LEGISLATIVE AUDIT COMMISSION

Management Audit

College Illinois!
Prepaid Tuition Program's
Administrative Operations

May 2012

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Springfield, Illinois 62706
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RECOMMENDATIONS – 15
Accepted – 3
Implemented – 12

Background

Established in 1997, the College Illinois! Prepaid Tuition Program allows participants to purchase a contract that prepays the full cost of tuition and mandatory fees at Illinois public universities and Illinois community colleges. The Illinois Student Assistance Commission (ISAC) administers the Program. ISAC's duties include investing Program funds with investment managers. The funded ratio of the Program has declined from 93.3% in 2007 to 70.5% in the most recent actuarial report which is as of June 30, 2011.

College Illinois offers plans for public university semesters, community college semesters, and a combined plan that includes two years at a community college and two years at a public university. Plans could be purchased one semester at a time or up to a maximum of nine semesters for any one future student. Benefits may also be used at private colleges within Illinois and at public universities and private colleges and universities across the country as well. The purchase of the plans was suspended in September 2011 amid questions about the plans' financial stability and oversight, and reinstated in October 2012.

The Illinois Student Assistance Commission is overseen by a 10-member commission appointed by the Governor. The current Commission consists of eight members with two vacancies. In May 2011, Governor Quinn replaced the Chairperson, Don McNeil, who had been appointed in 2005, with Kym Hubbard. The current eight members are all newly appointed since May 2011.

Andrew Davis served for less than a year as a Commission member before leaving to become Executive Director of ISAC. He took over as Executive Director in January 2007. Mr. Davis was placed on administrative leave in July 2011 and never returned to the agency. John Sinsheimer, ISAC's CEO, became Acting Director. In February 2012, Eric Zarnikow became Director. Mr. Zarnikow is a CPA and was the Associate Administrator of the U.S. Small Business Administration's Office of Capital Access.

House Resolution Number 174 directed the Auditor General to conduct a management audit of the College Illinois! Prepaid Tuition Program. To obtain an overview of operations, auditors established an audit period of six years encompassing fiscal years 2006 through

2011. The Office of the Auditor General contracted with a consultant to conduct an independent asset allocation study to determine overall level of risk associated with the Program's current alternative investment mix and compared the portfolio to a standardized investment portfolio without alternative investments, as well as the investment portfolios of similar prepaid tuition programs in other states.

Report Conclusions

Auditors identified several deficiencies in the administrative operations of the College Illinois! Prepaid Tuition Program including a procurement process that lacked consistency, transparency, independence, documentation, and compliance with procurement rules and the Procurement Code. Management issues identified included a lack of support for actuarial assumptions used when setting contract prices, not having a set policy for how Program costs are allocated, and not utilizing key controls governing the Program's investments. Specifically auditors found the following:

- The Illinois Student Assistance Commission (ISAC) circumvented the Illinois Procurement Code by selecting two investment managers outside of the normal procurement process. The procurement process was also circumvented when awarding a contract to perform due diligence services on the two investment managers.
- ISAC did not comply with its own conflict of interest policy. There were two instances where the former Executive Director did not disclose potential conflicts of interest that met ISAC's criteria for disclosure. In January 2010, the former Director of Portfolio Management made a personal investment with an investment manager while the selection process involving that investment manager was still ongoing.
- The process of selecting investment managers was inconsistent from fiscal years 2006 through 2011. Changes began to occur at the time the Program sought investment managers for alternative investments. The role of the independent Investment Consultant was reduced, including the removal of its role in evaluating proposals.
- Several issues with the procurements were noted including: a lack of documentation for vendor interviews/presentations, missing evaluations, changing evaluation criteria from what was specified in the RFP, and lack of support justifying the number of proposers selected for award.
- Internal controls over the investment process were not functioning properly including the Investment Committee that was created but not formally established, the Portfolio Committee that was not fulfilling its requirements, and the Investment Advisory Panel failing to fulfill its statutory duties. In addition, the Investment Advisory Panel raised questions or concerns on certain investment issues which were not communicated to members of the Commission.
- ISAC could not provide support for how actuarial assumptions, such as investment return and future contract sales, were established or any rationale to support the assumptions used. The Prepaid Tuition Fund had an annual average return of

3.5% from its inception in 1998, the actuarial assumed rates for 2006 to 2011 ranged from 7.5 percent to 9.25 percent.

- Program costs nearly tripled from $6.4 million in fiscal year 2006 to $18.1 million in fiscal year 2011 due to a substantial increase in investment management fees and increases in both direct and shared payroll expenses. Fees collected from purchasers of tuition contracts covered only 7% of operating costs in fiscal year 2011.
- ISAC made changes to its marketing materials over the years removing the term "backed by the State" in 2008 and adding language to its Master Agreement to emphasize the risk involved. However, ISAC continued to promote that an investment in College Illinois! was safe and secure.

The audit report contains 15 recommendations, and ISAC agreed with all of the recommendations.

Recommendations

1. The Illinois Student Assistance Commission should examine the current organizational structure of the College Illinois Program and implement changes to make operations more cohesive and to enhance accountability.

Findings: The Illinois Student Assistance Commission is overseen by a 10-member commission appointed by the Governor. The current Commission consists of eight members with two vacancies. The Commission is to perform a number of roles related to College Illinois including:

- **Setting contract prices and fees for the next enrollment period** – ISAC staff, in conjunction with the Program's actuary, develops the pricing schedules. The Commission votes to approve the pricing schedule.
- **Selection of investment managers** – Investment managers are generally selected through a procurement process and recommended to the Commission which then approves the selection. In September 2009, the Commission began approving resolutions which specified the managers and the amounts to be invested.
- **Approval of Investment Policy** – Revisions are made to the Statement of Investment Policy.
- **Approval of Budget** – The Commission is presented with and approves the budget request for the College Illinois Program annually.
- **Appointment of Investment Advisory Panel members** – The Commission approves the nominations of new members to the Panel and reappointments of members with expired terms.
- **Approval of other contracts** – The Commission approves the selection and authorizes staff to enter into contractual agreements with the vendors.

While the Commission oversees the College Illinois Program, ISAC staff control the day to day operations of the Program. After personnel changes in July 2011, the seven employees who work directly on the College Illinois Program are located in different organizational units at ISAC and there is no Director of the College Illinois Program. In 2006, there were four employees that worked on the Program, the Director of College Illinois and three employees that reported to him. The number of employees gradually increased. In 2008, the Director of the Program resigned and the position was not filled. Instead, a new position of Chief Investment Officer was created. However, none of the College Illinois employees report to the Chief Investment Officer. One effect of this reorganization was to give more control of the Program to the Executive Director of ISAC.

Updated Response: Accepted. Beginning with the appointment of the new Commission Board in July 2011, ISAC has begun to review and revise its organizational structure. The first step in this reorganization was hiring a new Chief Investment Officer and a new Executive Director, who began working in December 2011 and February 2012, respectively.

While the possibility of future changes remains, a cross-functional team consisting of representatives from College Illinois! operations, marketing and sales and information technology meet on a regular basis to ensure cohesive operations and to hold each functional area accountable.

In addition, the Executive Director, Chief Investment Officer and the program's outside investment advisor meet regularly with the meeting documented.

2. The Illinois Student Assistance Commission should ensure that its Statement of Investment Policy is approved on an annual basis as required by the Prepaid Tuition Act. The Commission should also conduct a formal review of its policy to ensure that asset classes are defined, that operational guidelines are included for each asset class, and that the Investment Policy is serving its intended purpose.

Findings: The Commission has not approved a new Investment Policy since January 2010 which violates the statutory requirement of annually adopting a comprehensive investment plan.

The Statement of Investment Policy is one of the Program's primary control mechanisms. The purpose of the policy is to record long range policy, to promote understanding among various functional roles, and to address fiduciary responsibilities. The Executive Director is responsible for preparing the plan and the Commission is to approve any changes to the plan.

Since 2006, the College Illinois Statement of Investment Policy was revised nine times. Changes to the Investment Policy included the following:

- In January 2007, the Commission's philosophy toward policy modification was significantly changed. The policy's opening sentence was replaced by "The Commission shall review this Policy annually with the intention to improve investment performance in collaboration with its staff, the Investment Advisory Panel, and professionals hired by the Commission to manage the portfolio."

- The most significant changes to the policy occurred in June 2008. Several new sections were added which appeared to strengthen the controls in place. These included adding and defining the roles of the Chief Investment Officer and an Investment Committee. A section on Internal Controls and Conflicts of Interest was added as well as a requirement to perform an asset liability modeling study.

- The June 2008 revision also included significant changes to the target asset allocation. The policy was changed to allow investments in hedge funds and infrastructure. Overall, the target allocation to alternative investments was increased from 10% to 25%. The policy also authorized direct private equity investments. This change allowed College Illinois to make a $12.7 million investment in ShoreBank which ultimately was valued to zero.

- The previous Investment Policy, prior to June 2008, contained four primary investment objectives: (a) to earn the highest possible total return consistent with levels of risk prudent to the cash flow requirements of the Fund, (b) to create a stream of investment returns to insure the systematic and adequate funding of actuarially determined benefits through contributions and professional management of the Fund assets, (c) to achieve 100% funding, and (d) to preserve the safety of principal. The June 2008 revision removed the fourth primary investment objective, to preserve the safety of principal, from the policy.

- The June 2009 policy revision substantially changed the asset classes. The fixed income asset classes were changed with the removal of intermediate bonds and core bonds and the addition of three new asset classes: broad fixed income, international government/credit, and mortgage/other. These new asset classes were not defined anywhere in the policy. A new asset class was added under real estate entitled "Real Estate (GSA)." This asset class was also not defined anywhere in the policy. Marquette Associates, the Program's Investment Consultant, stated that some of the asset classes used were not institutionally accepted asset classes.

- Also changed in June 2009 was the important responsibility of rebalancing the Fund to meet the guidelines established in the policy. This was changed from the Commission with the assistance of the Investment Consultant to the newly formed Portfolio Committee.

<u>Updated Response</u>: Partially Implemented. On May 23, 2012, the Investment Advisory Panel and the Investment Committee jointly reviewed a draft Statement of Investment Policy that the Commission subsequently adopted at its June 25, 2012 meeting. The Commission approved minor changes to the Policy at its meeting on September 14, 2012. The new policy clearly defines and establishes operational guidelines for each asset class. The agency Chief Investment Officer and the General Counsel and Compliance Officer will monitor to ensure there is an annual review of the Policy.

3. The Illinois Student Assistance Commission should assess the need for the Portfolio Committee. If the Commission decides to maintain the Portfolio Committee, it should re-define the membership of the Committee and ensure that it meets monthly to review and rebalance the investment portfolio. The Program's Investment Consultant should be included in any meetings of the Portfolio Committee.

<u>Findings</u>: A revision to the Investment Policy established the Portfolio Committee in June 2009. The Portfolio Committee was not fulfilling its requirement to meet monthly to review the portfolio, asset allocation and affect any rebalancing based on decisions of the Committee as defined in the Investment Policy. The Portfolio Committee consisted of the following three people:

1. The Executive Director of ISAC;
2. The Chief Investment Officer; and
3. The Director of Portfolio Management and Direct Investment.

The Portfolio Committee failed to meet in six of 16 months from July 2009 through October 2010. Additionally, as of January 2012, there was no documentation to support that the Committee had met in the past 14 months (November 2010 through December 2011) since the Committee's last meeting in October 2010. For the 10 meetings that did occur, it is unclear whether all Committee members attended the meetings because attendance records were not always kept.

Prior to the establishment of the Portfolio Committee, the responsibility for rebalancing was with the College Illinois Investment Consultant. Rebalancing is the process of monitoring the portfolio to ensure that it complies with the Investment Policy. Based on the cash available to be invested, the Investment Consultant would analyze the portfolio and recommend where the funds should be invested to keep the portfolio in compliance.

Taking away the rebalancing function from the independent Investment Consultant, who had expertise in this area, provided more control over the portfolio to College Illinois management. Officials with Marquette Associates, the Program's Investment Consultant, stated that taking the function from them eliminated a paper trail. They would not find out what had been done until the following month when they received bank statements.

The last documented meeting of the Portfolio Committee was in October 2010. As of July 2011, the position of Director of Portfolio Management and Direct Investment had been eliminated. The Program was also without a Chief Investment Officer from July 2011 to December 2011.

Updated Response: Implemented. The needs assessment for the Portfolio Committee is complete. The new Statement of Investment Policy, adopted by the Commission at its June 25, 2012 meeting, replaces the Portfolio Committee with a requirement that the CIO keep the Executive Director informed regarding Fund activity and performance and that the CIO coordinate joint meeting with the Executive Director and Investment Consultant as needed, but at least quarterly. Investment Policy requirements for the Portfolio Committee and Executive Director meetings have been met since April 2012.

4. The Illinois Student Assistance Commission should assess the duties of the newly formed Investment Committee and revise the Investment Policy accordingly. The Commission should then ensure that the Investment Committee is fulfilling the duties outlined in the Investment Policy.

Findings: The Investment Committee, created by the Investment Policy, was not formally established. The Investment Committee was created in the June 2008 revision to the Investment Policy. The policy defines the committee as follows:

In this Policy, the "Investment Committee" refers to a committee consisting of at least two (2) members of the Commission appointed by the Chairman of the Commission, which will provide advice and guidance to the Chief Investment Officer on issues related to the investments of Fund assets.

The policy states that the Investment Committee shall meet at least quarterly with the Chief Investment Officer. Duties of the Investment Committee include:

- Reviewing and discussing investment strategy and trading practice;
- Reviewing relationships with financial institutions, including investment managers, to ensure that investment managers were being selected and reviewed in accordance with the guidelines in the Investment Policy; and
- Monitoring use of all Program funds to ensure appropriateness and compliance with Investment Policy objectives.

The addition of an Investment Committee had the potential to strengthen the internal controls over the investment process. Not all Commission members had expertise in investment management. However, there was not a formal resolution naming the commissioners to the committee and no further documentation was provided to show that the Investment Committee ever met.

<u>Updated Response</u>: Implemented. The new Statement of Investment Policy articulates the duties and responsibilities of the Investment Committee. The Committee has met quarterly and expects to do so in the future.

Investment action items are being reviewed by the Investment Committee prior to presentation to the full Commission. The Investment Committee agenda and quarterly performance review materials are created/formatted to meet the Committee's specific responsibilities for monitoring as outlined in the Investment Policy.

5. The Illinois Student Assistance Commission should ensure that the Investment Advisory Panel fulfills its statutory duties including:

- **Meeting at least twice annually;**
- **Meeting publicly with the Commission at least once per year;**
- **Filing statements of economic interest in a timely fashion; and**
- **Reviewing and advising the Commission with regard to the annual report.**

ISAC staff should ensure that any advice and counsel provided by the Panel regarding investments of the Program is relayed to the Commission. The Advisory Panel should submit its meeting minutes to the Commission to be reviewed at the subsequent Commission meeting.

<u>Findings</u>: The Investment Advisory Panel (Panel), established by the Illinois Prepaid Tuition Act, raised questions or concerns on certain investment issues which were not communicated to members of the Commission.

In addition, the Panel failed to fulfill its statutory duties by not meeting at least twice annually as required by the Illinois Prepaid Tuition Act. The Panel also did not meet publicly with the Commission at least once annually to discuss issues and concerns relating to the Illinois Prepaid Tuition Program. There was also at least one vacancy on the seven-member Panel throughout the audit period.

Duties of the Investment Advisory Panel

ISAC is to administer the College Illinois Program with the advice and counsel from the Investment Advisory Panel. The Illinois Prepaid Tuition Act states that the Panel shall consist of seven members who are appointed by the Commission:

- One that is recommended by the State Treasurer;
- One that is recommended by the State Comptroller;
- One that is recommended by the Director of the Governor's Office of Management and Budget; and
- One that is recommended by the Executive Director of the Board of Higher Education.

The remaining three members are recommended by the Commission. The Act further specifies:

- The Panel shall offer advice and counseling regarding the investments of the Program with the objective of obtaining the best possible return on investments consistent with actuarial soundness of the program. This includes reviewing and advising the Commission on provisions of the strategic investment plan and the annual report. The Panel at its own discretion also may advise the Commission on other aspects of the Program.

There was at least one vacancy (GOMB recommendation) on the seven-member Panel throughout the audit period. In addition, the seat filled by the Comptroller was vacant from December 2008 through the end of fiscal year 2011. This seat was recently filled in September 2011. The current Panel consists of six newly appointed members; however, there is still one vacancy to be filled from a recommendation from GOMB.

Meetings of the Investment Advisory Panel

The Act requires that the Panel meet at least twice annually. The Panel did not meet twice annually, as required, in three of the six years of the audit period. The meeting minutes reflect that the Panel did not meet twice in fiscal years 2008, 2010, and 2011.

In addition, the Panel failed to meet at least once each year with the Commission. Panel members attended a total of seven Commission meetings. Of the seven meetings, three were attended by only two Panel members and four were attended by only one Panel member.

At only two meetings did Panel members speak addressing "issues and concerns relating to the Illinois prepaid tuition program." Both of these meetings occurred during fiscal year 2007.

Concerns Raised by the Investment Advisory Panel

In addition to the Panel members, Advisory Panel meetings were attended by the Program's Investment Consultant as well as senior staff such as the Executive Director and Chief Investment Officer. The Panel fulfilled its statutory requirement by offering advice and counseling regarding the investments of the Program.

While the Panel offered advice and counsel regarding the investments of the College Illinois Program during the meetings it held, the guidance that Panel members offered was not always relayed back to the Commission.

June 18, 2008 Meeting of the Investment Advisory Panel

The Panel discussed proposed changes to the Investment Policy which included changing the policy to allow direct private equity investments. The Panel members offered the following comments:

- A Panel member suggested that a limit be placed so that no more than $750,000 be invested with one company.
- A Panel member suggested if the College Illinois Fund was going to invest in private equity that it be limited to a fund-to-fund approach. She stated "...to have a direct investment of a specific company is not in alignment with what the fund should be doing." Another Panel member agreed.

One Panel member specifically asked the Executive Director to communicate the Panel's concern about a direct investment to the Commission. The Commission met nine days later on June 27, 2008. One Commission member specifically asked if the Investment Advisory Panel had approved the Investment Policy. The Chief Investment Officer replied that it had. ISAC's General Counsel then clarified that the Panel's changes were incorporated but the Panel is not required to approve the policy. The meeting minutes do not indicate that the concerns raised by the Panel were communicated to the Commission.

May 28, 2009 Meeting of the Investment Advisory Panel

The Panel discussed proposed changes to the Investment Policy. One change discussed was a new asset class called "Real Estate (GSA)" which would have a target allocation of 10 percent of the entire Fund. This change to the asset allocation structure would allow for the investment into GSA leased buildings. This refers to the U.S. General Services Administration which provides workspace for federal workers. ISAC officials discussed investing in a specific FBI building in Kentucky.

A Panel member expressed concern over committing $80 million into one building. Another Panel member emphasized the importance of due diligence.

The Investment Policy was approved at the next Commission meeting on June 26, 2009. The new asset class, Real Estate (GSA), was included in the policy. However, there was no specific mention of the asset class during the meeting. The Chief Investment Officer stated that the revisions being brought to the Commission had been reviewed with the Investment Advisory Panel. The meeting minutes do not indicate that the concerns raised by the Panel were communicated to the Commission.

Other requirements of the Investment Advisory Panel were not completely fulfilled:

- Two of the 15 Panel members examined did not file their statements of economic interest until months after their first meeting.
- There is no documentation in the Panel meeting minutes that the Panel reviewed the annual reports. Minutes do show that the Panel reviewed the Actuarial Soundness Report for fiscal years 2005 and 2006 which is part of the annual report. None of the other minutes provided reflect that the Panel reviewed the actuarial reports for other years or the entire annual report in any of the years.
- There was no documentation to support that the requirement was being met for Panel members attend continuing educational forums, sessions, and seminars to improve knowledge on new investment products, strategies, and opportunities available in the marketplace.

Response: Accepted. The Statement of Investment Policy to be presented to the Commission Board at its June 2012 meeting for approval articulates the responsibilities and statutory duties of the Investment Advisory Panel. In addition, the General Counsel, as ISAC's Compliance Officer, has undertaken the preparation of an annual checklist of items that must be complied with including, without limitation, ensuring compliance by the Investment Advisory Panel with its statutory duties.

Updated Response: Partially Implemented. We have met the meeting requirement of the Investment Advisory Panel. Following is a list of meetings.

December 29, 2012
January 27, 2012 – Jointly with the Commission
January 27, 2012 – Jointly with the Investment Committee
May 23, 2012 – Jointly with the Investment Committee
December 3, 2012

Note - A joint meeting with the Commission was scheduled for January 24, 2013 but one panel member had to cancel at the last minute and this prevented the establishment of a quorum of panel members. The Chief Investment Officer reviewed the activity of the Panel with the Commission and the two attending members of the Panel were invited to raise any issues or concerns. No concerns were raised. We plan to hold a joint meeting at the next Commission meeting, which is scheduled for April 5, 2013.

The Panel members are on the Secretary of State list for the statements of economic interests. The Commission Secretary verifies the list with the Secretary of State and then monitors responses to ensure completion by all Panel members.

The annual report was reviewed and input solicited at the May 23, 2012 and December 3, 2012 meetings of the Panel. We will continue to seek input from the panel regularly.

6. The Illinois Student Assistance Commission should examine its process used to select investment managers and determine the role of its Investment Consultant in the process. The Commission should also ensure that:
- **Interviews/presentations are documented including who attended, the presentation given, and questions asked by evaluators;**
- **Selections are supported by rationale that justifies the number of vendors selected;**
- **The procurement files contain all completed evaluations. The evaluations should also include notes that support the scores given;**
- **The combined score sheets are reviewed to ensure they are free of errors; and**
- **The proposals are evaluated based on the criteria specified in the Request for Proposals.**

Findings: The process of selecting investment managers was inconsistent from fiscal years 2006 through 2011. Changes began to occur at the time that the College Illinois Program sought investment managers for alternative investments. The selection of investment managers changed in several distinct ways:
- The makeup of the evaluation committee changed;
- The role of the Investment Consultant changed; and
- The discussion of the selection of investment managers moved from the open session of the Commission meetings to the closed session.

Auditors also noted several issues with the procurements including: a lack of documentation for vendor interviews/presentations, missing evaluations, changing evaluation criteria from what was specified in the Request for Proposals, and lack of support justifying the number of proposers selected for award.

Procurement Process

ISAC invests College Illinois funds with a number of investment managers in a variety of different asset classes. To obtain investment managers, ISAC goes through a competitive procurement process. This process includes:
- Issuing a Request for Proposals (RFP) that outlines the desired services;
- Collecting responses to the RFP;
- Establishing an evaluation committee;
- Conducting a manager search on all proposers;
- Performing an initial ranking of the proposers;
- Narrowing the proposers to a set of finalists for interviews/presentations;
- Performing a final ranking of the finalists;
- Determining the number of proposers selected for award;
- Submitting the list of selected proposers to the Commission for approval; and
- Announcing the vendors selected for award.

During the period from fiscal year 2006 through fiscal year 2011, ISAC conducted 14 procurements to obtain investment managers. Auditors examined all 14 procurements to determine the process followed and how it changed over the time period. Auditors noted the following issues with the procurements:

- All members of the evaluation team did not complete an evaluation;
- The Investment Consultant did not perform the initial evaluations;
- Discussion of the investment decisions moved to closed session;
- Interview/Presentations not documented;
- No documentation of initial scoring;
- Errors in scoring;
- Evaluation criteria changed; and
- Potential conflict of interest issues.

Evaluation Committee

The makeup of the evaluation committee changed over the time period examined. The evaluation committee was more diversified in the earlier procurements including a Commissioner and a member of the Advisory Panel, in addition to staff at ISAC. Later procurements included only ISAC staff on the evaluation committee. For the last three procurements, the Executive Director of ISAC was included on the evaluation committee. This had not been done in any of the prior procurements. In the Hedge Funds RFP, which was the first time the Executive Director was on the evaluation committee, 24 firms were selected as finalists, far more than were selected for any other procurement examined. An e-mail from the Executive Director discussed his rationale for selecting finalists and noted "*Anything less than two dozen I will deem negligent.*"

Auditors also noted:

- For two procurements (Core Fixed Income and Infrastructure), one of the Commission members was listed as being on the evaluation committee but did not complete evaluations. For one procurement (Large-Cap International Equity), the Executive Director was included on the evaluation team, completed a conflict of interest form, but did not complete any evaluations. There was no documentation in the procurement files to indicate why he did not complete evaluations.

- For the earlier procurements, the Investment Consultant performed the initial evaluations that narrowed the list of proposals down to finalists. For later procurements, members of the evaluation committee performed the initial evaluations. However, this was not done consistently.

Role of the Investment Consultant

The role of the Investment Consultant changed over the time period examined. In the earlier procurements the process was consistent. The Investment Consultant was provided all of the proposals. The Investment Consultant then conducted a detailed manager search on each of the proposers creating a report with the results. The Investment Consultant also analyzed and scored the proposals based on the criteria in the RFP.

The Investment Consultant's role noticeably changed beginning with the Infrastructure procurement in 2009. Investment Consultant, Marquette Associates, stated with this change their role became basically secretaries setting up the meetings and providing space for the meetings. The Investment Consultant no longer provided any input.

Commission Approvals of the Investment Managers

Another noticeable change was that beginning with the Private Equity procurement in 2009 the discussions regarding the selection of investment managers moved from open sessions of the Commission to closed sessions. This continued for the next four procurements. The only part of the process that remained during open session was the vote on whether to approve the selections.

Other Procurement Issues

During the review of the 14 procurements, auditors noted several issues, some of which applied to the process as a whole while others were regarding specific procurements.

Interviews/Presentations Not Documented

For the interviews/presentations of the finalists, none of the 14 procurements contained documentation on who attended or what was discussed. The only documentation found in some files were schedules of when interviews were to take place and copies of PowerPoint presentations.

Lack of Information Justifying the Number of Proposers Selected for Award

The procurement files lacked evidence of discussions regarding the rationale for the number of proposers selected for award as required by procurement rules.

Incomplete Scoring Documentation

Three of the 14 procurements lacked documentation on the initial scoring of the proposers. Procurement rules specify certain documentation that is to be maintained in the procurement file including completed score sheets for individual evaluators and the evaluation committee's combined score sheets. For one of the 14 procurements, there was no documentation of the final scoring in the procurement file:

Lack of Notes to Support Scores Given

The evaluation forms, particularly for the later procurements, contained little to no justification for the scores given. Completed score sheets should be supported by thorough and appropriate comments. In the final procurement, one of the preliminary evaluations was handwritten on a blank sheet of paper with scores listed for the eight proposers. No further notes were listed and there was no name on the sheet. This was scanned and saved electronically indicating that it was the Executive Director's evaluation.

Errors in Scoring

Auditors noted mistakes during the scoring process for four of the 14 procurements. Some of these errors impacted the firms selected. Each of the errors is discussed in the following case examples.

Evaluation Criteria Changed

For three of the 14 procurements, the evaluation criteria were changed to total only 450 points instead of the 500 points outlined in the RFP. Procurement rules state that proposals shall be evaluated only on the basis of evaluation factors stated in the Request for Proposals.

Updated Response: Implemented. ISAC is complying with the Illinois Procurement Code in its selection of investment managers. The process for procurement of investment managers is currently subject to review and approval by the Executive Ethics Commission's procurement officer assigned specifically to ISAC. Additionally, The Investment Consultant participates in the procurement process. The Agency's Compliance Officer will monitor all procurements.

7. **The Illinois Student Assistance Commission should comply with the requirements set forth in the Illinois Procurement Code and administrative rules in procuring professional and artistic services. Prior to approving funding, the Commission should ensure that investment managers were selected through a competitive selection process.**

Findings: ISAC circumvented the Illinois Procurement Code by selecting the two investment managers, Kennedy Wilson and Lyrical-Antheus, outside of the normal procurement process. The Illinois Procurement Code requires that all professional and artistic services greater than $20,000 be awarded using a competitive request for proposal process. Neither Kennedy Wilson nor Lyrical-Antheus, who were the subjects of the due diligence reports, were one of the five firms selected as real estate investment managers in the May 1, 2009 RFP. Three of the five firms selected for award in the May 1, 2009 RFP have never received funding.

It is unclear how Kennedy Wilson and Lyrical-Antheus were initially identified. According to the former Chief Investment Officer, the Lyrical-Antheus investment was introduced to ISAC by the Director of Portfolio Management. By the time the investment was approved, the Director of Portfolio Management was no longer with the College Illinois Program. In April 2011, it was discovered that the Director of Portfolio Management had become a limited partner in Lyrical-Antheus.

During fiscal year 2011, Kennedy Wilson and Lyrical-Antheus received more than $2.6 million in investment fees.

Updated Response: Implemented. ISAC is complying with the Illinois Procurement Code in its procurement of professional and artistic services. The process for procurement of professional and artistic services is currently subject to review and approval by the Executive Ethics Commission's procurement officer assigned specifically to ISAC. The Agency's Compliance Officer will monitor all procurements.

8. The Illinois Student Assistance Commission should assess its conflict of interest policy making any needed revisions including appropriate disclosures of potential conflicts prior to procurement evaluation. Revisions should also include investment restrictions related to potential or recent ISAC investments for any ISAC employee involved in the investment process or members of the Commission or Investment Advisory Panel. The Commission should ensure that the policy is implemented and followed.

Findings: ISAC did not comply with its own conflict of interest policy. A conflict of interest requirement contained in the Program's Investment Policy, which required an annual conflict of interest attestation by Commissioners and employees authorized to make investment decisions, was never implemented.

There were two instances where the former Executive Director did not disclose potential conflicts of interest that met ISAC's criteria for disclosure. Both involved investment firms that were selected as investment managers, one of which received $20 million in funding.

There were also two instances where the Director of Portfolio Management made personal investments with vendors that were selected to be investment managers. In one instance, the Director of Portfolio Management made a personal investment while the selection process was still ongoing – specifically, a family partnership in which the individual had an economic interest made a $500,000 investment in Balestra Capital. He was also a member of the evaluation team that selected the vendor. In the other instance, the individual introduced the investment to ISAC and then, after leaving ISAC, became a limited partner in the investment.

ISAC has three different ethics or conflict of interest policies that impact the College Illinois Program:

- An agency wide employee ethics policy;
- A conflict of interest policy established as part of the College Illinois Investment Policy; and
- A conflict of interest statement that is required for members of an evaluation team.

Updated Response: Implemented. A new conflicts of interest policy was presented to the Commission Board at its June 2012 meeting that included appropriate disclosure requirements of potential conflicts of interest prior to procurement evaluation. The revised policy includes investment restrictions related to potential or recent investments for any ISAC employee involved in the investment process as well as members of the Commission Board or Investment Advisory Panel. ISAC, through its Compliance Officer, will ensure that the policy is implemented and followed.

9. The Illinois Student Assistance Commission should revise its Investment Policy to clarify its position on direct private equity investments and similar private equity investments where a substantial amount of funds is invested in a single company.

Findings: In April 2011, the Commission passed a resolution prohibiting direct private equity investments. This was less than two months after approving $10 million of additional funding for a similar private equity investment (Fisker) totaling $14 million.

In 2008, the Commission authorized a direct private equity investment of $12.7 million in ShoreBank. The Investment Policy was changed to allow this investment. By the end of fiscal year 2010, the Commission determined the entire $12.7 million value of the investment was worthless when the bank was taken over by the Federal Deposit Insurance Corporation (FDIC). At its April 1, 2011 meeting, the Commission adopted a resolution that stated that the Commission:

> *"...revise its investment policy to no longer allow Fund assets to be invested in any direct private equity investment, and that until such time as the investment policy is revised, the Commission shall not invest Fund assets in a direct private equity investment."*

The Executive Director stated at the meeting that this was intended to prohibit investments where there is not a fiduciary that lies between ISAC and the user of the capital. However, this was not clearly specified in the resolution.

Updated Response: Implemented. The new Statement of Investment Policy states that new commitments or search activity for private equity or similar closed-end investments cannot be initiated without the expressed approval of the Commission.

Additionally the new policy prohibits direct private equity investments or co-investments that are tied to a single company or investment. This statement does not prevent funding prior contractual commitments.

10. The Illinois Student Assistance Commission should:

- **ensure that all positions contain position descriptions that outline the education and experience needed for the position;**
- **ensure that only the salaries for employees whose work relates directly to the Program are charged as a direct payroll expense; and**
- **examine its practice of making additional payments to employees at the end of their employment.**

Findings: The number of employees working for the College Illinois Program increased significantly over the six-year period. Twelve of the 20 employees hired during that time period were principal administrative appointments which are positions hired at the discretion of the Executive Director. Two of the positions created were investment positions for which it was not clear what duties and responsibilities were performed. Both of these positions have subsequently been eliminated.

For eight of the 24 employees examined, position descriptions and other information in the file indicated that the positions did not relate directly to the College Illinois Program. Salaries and benefits charged for these eight employees totaled $613,000.

Other testing results showed that 46% (11 of 24) of the employees tested lacked position descriptions that listed the education and experience needed for the positions making it impossible to determine if employees were qualified. Eight employees received salary payments totaling $176,000 when they resigned or when they were terminated.

Updated Response: Implemented. The agency completed a systematic review to ensure that all employees have updated job descriptions on file, and that all current and new employees meet the stated job qualifications. The agency re-instituted procedures wherein new or updated position descriptions will be required at the point of hire and will be reviewed and updated as key job duties change.

Direct payroll expenses have been eliminated, replaced by allocating payroll cost based on actual time expended by a coworker as reported in the agency's new time management system. The Trust is invoiced for payroll expenses monthly.

The Executive Director has determined that there is a single College Illinois! employee who is a PAA who is potentially eligible for a potential payment at the end of their employment. Any agreement is included within the terms of the individual's original employment letter with ISAC. The Executive Director has made a recommendation to the Commission Chairman regarding the use of severance, voluntary separation agreements and other forms of payout that could occur at the point of employment termination for all other affected ISAC employees.

11. The Illinois Student Assistance Commission should ensure that its annual report contains all information required by its Investment Policy. ISAC should also include additional information that would be useful to contract holders and others who are evaluating the Program.

Findings: The annual report, which includes the actuarial report, is one of the primary vehicles for presenting meaningful information on the College Illinois Program. While the reports contain the minimal required statutory information, they do not contain further information required by the Investment Policy. The reports also do not contain certain information that would be useful to contract holders and others who are evaluating the Program. For example:

- The reports do not have any type of management discussion and analysis of the Program.
- The reports do not contain historical comparisons such as contract sales year by year, investment return year by year, or actuarial deficit year by year. The reports also do not contain any information on contract cancellations.
- The reports contain minimal information on the users of the Program. Useful information could include information on the number of prepaid students using benefits each year, the colleges and universities where those benefits are being utilized, and the average paid at each institution. This could also be presented historically to show trends in the Program.
- The actuarial reports, which are part of the annual reports, did not contain any comparison of assumptions used to what actually occurred. The actuarial reports also did not contain a historical comparison of assumptions and how they have changed over time. Actuarial reports will be discussed in more detail in the next section.

The Illinois Prepaid Tuition Act requires ISAC to prepare an annual report. The Act states:

> *The Commission shall annually prepare or cause to be prepared a report setting forth in appropriate detail an accounting of all Illinois prepaid tuition program funds and a description of the financial condition of the program at the close of each fiscal year. Included in this report shall be an evaluation by at least one nationally recognized actuary of the financial viability of the program. This report shall be submitted to the Governor, the President of the Senate, the Speaker of the House of Representatives, the Auditor General, and the Board of Higher Education on or before March 1 of the subsequent fiscal year. This report also shall be made available to purchasers of Illinois prepaid tuition contracts and shall contain complete Illinois prepaid tuition contract sales information, including,*

> *but not limited to, projected postsecondary enrollment data for qualified beneficiaries.* (110 ILCS 979/30(d))

The College Illinois Statement of Investment Policy imposes further requirements for the annual report. The Policy states the Commission is responsible for producing an annual report covering the following subjects:

- Investment performance summary including comparisons to benchmarks;
- Current and historical asset allocation in the Program;
- Progress toward the stated performance objectives in the Policy; and
- Other pertinent matters.

<u>Updated Response</u>: Implemented. ISAC complies with all statutory requirements in the current form of the annual report. That said, the agency believes that increasing transparency and the amount of information shared with current contract holders and future purchasers of College Illinois! contracts is vital in rebuilding and maintaining confidence in the program.

The agency has begun to post additional information, and on a more frequent basis, to both its primary websites: 529prepaidtuition.org and isac.org. ISAC staff has completed a review of other prepaid programs to identify best practices that could be adopted in future annual reports.

The next Annual Report is scheduled to be completed by March 1, 2013. A draft report will be circulated to Investment Advisory Panel members for individual review and to solicit recommendations.

12. The Illinois Student Assistance Commission should ensure that assumptions used in both the actuarial report and in setting contract prices are supported by documentation that shows how the assumptions were established.

<u>Findings</u>: ISAC, which is responsible for the actuarial assumptions used in both the actuarial report and to set tuition contract prices, was unable to provide documentation for how assumptions were established.

Exhibit 3-4 also shows the assumed and actual return for each year as well as the 5-year return as of the end of each fiscal year. As of June 30, 2011, the total fund had an average return of 2.9% over the last five years and a return of 3.5% since the Program's inception in 1998. This compares to an actuarial assumed rate used in the 2006 – 2011 actuarial reports ranging between 7.5% and 9.25%.

Exhibit 3-4
ACTUARIAL ASSUMED RATE OF RETURN VS. ACTUAL RETURN

	FY06	**FY07**	**FY08**	**FY09**	**FY10**	**FY11**	**FY12**
FY05 Report Assumptions	7.75%	7.75%	7.75%	7.75%	7.75%	7.75%	7.75%
FY06 Report Assumptions		8.00%	8.00%	8.00%	8.00%	8.00%	8.00%
FY07 Report Assumptions			8.25%	8.50%	8.75%	9.00%	9.00%
FY08 Report Assumptions				8.50%	8.75%	9.00%	9.00%
FY09 Report Assumptions					9.25%	8.75%	8.75%
FY10 Report Assumptions						9.25%	8.75%
FY11 Report Assumptions							7.50%
Actual Annualized Return	7.6%	15.4%	(7.7%)	(15.1%)	9.7%	16.1%	-
5-year Annualized Return	5.6%	9.3%	7.1%	1.2%	0.8%	2.9%	-

Source: College Illinois actuarial reports and investment reports.

The investment return assumption increased from 8% in the FY06 report to 9.25% in the FY2010 report. The FY11 report lowered the investment return assumption to 7.5%.

The lowering of the investment assumption coincided with the change in administration at ISAC. Auditors asked, based on the change in assumptions, whether ISAC considered the assumption used in the previous reports to be unrealistic. Officials responded that ISAC believes those prior return assumptions were realistic, albeit within the high end of a realistic band of assumptions.

Tuition Increases Assumption

The assumption for tuition increases remained fairly consistent ranging between 7.5 % and 11% depending on the type of contract. In the earlier years, a higher rate was assumed for the next year and lower rate for the following years. This changed in 2010 when a constant rate was used.

Exhibit 3-5 shows the weighted average for tuition and fees at Illinois public universities for the last 20 years. A weighted average is determined by adjusting the average tuition based on attendance at each school. Since the 2001-02 academic year, tuition and fee increases have increased by at least 8.6% in every year with a high of 13.5% in 2004-05.

Future Contract Sales Assumption

During the audit period, ISAC met or exceeded its assumed contract sales only once, in 2007-2008 when 4,860 contracts were sold. In all other years, the assumed rate, which varied from 6,000 to 3,500 was well above the actual rate in every enrollment period. In 2011, the assumption was changed to a constant of 2,500 per year.

Setting Tuition Contract Prices

The actuarial projections play a big part in establishing the tuition contract prices. Each year, the Commission established the contract prices to charge for the next enrollment period. Prices were developed by staff in cooperation with the program's actuary. Recommended pricing was then submitted to the Commission for approval.

Exhibit 3-5
HISTORIC INCREASES IN TUITION AND FEES AT ILLINOIS PUBLIC UNIVERSITIES (WEIGHTED AVERAGE)

Academic Year	Tuition and Fees	Annual Increase
1990-91	$2,410	
1991-92	2,538	5.3%
1992-93	2,901	14.3%
1993-94	3,134	8.0%
1994-95	3,303	5.4%
1995-96	3,434	4.0%
1996-97	3,629	5.7%
1997-98	3,817	5.2%
1998-99	3,942	3.3%
1999-00	4,160	5.5%
2000-01	4,406	5.9%
2001-02	4,786	8.6%
2002-03	5,298	10.7%
2003-04	5,785	9.2%
2004-05	6,565	13.5%
2005-06	7,151	8.9%
2006-07	7,875	10.1%
2007-08	8,553	8.6%
2008-09	9,452	10.5%
2009-10	10,442	10.5%
2010-11	11,386	9.0%

Source: Illinois Student Assistance Commission.

When considering approval of the proposed contract prices, the documentation provided to the Commission stated that when establishing contract prices, a number of different factors were considered including:

- Actuarial impact of tuition and fee increases;
- Impact of truth-in-tuition legislation;
- State budget constraints creating upward pressure on tuition and fees;
- Improving the actuarial soundness of the program;
- The projection of investment performance; and
- Anticipated annual contract sales.

For the most recent pricing period, this documentation consisted of a four-page discussion of the factors considered. **This is the only documentation that exists to support how the prices were established. There is no underlying analysis that would provide needed support for the level of contract pricing.** For example, when discussing the investment return assumption for the 2010-2011 pricing period, the documentation stated:

> *Beginning with 2009-2010, expectations for future (gross) investment performance have increased to reflect the changes made to the investment policy: from 8.5 percent in FY2009; to 9.25 percent in FY2010 and FY 2011; and to 8.75 percent in each year thereafter. This enhanced investment performance is possible in part because of opportunities inherent in the portfolio's size (now nearly $1.0 billion) and*

flows from asset allocation changes and further diversification of the program's investment portfolio implemented in FY2010 and thereafter, actions endorsed earlier this year by both the program's Investment Advisory Panel and the Commission. Those actions include further diversification of the investment portfolio's allocation to other asset classes with lower correlations to domestic equities such as Real Estate, Private Equity, Infrastructure and Hedge Funds.

This is the only documentation that exists for setting the investment return assumption. There is no underlying analysis to show how this percentage was determined or that would show if this was a reasonable assumption given the investment portfolio.

The first two years of the Program showed an actuarial reserve and funded ratio greater than 100%. The last 11 years, however, have all shown an actuarial deficit. In FY02, the funded ratio had gone down to 81.2% before rebounding to 93.3% in FY07. The funded ratio fell dramatically over the next two fiscal years to a low of 67.6% in FY09. The most recent actuarial report showed a funded ratio of 70.5%.

Updated Response: Implemented. The agency has documented how it arrived at the assumptions used for the March 30, 2011, the June 30, 2011 and the June 30, 2012 Actuarial Soundness Valuation Reports.

13. The Illinois Student Assistance Commission should assess its process for determining fees and charges assessed to purchasers of prepaid tuition contracts including maintaining documentation that quantifies the effect of administrative costs on the overall pricing structure.

Findings: In FY11, fees collected from tuition contract purchasers covered only 7% of the total cost of operating the program. An administrative load fee was included as part of tuition contract prices. However, ISAC could not provide any information to quantify this fee and its effect on the overall pricing structure. Without further documentation, there is no assurance that ISAC is accounting properly for administrative costs when establishing tuition contract prices. The difference between the fees collected and the operation costs comes from participant contributions and investment income.

The Illinois Prepaid Tuition Act states that charges and expenses shall be paid exclusively from the Illinois Prepaid Tuition Trust Fund. The Fund was created as the repository of all moneys received by the Commission in conjunction with the Illinois prepaid tuition program. The Fund is a non-appropriated fund; therefore, all Program funding is derived entirely from payments received from contract purchasers and the investment income earned by the Fund.

Including Administrative Costs in Tuition Contract Prices

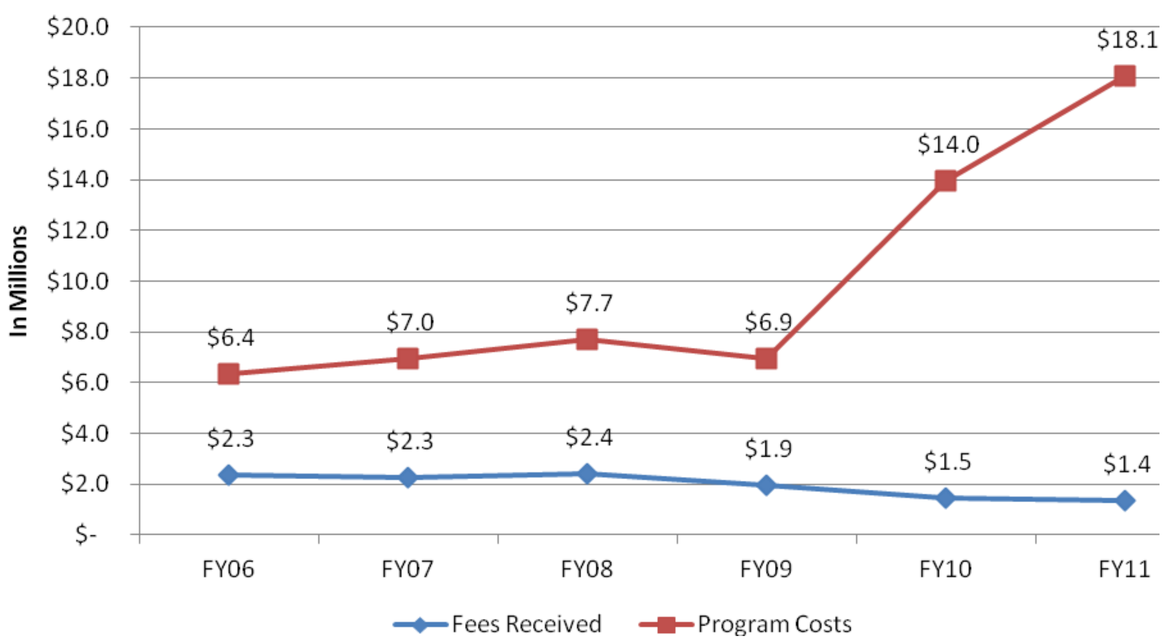
Tuition contract prices are established prior to each year's enrollment period. Contract prices are developed in consultation with the Program's actuary and presented to the Commission for approval. The Commission is provided a summary of how the contract prices were developed and the factors considered.

The summary provided no further information to quantify the effect of administrative costs on the overall pricing structure. However, ISAC was unable to provide any further documentation other than what appeared in the actuarial report and the Commission meeting minutes.

Fees Received from Contract Purchasers

The annual financial statements include the amount of the fees received by ISAC to cover College Illinois' administrative costs. Exhibit 4-2 shows the fees received for fiscal years 2006 through 2011.

Exhibit 4-2
FEES RECEIVED COMPARED TO PROGRAM COSTS



Source: OAG analysis of program costs and fees received.

Updated Response: Implemented. Going forward, the agency is documenting the administrative cost built into contract pricing and program fees.

14. The Illinois Student Assistance Commission staff should provide information to Commission members on budgeted vs. actual expenses. The information provided should coincide with the categories in the approved budget so that Commission members can make meaningful comparisons.

Findings: The primary control over Program costs is the passage of an annual budget. Each year, ISAC staff prepares a budget request which is presented to the Commission. The budget request compares the amount approved the previous year to the amount requested for the next year. The budget request also contains a narrative discussing the amounts requested and explaining increases and decreases compared to the previous year's budget. At the Commission meeting, the budget is presented and discussed. The Commission then votes to approve the budget.

Auditors examined the budget requests for each year beginning with FY06 through FY11. They also examined the Commission meeting minutes for the discussion of the annual budget. While Commission members raised questions about the budget, there was never a change to the proposed budget in the six years examined.

Actual expenses were often lower than what was budgeted, but also were frequently higher than what was budgeted. For example, in fiscal year 2009, the Commission approved $432,000 for intra-agency services. Intra-agency services represent other ISAC personnel and agency resources used to support the program. The actual expense totaled $999,165. Documentation indicated that the Executive Director and the Chief Program Officer approved an increase in the budgeted amount to $1,000,000. This was not brought to the Commission for approval.

The administrative portion of the budget increased significantly over the six year period doubling from $3.8 million to over $7.6 million. The biggest increases occurred in the areas of personal services and intra-agency services. Personal services increased by 298% while intra-agency services increased by 525%.

It should be noted that the Commission did not approve a budget for College Illinois for fiscal year 2012. The budget was usually approved at the Commission's June meeting. However, the June meeting was rescheduled to July and the membership of the Commission was revamped during this time. The budget was never placed on the agenda and was not discussed.

Updated Response: Implemented. Starting with the June 25, 2012 Commission meeting Agenda Book, this information is being presented in a consistent format to facilitate comparisons.

15. The Illinois Student Assistance Commission should establish a cost allocation policy or a payment methodology that establishes a reasonable basis of

allocating expenses to ensure a consistent allocation of expenses from year to year.

<u>Findings</u>: ISAC does not have a set policy for how costs are allocated. Although ISAC follows the same basic method each year, there is no policy or methodology in place to ensure that costs are allocated consistently from year to year. This resulted in expenses being inconsistently allocated in order to bring expenses up to the budgeted amounts.

Methods Used

While some costs can be directly attributed to the College Illinois Program, other costs are allocated to the Program. The costs of centralized functions such as legal and accounting are allocated to various programs, including College Illinois, based on management estimates.

The cost allocation was determined during the budget process which occurs during the third and fourth quarters of the preceding fiscal year. According to the summaries provided, the cost allocation process was as follows:

- Fiscal years 2006 to 2009 – ISAC developed an estimated cost allocation percentage by division based on discussions with directors for the various programs and functions.
- Fiscal year 2010 – ISAC prepared a shared cost allocation by employee by department based on input from managers and directors.
- Fiscal year 2011 – ISAC prepared a cost allocation survey by employee by department which was then submitted to the directors for approval. Once received back from the directors, the cost allocation percentages and personnel data were consolidated to determine the cost by programs and functions.

Actual Practice

An examination showed that the method for allocating costs worked as described for the beginning of the process. In fiscal year 2010, ISAC developed a shared cost allocation by employee.

The actual allocation of expenses, however, worked much differently. Rather than allocate a percentage of the salary from each employee identified that worked on College Illinois, ISAC charged the entire salaries of selected individuals.

ISAC officials stated that for efficiency and convenience purposes a majority of the shared expenses are charged to the personnel and payroll. Rather than move employees in and out of the fund for payroll, they pay a certain predetermined number of employees from the College Illinois Fund for the whole year. Officials also stated that if personal services expense does not cover the budgeted amount, invoices from other services are charged to cover the balance.

This method results in an inconsistent allocation of expenses from year to year. It also makes the process appear arbitrary and makes it difficult to determine the true cost of operating the program.

Updated Response: Implemented. The agency has implemented new processes to reasonably allocate expenses to the appropriate program and activities, including College Illinois! Personnel costs are allocated based on the actual time spent on each program. Direct costs, other than personnel, are billed to the appropriate Fund. Indirect or shared expenses (building, utilities, telecom, etc.) are allocated based on the average expense per FTE. A team has been established to review allocations on a periodic basis.

Asset Allocation

House Resolution 174 directed the Auditor General to conduct an independent asset allocation study of the College Illinois! Prepaid Tuition Program to determine the overall level of risk associated with its investments. The Office of the Auditor General contracted with a consultant to perform the study. A summary of the study follows.

The College Illinois asset allocation has evolved over the last six years. In 2006, the Fund was invested entirely in traditional asset classes: fixed income, equity, and cash. Conversely, in 2011, these asset classes accounted for 58 percent of the Fund while the remaining 42 percent was invested in alternative investments: private equity, hedge funds, real estate, and infrastructure.

The Office of the Auditor General contracted with a consultant, Ibbotson Associates, to perform an independent asset allocation study of the College Illinois current investment mix as directed by House Resolution 174. **The analysis was of the asset allocation as of June 30, 2011, and was not an analysis of the actual past performance of the portfolio.** Results of the analysis included the following:

- Historical analysis showed that the College Illinois asset allocation, as of June 30, 2011, with alternative investments was less risky compared to a standardized portfolio without alternative investments. Returns were lower for the shorter time periods examined but higher for the longer time periods. A forward looking analysis showed that the College Illinois asset allocation with alternatives has the potential to outperform the standardized portfolio without alternatives with potentially lower risk/volatility.

- **It is important to note that the allocation study used benchmark indices for the different asset classes. The actual investments made by College Illinois and their performance may differ.** To perform the analysis, Ibbotson analyzed College Illinois' asset allocation as of June 30, 2011, and selected benchmarks to accommodate the study. Ibbotson noted that decisions made when implementing an asset allocation policy with different investment managers have the potential to significantly add or detract value by introducing manager specific risk. As an example, College Illinois recently invested $14 million in a single company. This investment involved a high degree of risk in that the company is in a relatively early stage of development with little operating history. In addition, Chapter Two notes several issues with ISAC's selection of investment managers including selecting two managers outside of the normal procurement process.

- The College Illinois portfolio as of June 30, 2011, was less risky than 3 of the 4 states examined. The state with the least risky portfolio concentrated the majority of its assets in fixed income investments. Only 1 of the other 4 states examined included alternative investments in its portfolio. This state's alternative investments comprised 13 percent of its total portfolio compared to 42 percent for College Illinois.
- The College Illinois program differentiates itself from the programs of other states by having a more diversified asset allocation policy. Both the target and actual asset allocations offer exposures to a larger number of asset classes than the portfolios of the other states. Historically, alternative asset classes such as private equity, hedge funds and infrastructure had lower correlations to the traditional asset classes. Therefore, adding these asset classes to a traditional equity and fixed income portfolio has the potential to improve a portfolio's risk and return characteristics.
- Although the overall asset allocation is well diversified as measured by the number of asset classes in the opportunity set, there is a lack of diversification within the traditional fixed income portion of the portfolio.
- In addition, while the exposure to alternative asset classes was one of the strengths of the College Illinois asset allocation, the individual weights to the alternative asset class do not seem to be optimal given the results for mean-variance optimization and they seem to be concentrated in the hedge fund asset class.

While the asset allocation study showed that a portfolio with alternative investments was less risky compared to a standardized portfolio without alternative investments, there are other issues to consider when using alternative investments. The lengths of the agreements with investment managers for alternative investments are much longer making the portfolio less liquid. Management fees were also substantially higher and additional outside costs were incurred related to legal services and due diligence services.