STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

# Arizona State Retirement System

REPORT
HIGHLIGHTS
**PERFORMANCE AUDIT**

## Subject

The Arizona State Retirement System (ASRS) was established in 1953 and provides retirement, disability, survivor, and retiree health insurance benefits. ASRS has about $22 billion in assets, over 340,000 nonretired members, and nearly 70,000 retired members who currently receive benefits.

## Our Conclusion

The Arizona State Retirement System has generally managed its investments reasonably through appropriate use of asset allocation approaches. However, it needs to improve the timeliness of benefits paid to new retirees and of the withdrawals requested by terminating employees. ASRS also should monitor and assess its staffing plan to improve the performance of its call center.

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# ASRS Generally Manages Investments Appropriately

The Arizona State Retirement System (ASRS) provides retirement, disability, survivor, and health insurance benefits. It has over 400,000 members, including nearly 70,000 retirees. ASRS pays over $1.2 billion in benefits to its members annually.

Benefits are paid from ASRS' $22 billion trust fund. This fund consists of contributions from members and employers, and the income ASRS earns by investing the fund. ASRS' goal is to average an 8 percent rate of return on its investments over the long-term.

## ASRS' investment approach reflects industry practices

The ASRS Board uses a blend of two investment approaches–strategic and tactical–to guide its investments.

**Strategic asset allocation**—The ASRS Board invests assets primarily through an approach called "strategic asset allocation" that focuses on a long-term investment strategy. Using the strategic asset allocation approach, the Board balances its investments by setting a goal to have a specific percentage of its assets invested in each of four main asset classes (see Table 1).

Table 1: ASRS Asset Allocations

| Asset Class | Goal | Actual Percentage |
|---|---|---|
| Domestic equities | 53% | 55.9% |
| International equities | 15 | 18.1 |
| Fixed income instruments | 26 | 25.9 |
| Real estate | 6 | 0.1 |

**Tactical asset allocation**—The Board complements its strategic asset allocation approach with a tactical allocation approach, which focuses on adapting to changing economic conditions. This approach focuses more on achieving short-term results and can help to increase investment returns beyond those projected under the strategic asset allocation.

**Use of both approaches appropriate**—The blended use of strategic asset allocation and tactical asset allocation is generally accepted as the appropriate way of governing investment decisions for public pension funds. Auditors interviewed chief investment officers at four state pension funds, and all reported that their fund primarily used strategic asset allocation, but also used tactical asset allocation.

## Investment returns follow U.S. stock market

Because ASRS has a higher-than-average investment in domestic stocks, its investment returns are correlated with the rise and fall of the broad U.S. stock markets. With the markets' strong performance in the late 1990s, ASRS' rate of return currently exceeds its benchmarks for the past 10-year period.

**Higher-than-average investment in domestic stocks**— As of March 31, 2005, the Board had invested 56 percent of its assets in domestic stocks. The average for public pension funds is 44.5 percent. According to ASRS, it invests a higher percentage in domestic stocks because this asset class produces long-term returns that are higher than those of other asset classes.

**Returns versus benchmarks**—The Board measures its investments' performance against four main benchmarks:

- The Board's 8 percent actuarial rate of return goal.
- ASRS' Strategic Asset Allocation (SAA) benchmark, which is a single, weighted benchmark that includes the performance of all four asset class benchmarks.
- Recognized investment performance benchmarks, such as the S&P 500 index for domestic stocks.
- Other pension plans' returns.

Table 2: Total Investment Returns Compared To 8 Percent Goal and SAA As of March 31, 2005

| | Percentage Returns | Percentage Comparison To Actuarial Goal | Percentage Comparison To SAA |
|---|---|---|---|
| 1 year | 6.7% | -1.3% | +0.1% |
| 3 years | 6.2 | -1.8 | +0.5 |
| 5 years | 1.6 | -6.4 | +0.9 |
| 10 years | 10.0 | +2.0 | +1.3 |

Source: Auditor General staff analysis of unaudited *Pension Plan Presentation Report First Quarter 2005* prepared by Mercer Consulting.

Total ASRS returns are correlated with the returns of the broad U.S. stock markets. U.S. stock markets' strong performance in the late 1990s helped ASRS meet its 8 percent rate of return benchmark for the 10-year period ending March 31, 2005, as shown in Table 2. However, coincident with a sharp decline in stock prices in 2000 and again in 2004, ASRS has not exceeded its 8 percent benchmark for the past 1-, 3-, and 5-year periods.

## Real estate investments

In August 2003, the Board approved the allocation of 6 percent of total assets in real estate investments. In order to diversify its investment, the Board plans to invest in Core and non-Core real estate. Core real estate is high-quality property that is substantially leased and produces a generally stable stream of income. These are office buildings, industrial facilities, retail stores, and apartments. Non-Core properties are lower quality or not substantially leased.

ASRS has made progress preparing to begin its real estate investments. It has hired a consultant to advise it, hired an internal real estate expert to help manage the program, hired real estate legal counsel, and selected three external managers to make the actual real estate investments. However, ASRS still needs to sign contracts with the three managers and also needs to approve its real estate investment policies and procedures.

In 2006, the Board will again review its asset allocation and consider investing in other new investment areas. These areas may include private equities, venture capital, and hedge funds, which offer a higher potential return for the trust fund, but also carry significant risk.

### Recommendation

ASRS should:

- Adopt the policies and procedures needed to implement its real estate program.

# ASRS Can Improve Performance of Paying Some Benefits

ASRS pays several monetary benefits to its members, including pensions to members upon retirement and contribution refunds to members who terminate employment. Pensions paid to members increased from about $695 million in fiscal year 2000 to over $1.2 billion in fiscal year 2004, an increase of about 80 percent.

Terminating employees who choose to withdraw their money will receive their contributions plus interest. If they have more than 5 years of service, they also receive a portion of their employer's contributions based on years of service, receiving 100 percent with 10 years of service.

**Timeliness of new retiree pensions**—ASRS' goal is to send retirees their first check within 60 calendar days of retirement, while its peer retirement systems pay the majority of their new retirees within 30 days. ASRS took more than 2 months to pay a quarter of its new retirees between July 2003 and January 2005 (see Table 3).

Table 3: Time Frame for Paying New Retirees

| Calendar Days | Number of New Retirees | Percentage of Total |
|---|---|---|
| 30 or less | | -- |
| 31-45 | 3,619 | 49.8 |
| 46-60 | 1,773 | 24.4 |
| 61 or more | 1,870 | 25.8 |
| Total | 7,262 | 100% |

**Accuracy of initial pension payments**—ASRS conducts a final audit of the pension amount within 3 months after retirement. Although some errors do occur in calculating pension amounts, the audits appear to correctly identify them. Further, the size of the errors is generally small—about 2 percent of the correct amounts—and ranged from $0.01 to $35.61 for the files we reviewed.

**Improving the timeliness of refunds**—ASRS' goal is to make refund payments within 45 business days of a request. However, it achieves this goal only about 50 percent of the time.

Delays appear to occur in issuing refunds largely because ASRS has a backlog of requests that it needs to manually review to confirm the employees' years of employment.

## Recommendations

ASRS should:

- Improve the timeliness and accuracy of paying new retirees their annuities.
- Improve the timeliness of paying refunds.

# ASRS Should Monitor and Assess Plan for Improving Call Center Performance

Since June 2004, the ASRS call center's performance has worsened. However, a plan to correct the problems likely added more staff than necessary.

**Fewer calls answered and longer wait times**—Before June 2004, the call center answered an average of 94 percent of its calls; however, that average fell to 69 percent by May 2005. During the same time, wait times increased from an average of 37 seconds to over 5 minutes.

**Plan likely adds too many staff**—To address the problems with the call center performance, ASRS developed a plan and added ten more staff. However, the plan assumes too high a growth in call volume, which has already decreased in the past few months. Also, the model used to project the staffing has a tendency to overestimate staffing needs. It appears five new positions may be all that were needed.

### Recommendation

ASRS should:

- Monitor, and redeploy as appropriate, the new positions allocated to the call center.

## Followup To 1994 Audit

This report follows up on several issues examined in a 1994 performance audit and sunset review of ASRS (Auditor General Report No. 94-3).

**Contribution rates have been increasing**—The 1994 audit warned that conditions that had kept contribution rates low were unlikely to continue. Contribution rates have risen from 2.0 percent in fiscal year 2003 to 6.9 percent in fiscal year 2006 and are projected to increase to 8.6 percent in fiscal year 2007. The recent higher contribution rates were brought on by several factors, including low rates of return on investments from 1999 through 2002, increases in benefits, and changes to actuarial assumptions, including mortality rates. As of June 30, 2004, the Plan's pension fund and Plan and System health benefits funds had assets equal to 91.2 percent of liabilities.

**Greater internal management of assets**—The previous audit also identified that ASRS could reduce management costs by internally managing more assets. ASRS now internally manages approximately 30 percent of its assets.

**Problems in implementing a new information system**—Additionally, the 1994 report examined problems in the development of ASRS' new computer system. Since the 1994 audit, several parts of the new system have been completed, but further development remained somewhat in flux. ASRS had some concerns about the integration of its financial systems. After considering the option of buying some off-the-shelf software, ASRS decided to continue developing its own IT systems.

**Long-term disability costs**—Finally, the 1994 audit recommended restructuring the long-term disability program by using other state agencies to provide services while saving an estimated $250,000 per year. ASRS continues to have a contractor provide these services because it does not believe the State has a program that can offer all of the current LTD program's services for an equal or lower cost.

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