Sayles and Co., Inc.					\$217,601,442	7.3%				
Loomis, Sayles and Co., Inc. (Equity)							\$166,024,803	4.8%	\$177,580,632	4.7%
Loomis, Sayles and Co., Inc. (Fixed Income)							\$273,202,504	7.8%	\$416,575,976	10.9%
Market Research and Management Corp.	\$66,755,760	2.5%	\$71,460,302	2.3%	\$65,668,896	2.2%	\$87,542,808	2.5%	\$97,411,515	2.6%
Nomura Capital Management, Inc.			\$47,884,969	1.6%	\$107,239,071	3.6%	\$140,089,040	4.0%	\$169,773,414	4.4%
Pacific Investment Management Co.	\$348,441,110	13.1%	\$376,186,500	12.4%	\$387,882,704	13.0%	\$427,281,535	12.2%	\$411,170,717	10.8%
Peters, Gamm, West and Vincent, Inc.			\$438,872,045	14.4%	\$449,335,267	15.0%	\$454,779,768	13.0%	\$483,285,085	12.7%
Pilgrim, Baxter, Greig and Associates	\$160,473,819	6.0%	\$178,769,886	5.9%	\$173,449,047	5.8%	\$194,956,251	5.6%	\$233,681,839	6.1%
Provident Investment Counsel, Inc.	\$199,131,747	7.5%	\$237,367,191	7.8%	\$215,162,164	7.2%	\$254,994,819	7.3%	\$341,710,077	9.0%
Reimer and Koger Associates, Inc.	\$508,375,067	19.2%	\$541,461,647	17.8%	\$481,568,231	16.1%	\$327,451,128	9.4%	\$242,032,080	6.3%
Wells Fargo Bank									\$215,040,160	5.6%
Totals	\$2,654,564,348	100.0%	\$3,040,556,420	100.0%	\$2,986,925,342	100.0%	\$3,491,210,824	100.0%	\$3,813,595,495	100.0%

(a) This firm managed no Retirement System assets at the end of this fiscal year, but was paid for services provided during the year.

(b) Management fees are withheld by Lehndorff and Babson prior to distributions to the Retirement System, therefore, the Retirement System has no record of the amount of fees paid to this firm.

Kansas Public Employees Retirement System

**Investment Manager Fees Paid
Fiscal Years 1986 through 1990**

Investment Manager	Fiscal Year 1986		Fiscal Year 1987		Fiscal Year 1988		Fiscal Year 1989		Fiscal Year 1990	
	Fees Paid	Percent of Total								
Alliance Capital Management Corp.			\$68,036	0.8%	\$257,882	2.4%	\$332,944	3.0%	\$430,025	4.2%
Bank IV	\$48,808	1.2%	\$43,834	0.5%						
Robert C. Brown and Company	\$377,077	9.2%	\$374,814	4.3%	\$279,137 (a)	2.6%				
Capital Supervisors	\$358,676	8.7%	\$476,256	5.4%	\$502,150	4.7%	\$388,405	3.5%	\$219,935 (a)	2.1%
Delaware Investment Advisers							\$103,842	0.9%	\$818,356	7.9%
Investment and Capital Management	\$247,468	6.0%	\$259,385	3.0%	\$290,482	2.7%	\$263,908 (a)	2.4%		
Investment Management Group	\$428,974	10.5%								
Julius Baer Investment Management, Inc.					\$219,504	2.1%	\$315,589	2.9%	\$243,165	2.4%
The O'Connor Group	\$250,000	6.1%	\$1,477,706	16.8%	\$1,967,836	18.6%	\$932,115	8.4%	\$1,222,425	11.9%
Lehndorff and Babson Real Estate Counsel									\$0 (b)	0.0%
Loomis, Sayles and Co., Inc.					\$136,548	1.3%				
Loomis, Sayles and Co., Inc. (Equity)							\$54,006	0.5%	\$452,944	4.4%
Loomis, Sayles and Co., Inc. (Fixed Income)							\$508,735	4.6%	\$791,325	7.7%
Market Research and Management Corp.	\$112,630	2.7%	\$213,379	2.4%	\$233,131	2.2%	\$249,048	2.3%	\$283,598	2.8%
Nomura Capital Management, Inc.			\$81,810	0.9%	\$367,577	3.5%	\$498,340	4.5%	\$564,833	5.5%
Pacific Investment Management Co.	\$515,205	12.6%	\$592,184	6.7%	\$611,901	5.8%	\$615,583	5.6%	\$755,662	7.3%
Peters, Gamm, West and Vincent, Inc.			\$905,576	10.3%	\$1,340,877	12.6%	\$3,171,727	28.7%	\$1,092,326	10.6%
Pilgrim, Baxter, Greig and Associates	\$498,118	12.1%	\$578,433	6.6%	\$585,757	5.5%	\$563,778	5.1%	\$638,166	6.2%
Provident Investment Counsel, Inc.	\$500,235	12.2%	\$740,655	8.4%	\$877,633	8.3%	\$988,767	8.9%	\$1,294,789	12.6%
Reimer and Koger Associates, Inc.	\$766,746	18.7%	\$2,977,648	33.9%	\$2,931,668	27.7%	\$2,063,949	18.7%	\$1,439,475	14.0%
Wells Fargo Bank									\$46,006	0.4%
Totals	\$4,103,937	100.0%	\$8,789,716	100.0%	\$10,602,083	100.0%	\$11,050,736	100.0%	\$10,293,030	100.0%

(a) This firm managed no Retirement System assets at the end of this fiscal year, but was paid for services provided during the year.

(b) Management fees are withheld by Lehndorff and Babson prior to distributions to the Retirement System, therefore, the Retirement System has no record of the amount of fees paid to this firm.

Appendix C

Kansas Public Employees Retirement System Summary of Investment Manager Fee Terms As of May 1, 1991

This Appendix shows the types of fees paid to each of the firms contracted to manage the investments of the Kansas Public Employees Retirement System. The Appendix also shows basis for the fees, examples of base management fees for various amounts of assets managed, and how fees are to be paid to the firms.

Firm / Type of Compensation	Fee Description
Domestic Equity Fund Managers:	
Market Research and Management Corp.	
Base Management Fee:	.50% of first \$20 million in assets managed -- .25% on assets in excess of \$20 million
Loomis, Sayles and Co., Inc.	
Base Management Fee:	.30% of first \$100 million in assets managed -- .20% of next \$100 million in assets managed -- .10% on assets in excess of \$200 million
Wells Fargo Bank	
Base Management Fees:	.48% of first \$500,000 in assets managed --.32% of next \$1.5 million in assets managed -- .08% of next \$48 million in assets managed -- .048% of next \$25 million in assets managed -- .032% of next \$25 million in assets managed -- .016% on assets in excess of \$100 million
Pilgrim, Baxter, Greig and Associates	
Base Management Fee:	.75% of first \$25 million in assets managed-- .50% of next \$25 million in assets managed -- .25% on assets in excess of \$50 million
PBG Growth/Opportunity Partners, L.P. Income Incentive Fee:	20% of Adjusted Excess Return (Excess Return = (Annual Return - average T-Bill rate) - (Deficit Excess Return from prior year, less than 0%) + (Surplus Excess Return from prior year, more than 25%))
Delaware Investment Advisers	
Base Management Fee:	.30% of first \$200 million in assets managed-- .20% on assets in excess of \$200 million
Provident Investment Counsel, Inc.	
Base Management Fee:	.585% on first \$50 million in assets managed-- .29% on next \$50 million in assets managed -- .25% on assets in excess of \$100 million
Steller Fund -- Base Management Fee:	1% of funds under management (limited to \$30 million invested) (Percent of shares times month end Mkt. Value) times .01/12
International Equity Fund Managers	
Alliance Capital Management Corp.	
Base Management Fee:	.425% of first \$50 million in assets managed -- .1875% of excess of next \$50 million in assets managed -- .09% on assets in excess of \$100 million
Income Incentive Fee:	Rate varies from .175 to .575 of the return in excess of the "Morgan Stanley Capital International Europe, Australia, Far East Index"
Nomura Capital Management, Inc.	
Base Management Fee:	.50% of the first \$50 million in assets managed-- .35% of the next \$50 million in assets managed-- .25% on assets in excess of \$100 million

<u>Fees for Assets Under Management -- Market Value (Millions)</u>				<u>Payment Procedures</u>
<u>\$100</u>	<u>\$200</u>	<u>\$300</u>	<u>\$400</u>	
\$300,000	\$550,000	\$800,000	\$1,050,000	Payable quarterly in advance based on market value at end of each quarter
\$300,000	\$500,000	\$600,000	\$700,000	Payable quarterly in arrears -- (calculated on quarterly basis using the quarter ending market value of the investment capital of the account, including cash or its equivalent)
\$65,600	\$81,600	\$97,600	\$113,600	Payable quarterly in arrears based on average monthly market value
\$437,500	\$687,500	\$937,500	\$1,187,500	Payable quarterly in advance based on prior quarter ending market value of the investment portfolio Fees assessed by fund manager directly to fund
\$300,000	\$600,000	\$800,000	\$1,000,000	Payable quarterly in advance (calculated on quarterly basis using the closing market value of the securities at the end of each quarter)
\$437,500	\$687,500	\$937,500	\$1,187,500	Payable quarterly in advance based on beginning market value Payable monthly through partial sales of investment
\$306,250	\$396,250	\$486,250	\$576,250	Payable quarterly in arrears (based on the assets under management on the date of payment) Payable quarterly in arrears
\$425,000	\$675,000	\$925,000	\$1,175,000	Payable following close of each quarter

Firm / Type of Compensation	Fee Description
Domestic Fixed Income Fund Managers	
Loomis Sayles and Co., Inc.	
Base Management Fee:	.50% of the first \$10 million in assets managed -- .30% of the next \$90 million in assets managed -- .20% on assets in excess of \$100 million
Pacific Investment Management Co.	
Base Management Fee:	.25% of managed asset value
Peters, Gamm, West and Vincent, Inc.	
Base Management Fee:	.20% of managed asset value
International Fixed Income Fund Managers	
Pacific Investment Management Co.	
Pacific Investment Management Institutional Trust -- Base Management Fee: (limited to 20% of KPERS managed funds)	.65% of managed asset value
Julius Baer Investment Management Inc.	
Base Management Fee:	.60% on first \$20 million in assets managed -- .50% on next \$20 million in assets managed -- .20% on next \$60 million in assets managed -- .10% on assets in excess of \$100 million
Real Estate Fund Managers	
The O'Connor Group	
Base Management Fee:	.50% of first \$100 million total book value of all real estate investments -- .375% of book value above \$100 million.
Income Incentive Fee:	10% of the amount of adjusted net income from all real estate investments after KPERS has received a 10% per annum cumulative, non-compounded return on its adjusted cash investments and the excess of realized gains over realized losses.
Gains Incentive Fee:	10% of the realized gains resulting from any capital transactions less the cumulative amount of any realized losses.
Acquisition Fee:	1.25% of the total consideration paid or incurred by KPERS in connection with the acquisition of real estate investment.
Financing/Disposition Fee:	1% of the financing (excluding financing included in computation of acquisition fee) or refinancing, or the gross sales price of any real estate investment.
Retail Property Trust	.50% of aggregate net equity invested in properties -- .05% of aggregate net book value of all short-term investments
Lehndorff and Babson Real Estate Counsel	
Base Management Fee:	.65% of the valuation of the real property assets including debt.

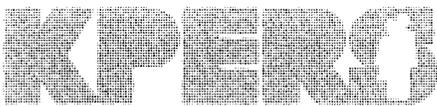
Fees for Assets Under Management -- Market Value (Millions)				Payment Procedures
\$100	\$200	\$300	\$400	
\$320,000	\$520,000	\$720,000	\$920,000	Payable quarterly in advance based on market value of account, including cash, at end of the prior quarter
\$250,000	\$500,000	\$750,000	\$1,000,000	Payable quarterly in advance based on beginning market value
\$200,000	\$400,000	\$600,000	\$800,000	Payable quarterly in advance based on market value at beginning of quarter
\$650,000	\$1,300,000	\$1,950,000	\$2,600,000	Payable quarterly based on the percentage of total shares held by KPERS
\$340,000	\$440,000	\$540,000	\$640,000	To be paid promptly upon receipt of statement
\$500,000	\$875,000	\$1,250,000	\$1,625,000	To be paid within 10 days after end of each fiscal quarter To be paid within 30 days after end of each fiscal quarter To be paid within 30 days after capital transaction To be paid upon closing To be paid upon closing Fees deducted from fund earnings prior to dividend payments to shareholders
\$650,000	\$1,300,000	\$1,950,000	\$2,600,000	Payable monthly in arrears based on valuation of real property Payment assessed by manager prior to the distribution to participants

Firm / Type of Compensation	Fee Description
Direct Placement Fund Managers	
Reimer and Koger Associates Inc.	
Base Management Fee:	.50% of first \$100 million in assets managed -- .375% on assets in excess of \$100 million
Income Incentive Fee:	13% of the income received on accrual basis on amount of income exceeding 90-day Treasury Bill rate. Includes income when interest is capitalized and reinvested.
Gains Incentive Fee:	13% of the realized gains resulting from any capital transactions less the cumulative amount of any realized or unrealized losses.
Marketable Securities & Limited Partnership funds:	.20% of all managed assets
Peters, Gamm, West and Vincent, Inc.	
Base Management Fee:	.50% of first \$100 million in assets managed -- .375% on assets in excess of \$100 million
Income Incentive Fee:	13% of the income received on accrual basis on amount of income exceeding 90-day Treasury Bill rate. Includes income when interest is capitalized and reinvested.
Gains Incentive Fee:	13% of the realized gains resulting from any capital transactions less the cumulative amount of any realized or unrealized losses.

Fees for Assets Under Management -- Market Value (Millions)				Payment Procedures
\$100	\$200	\$300	\$400	
\$500,000	\$875,000	\$1,250,000	\$1,625,000	<p>Paid quarterly in advance based on total cost of all investments at the end of the prior quarter</p> <p>To be paid within 30 days of the end of the quarter</p> <p>To be paid within 30 days of the capital transaction</p>
\$200,000	\$400,000	\$600,000	\$800,000	<p>Payable quarterly in advance based on market value of assets at the beginning of the quarter</p>
\$500,000	\$875,000	\$1,250,000	\$1,625,000	<p>Paid quarterly in advance based on total cost of all investments at the end of the prior quarter</p> <p>To be paid within 30 days of the end of the quarter</p> <p>To be paid within 30 days after year end in which transaction occurs</p>

Appendix D
Agency Response

On June 21, 1991, we provided a copy of the draft audit report to Kansas Public Employees Retirement System. Its response is included in this Appendix.



Kansas Public Employees Retirement System

MARSHALL CROWTHER, Executive Secretary

JUNE 26, 1991



Mr. Meredith Williams
Legislative Post Auditor
Legislative Division of Post Audit
1200 Merchants Bank Tower
8th & Jackson
Topeka, Kansas 66612-1212

Dear Mr. Williams:

This letter is in response to your request for comments regarding draft copies of performance audit reports as were received in this office June 21, 1991.

We have no comments regarding the Tallgrass performance audit report. Comments regarding the Investment Practices audit report are as follows:

To ensure that all claims submitted by investment managers for compensation and expense reimbursements are accurate and allowable, the Retirement System should:

- a. ensure that its established procedures for monitoring investment manager compensation payments and expense reimbursements are followed.

KPERS response: The Retirement System staff does have an established set of procedures that are routinely followed regarding the verification and payment of all discretionary manager fees who individually are required by executed Board contracts to remit invoices to the KPERS office prior to receipt of payment. Established internal procedures include the verification of market value information reported by the Manager to the portfolio values maintained by the Custodian Banks, recomputation of fee invoice amounts, and isolation and resolution of computational differences of \$200 per invoice or more.

- b. document the steps taken by Retirement System staff to verify the accuracy of fee billings and expense claims.

KPERS response: Staff utilizes standard tic and initialing procedures to indicate verification of portfolio market values and recomputed fee amounts, and approval for payment, evidenced on all manager fee invoices. No other documentation is completed by staff to document these procedures or the variance amounts computed.

To support additional documentation of reconciliation and verification efforts would require human resources in excess of the relative cost

associated with established tolerable variance level of generally \$800 per discretionary manager, per fiscal year or less.

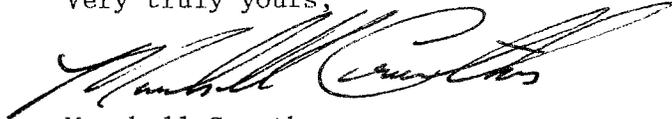
- c. Systematically require investment managers to provide any additional information needed to support compensation billings and expense claims.

KPERS response: In the limited instances where executed Board of Trustee contracts do not require prior approval by KPERS staff for fees charged the Retirement System, KPERS has not always been in possession of sufficient documentation need to verify fees. Executed Board contracts are being reviewed to determine where this fee arrangement is permissible, and staff will initiate formal requests for information from discretionary managers to fulfill this recommendation.

Upon engagement of direct placement portfolio managers, Pacholder Associates and Chemical Bank, KPERS staff initiated procedures to insure receipt of such documentation at the time request for reimbursement of expenses is forwarded to this office.

For the remaining discretionary manager where expenses and other miscellaneous payments can be allowed, O'Connor Realty Advisors Inc., KPERS staff is initiating procedures to ensure receipt of documentation when request for reimbursement of expenses or advice of capitalization is received for processing.

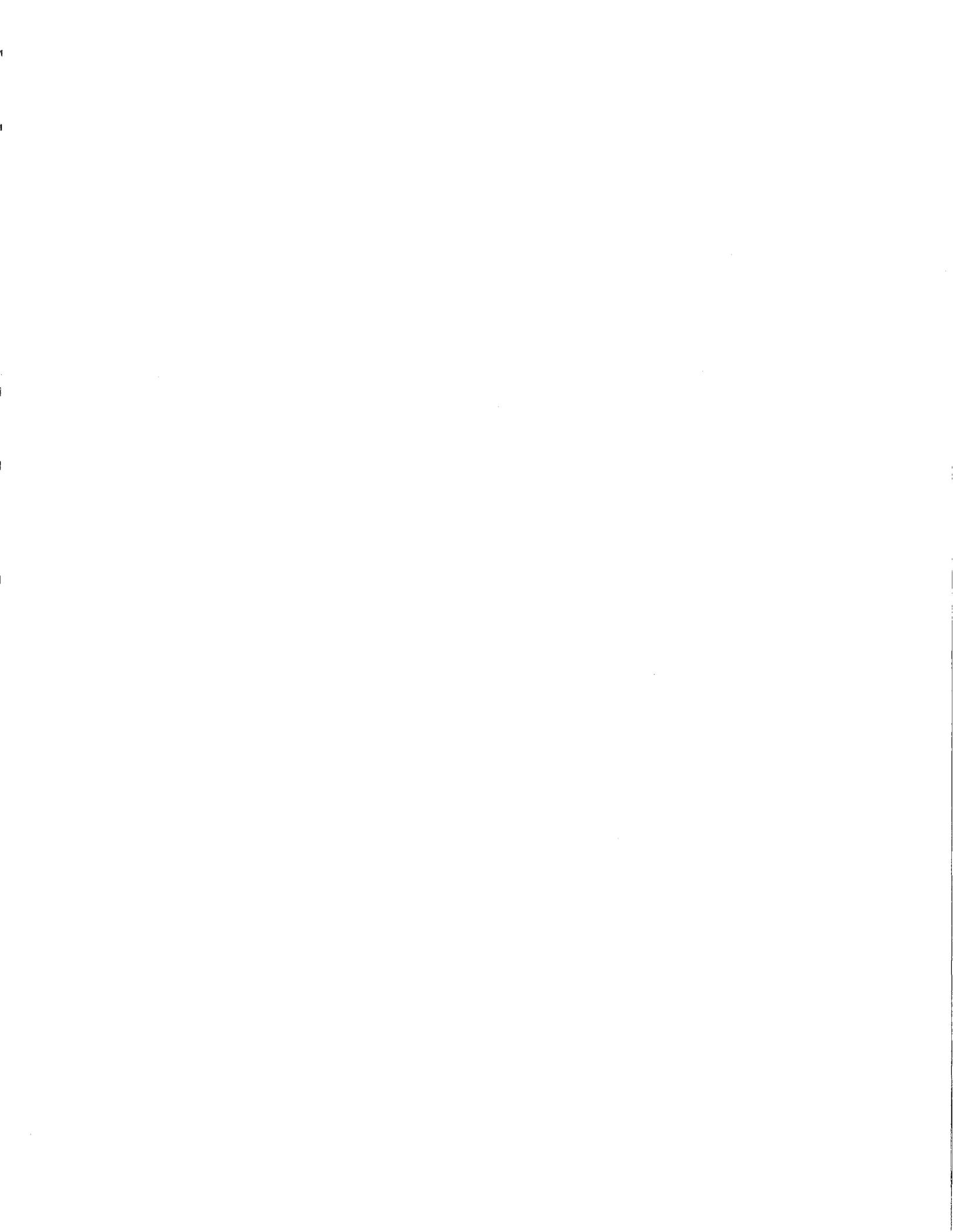
Very truly yours,



Marshall Crowther
Executive Secretary

MC:LAB

cc: Walter Cobler, Chairman
Jack Hawn
Louise Brock



Appendix E

An Overview of Investment Manager Compensation: An Example of Base Management and Income Incentive Fee Calculations

The fee calculation examples presented in this Appendix illustrate some of the information presented on pages 10 and 11 of the audit report. It includes the base management and income incentive fees actually paid to Reimer and Koger Associates for the second and third quarters of fiscal year 1991 as well as examples of the fees that could have been paid to that firm if the value of the Retirement System's \$65 million investment in Home Savings Association had been written down to \$0 as of September 30, 1990.

The information included in this Appendix was presented to the Legislative Post Audit Committee at its July 2, 1991, meeting. The example has been included in the audit report at the Committee's request.



**An Overview of Investment Manager Compensation:
An Example of Base Management and Income Incentive Fee Calculations**

	<u>October 1, 1990 Fees</u>		<u>January 1, 1991 Fees</u>	
		(a)		(a)
	<u>As Reported By Manager</u>	<u>Home Savings Written Down</u>	<u>As Reported By Manager</u>	<u>Home Savings Written Down</u>
<u>Base Management Fee Calculation</u>				
Assets Under Management	\$260,588,318	\$195,366,751	\$259,471,300	\$194,249,733
Base Management Fee	\$275,632	\$214,454	\$274,584	\$213,406
 <u>Income Incentive Fee Calculation</u>				
Assets Under Management	\$260,588,318	\$195,366,751	\$259,471,300	\$194,249,733
Preferred Return (Assets Under Management multiplied by 90-day Treasury Bill rate)	4,986,967	3,813,247	4,728,081	3,522,499
Adjusted Net Income Earned by Kansas Investment Fund	3,469,173	3,469,173	3,640,826	3,702,003
Income Subject to Incentive Fee (Actual Income Less Preferred Return)	(1,517,794)	(344,074)	(1,087,255)	179,504
Income Incentive Fee (13 Percent of Income Subject to Incentive Fee)	(197,313)	(44,730)	(141,343)	23,336
Cumulative Income Incentive Fee Deficit Carry Forward (from previous quarters)	(78,101)	(78,101)	(275,414)	(122,831)
Income Incentive Fee Paid or (Deficit Carry Forward)	(275,414)	(122,831)	(416,757)	(99,495)

(a) These calculations assume that the value of the Retirement System's \$65 million investment in Home Savings Association was written down to \$0 as of September 30, 1990.

The write-down of the \$65 million Home Savings investment would not act as a loss or decrease when considering the income incentive fee calculated above. It would, however, have counted as a loss to the investment manager's gains incentive fees until the entire loss--and all other losses--had been recovered in gains from the sale or disposal of other assets. For the second and third quarters of fiscal year 1991, the write-down would not have affected the actual amount paid to the investment manager because, due to earlier losses on investments, this manager has not actually received a gains incentive fee payment since fiscal year 1988.

Appendix F

Losses on Direct Placement Investments: Fiscal Years 1989 and 1990

The information presented in this Appendix illustrates the relationship between estimated impairments of direct placement investments, write-downs of the amounts for specific investments, and investment losses reported for direct placement investments by the Kansas Public Employees Retirement System. The illustrations use actual Retirement System amounts for fiscal years 1989 and 1990.

The information included in this Appendix was presented to the Legislative Post Audit Committee at its July 2, 1991, meeting. This information has been included in the audit report at the Committee's request.

**Kansas Public Employees Retirement System
LOSSES ON DIRECT PLACEMENT INVESTMENTS**

Reported Amount for Direct Placement Investments (in millions)

	Cost	Allowance for Losses	Reported Amount (Net)
As of June 30, 1989	\$ 243.6	\$ (24.4)	\$ 219.2
As of June 30, 1990	302.4	(64.1)	238.3

The year-end allowance for losses is based on analysis performed annually by the independent auditing firm. Establishing and recording the amount is the responsibility of the Retirement System.

Losses on Direct Placement Investments

	Write-Downs (Recorded for Specific Investments)	Losses Reported on the Financial Statements
Fiscal Year 1989	\$ 27.7	\$ 52.0
Fiscal Year 1990	10.6	50.3
Fiscal Year 1991 (through March)	<u>70.2</u>	<u>Not Avail.</u>
Totals	\$ 108.5 =====	\$ 102.3 =====

Write-downs result from decisions by investment managers that permanent impairments have occurred for particular investments.

The investment losses (in millions) reported on the financial statements for fiscal years 1989 and 1990 are determined as follows.

	Fiscal Year <u>1989</u>	Fiscal Year <u>1990</u>
Losses Identified With Specific Investments During the Fiscal Year (Write-Downs)	\$ 27.6	\$ 10.6
Estimated Losses Included in the Year-End Investment Cost (Allowance)	24.4	64.1
Less: Portion of the Above Two Items Already Reported as a Loss in a Previous Fiscal Year (Prior Allowance)	<u>0.0</u>	<u>(24.4)</u>
Total Investment Loss	\$ 52.0 =====	\$ 50.3 =====

Discussion Points

- ◇ The "allowance" method is usually used when there has been a decline in market value for some investments but that decline is not judged to be permanent. This is not the case for the Retirement System's direct placements. As we understand it, this method is used by the Retirement System so that it can present its financial statements on the basis of generally accepted accounting principles (recognizing that some permanent losses in value have occurred) while still allowing the investment managers to exercise their contractual responsibility to decide when a permanent loss in value has occurred for a particular investment.
- ◇ While judgment is involved in determining when permanent losses in the value of investments have occurred, the fact that investment managers are paid a base management fee that depends on the value of the investments managed would be a potential incentive to delay recognition of losses.
- ◇ The direct placement investment losses are not reported separately in the financial statements. They are reported together with other investment interest, dividends, gains and losses.

