SWIB STATE OF WISCONSIN INVESTMENT BOARD

December 16, 2021

Attorney General Josh Kaul
Wisconsin Department of Justice
P.O. Box 7587
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Re: SWIB's Authority to Issue Debt

Executive Summary

The State of Wisconsin Investment Board ("SWIB") has broad investment management authority under Wis. Stat. § 25.182, which was interpreted in 2008 by 2008 Wis. Op. Att'y Gen. 11 (hereinafter OAG-11-08). While the opinion did not specifically contemplate SWIB issuing debt on behalf of the Wisconsin Retirement System ("WRS"), it allowed SWIB to manage money and property in a manner consistent with the standard of prudence under Wis. Stat. § 25.12(2). OAG-11-08, 6. SWIB believes issuing debt to be a method of managing money and property that meets the standard, and thus within its authority under the current statutory framework.

Multiple constituents throughout the debt issuance process rely on an entity's express authority to issue debt, including credit rating agencies, the debt underwriter, and the law firm providing an opinion of counsel. Likewise, it is common for debt purchasers to request documentation clearly demonstrating an issuer's authority to engage in the debt issuance. Therefore, a key purpose of this request is to document the opinion of the Office of the Attorney General ("OAG") that SWIB has the statutory authority to issue debt.

Question Presented

SWIB is seeking clarification of OAG-11-08 and the scope of SWIB's investment management authority under Wis. Stat. § 25.182. Specifically, SWIB is requesting express confirmation that issuing debt with recourse only to the Core Retirement Investment Trust ("Core Fund") in a manner consistent with the prudent investor standard in Wis. Stat. § 25.12(2) is within its investment management authority to manage the money and property of the Core Fund.[1]

Background

SWIB Basics

SWIB is an independent agency of the State of Wisconsin created under Wis. Stat. § 15.76 to manage the assets of the trust funds of the WRS, which is composed of the Core Retirement Investment Trust and the Variable Retirement Investment Trust ("Variable Fund"). As such, SWIB is a fiduciary and is governed by the "prudent investor" standard, which requires it to use the diligence, skill, and care that a prudent person acting in a similar capacity with the same resources would use in managing a large public pension fund. Wis. Stat. § 25.15(2)(a). The law also requires SWIB to make investment decisions and conduct its operations solely to fulfill the purpose of the funds under management. Wis. Stat. § 25.15(2)(c).

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[1] This request for clarification relates only to the assets of the WRS contained within the Core Fund. The Variable Fund remains subject to Wis. Stat. § 25.17(5), which requires its assets to be invested primarily in equity securities. The Core Fund and the Variable Fund together constitute the WRS.

As part of its fiduciary responsibilities, SWIB is required by Wis. Stat. § 25.15(2)(b) to "diversify investments in order to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so, considering each trust's or fund's portfolio as a whole at any point in time." SWIB satisfies this duty in part by setting a broadly diversified asset allocation.

2007 Statutory Change and OAG Letter

To ensure it had the flexibility necessary to implement a balanced and disciplined investment strategy, SWIB requested an opinion of the OAG of the State of Wisconsin in 2008 regarding SWIB's investment management authority given certain provisions of 2007 Wisconsin Act 212. Particularly, Act 212 created new Wis. Stat. § 25.182, which provides as follows:

> In addition to the management authority provided under any other provision of law, and notwithstanding any limitation on the board's management authority provided under any other provision of law, the board shall have authority to manage the money and property of the core retirement investment trust and, subject to s. 25.17(5), the variable retirement investment trust in any manner that does not violate the standard of responsibility specified in s. 25.15(2).

Wis. Stat. § 25.15(2) specifies the prudent investor standard of responsibility. Act 212 also amended that subsection by replacing "To invest, sell, reinvest and collect income and rents [in accordance with the prudent expert standard]" with "To *manage the money and property* (emphasis added) [in accordance with the prudent expert standard]." Prior to such statutory language, SWIB's investment management authority for the WRS was limited to a "legal list" of enumerated investments and actions specifically authorized by statute. OAG-11-08, 3.[2]

On December 16, 2008, the OAG provided SWIB with an opinion detailing the management authority of SWIB in light of 2007 Wisconsin Act 212. OAG-11-08, 1. The opinion noted that the change in Wis. Stat. § 25.15(2)(a) directs SWIB "to manage the money and property" and that "this change makes clear that SWIB's duties include more than simply buying and selling investments." *Id*. At 3. The opinion concluded that 2007 Wisconsin Act 212 expanded SWIB's investment management authority beyond investments strictly on the "legal list," provided such investments meet the standard of prudence under Wis. Stat. § 25.12(2). *Id*. At 4. While the opinion confirmed SWIB's expanded investment management authority, it did not specifically address SWIB's ability to issue debt on behalf of the WRS.

Diversification and Asset Allocation

SWIB's Board of Trustees approves an annual asset allocation pursuant to a comprehensive and ongoing evaluation of the appropriate risk and return standards for each fund. The asset allocation determines the types of asset classes into which SWIB invests the Core Fund, as well as the percentage of the Fund invested in each asset class. The asset allocation is a key driver of SWIB's management of the Core Fund.

One aspect of SWIB's diversified asset allocation is the utilization of leverage. SWIB began implementing leverage in the Core Fund in 2012, following approval by its Board of Trustees, after recommendation by SWIB's independent asset allocation consultant and SWIB staff. SWIB utilizes leverage to improve the Core Fund's efficiency by

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[2] For instance, prior to the statutory amendment and OAG-11-08, 78 Wis. Op. Att'y Gen. 189 (1989) prevented SWIB from borrowing money and securing the borrowed money with real estate owned as an investment in the WRS. The relevant analysis included a step-by-step review of the "legal list" to determine that the authority was not expressly granted and parsed the definitions of "invest" and "Investment," which have been replaced in the updated statutory language.

increasing returns and decreasing risk. Leverage provides SWIB the opportunity to increase the Core Fund's diversification by reducing its concentration, which also reduces its risk.

Leverage is implemented by investing more capital than actual cash on hand. An investor may generate leverage through various methods, including issuing debt, purchasing securities on margin, using other securities the investor owns as collateral for an investment, or investing in derivative securities. SWIB currently generates leverage in two ways by: 1) investing in various financial instruments that can be bought without full payment required at the date of purchase; and 2) by using securities it owns as collateral for other investments. Leverage ranges for the Core Fund are approved by the Board of Trustees annually and monitored by SWIB staff on an ongoing basis. Currently, SWIB has a policy target of 15% leverage, meaning it invests $115 for every $100 of cash on hand. This is considerably less than the average homeowner who is levered at 500%.[3]

As stated above, Wis. Stat. § 25.15 established a dual mandate for SWIB to manage the money and property as a prudent investor, and to diversify investments to minimize the risk of large losses. Utilizing leverage allows SWIB to meet this dual mandate in an efficient manner.

All costs associated with the WRS are paid from the assets of the WRS. This is true of the expenses associated with SWIB's current methods for generating leverage. Similarly, any future expense associated with generating leverage, whether through current methods or issuing debt, would also be borne by the WRS. Any debt issued by SWIB on behalf of the Core Fund would not be considered public debt nor create recourse to the State of Wisconsin.

SWIB Believes It Has Authority to Issue Debt Under Its Current Framework

SWIB believes 2007 Wisconsin Act 212 confers upon it the ability to issue debt in a manner that meets the standard of prudence under Wis. Stat. § 25.12(2), and that interpretation is consistent with the statutes as written, the legislative history and the OAG opinion.

SWIB's statutory authority to incorporate leverage in its asset allocation and to implement it through any mechanism that does not utilize debt issuance is not in question and does not require express authority. To date, SWIB has not pursued debt issuance as a mechanism because: 1) SWIB has lacked the express authority required by multiple constituents throughout the debt issuance process; and 2) SWIB's implementation of leverage through other investment instruments and strategies has yielded enhanced returns in a cost efficient manner. However, SWIB is seeking alternative ways to implement leverage, allowing it flexibility to adapt to ever-changing market dynamics. Debt issuance is one such alternative.

The plain meaning of the statutory language in Wis. Stats. §§ 25.12(2) and 25.182 shows that "to manage the money and property" would allow for the issuance of debt. As discussed above, SWIB already generates leverage through other means. Any debt issued by SWIB would simply be another tool available for SWIB to generate leverage. As with the leverage currently generated, the debt issuance program would require continual oversight and monitoring from SWIB staff and approval of the Board of Trustees. In this manner, the program would be managed to the prudent investor standard. *See* Wis. Stat. § 25.15(2).

This interpretation also aligns with the legislative history. Courts have approved the use of legislative history to confirm the plain meaning of statutory language. *See State v. Burris*, 2004 WI 91, ¶ 32, 273 Wis. 2d 294, 682 N.W.2d

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[3] In this example, a homeowner pays $40,000 (20%) down on a $200,000 home and borrows the remaining $160,000 (80%) via a mortgage from the bank. So, the homeowner invests $200,000 with only $40,000 cash on hand for leverage of 5X or 500%.

812. The legislative history of 2007 Act 212 states that "SWIB may manage the money and property of the core trust . . . in any manner that does not violate SWIB's standard of responsibility." 2007 Assem. Bill 623, Analysis by the Legislative Reference Bureau. Generating leverage through a different method to increase the return potential of the WRS, while diversifying and decreasing its risk, would not violate SWIB's standard of responsibility.

The Attorney General opinion from 2008 also confirmed that SWIB's investment management authority was broad under 2007 Wisconsin Act 212. The opinion noted that the changes made under 2007 Wisconsin Act 212 made "clear that SWIB's duties include more than simply buying and selling investments." OAG-11-08, 3. It is apparent that the goal of the Act was to expand SWIB's investment management authority for situations such as these – to allow SWIB the flexibility necessary to meet its dual mandate of generating returns and managing risks – with the prudent investor standard as the governing principle.

Given that SWIB has been granted broad authority to manage the assets of the Core Fund, and should evaluate its actions through the lens of the prudent investor standard, SWIB believes having the authority to issue debt would enhance its ability to meet the standard. As discussed earlier, the prudent investor standard requires SWIB to use the diligence, skill, and care that a prudent person acting in a *similar capacity* with the same resources would use in managing a *large public pension fund*. Wis. Stat. § 25.15(2)(a). This standard requires SWIB to evaluate how other large public pension funds are managing their investments and ensure that it is optimizing costs, risks, and investment returns. *See id.*

Several of SWIB's peers in Canada issue debt to generate leverage and invest the proceeds. For example, The Canada Pension Plan Investment Board ("CPPIB"), The Public Sector Pension Investment Board ("PSP Investments"), and Ontario Teachers' Pension Plan ("Ontario Teachers'") have successfully run debt programs, some of which have existed for over a decade. Aside from the debt issuance programs, these plans act in a similar capacity to SWIB given the size of assets they manage, their investment sophistication, and the plans' funded status. Issuing debt to generate leverage allows these plans opportunities to optimize costs and provides them flexibility in the marketplace. In contrast, SWIB is not aware of any other U.S. pension plans generating leverage by issuing debt. This is mainly due to their underfunded status.[4] The underfunded status of other U.S. pension plans makes debt issuance a less attractive alternative due to a less robust balance sheet where unfunded obligations create liabilities, resulting in lower credit ratings and higher interest rates paid on any debt issued.[5] This effectively erodes the value that could be obtained from debt issuance utilized by a well-funded plan.

Aside from the investment flexibility provided by the Wisconsin State Statutes, SWIB's greatest strengths include the WRS's fully funded status and the strength of the Core Fund balance sheet. SWIB's above target and consistent investment returns maintain the WRS's 100+% funding ratio, with over $140 billion in assets under management. This size and scale, paired with SWIB's long-term investment horizon and certainty of assets, put it in the same situation as the Canadian plans mentioned above. Such positive characteristics create favorable credit ratings for the Canadian plans, with all rated AA or above. Likewise, SWIB can assume it will receive a similar rating, allowing it

[4] The Wisconsin Retirement System is one of only two fully funded pension plans in the country. The other, South Dakota, is significantly smaller at roughly $12 billion.

[5] The underfunded status of other U.S. pensions creates circumstances where another type of debt is utilized. Pension obligation bonds are taxable bonds issued by some state and local governments to fund the unfunded portion of their pension liabilities. This debt is issued by the government, as opposed to the plan itself, and thus creates recourse to the state or local government.

to issue its debt at attractively low interest rates.[6] Issuing debt at such low rates significantly reduces the costs associated with a debt program and lowers the hurdle for earning a profit investing the proceeds.
Lastly, allowing this interpretation of the statutory framework governing SWIB's investment management authority will not impact other State of Wisconsin agencies or authorities with similar statutory frameworks. SWIB is in a unique position because its primary mandate is managing the assets of the WRS. The sole purpose of the agency is to generate returns and manage risks in accordance with the prudent investor standard codified in statute. Other agencies and authorities may have assets that they manage, but such management is not the primary mandate and/or there is no prudent investor standard attached to the management of the assets. Also, any costs and recourse associated with debt issuance are borne by the WRS, not the State of Wisconsin.

Conclusion
SWIB has a fiduciary duty to manage the money and property of the WRS as a prudent investor, simultaneously generating returns while controlling risks. The statutory changes in 2008 recognized the importance of flexibility in SWIB's investment management authority. This flexibility includes the ability to implement leverage. Specifically, SWIB has the authority to generate leverage by issuing debt, and respectfully requests that such authority be confirmed explicitly by the OAG. Allowing SWIB to meet its mandate more efficiently benefits all participants of the WRS and the State of Wisconsin.

Sincerely,

Sara Chandler, Chief Legal Counsel

[6] Ontario Teachers' issued 3- and 10-year notes in September 2020 at 0.375% and 1.250%, respectively.