VRS OVERSIGHT Report

JOINT LEGISLATIVE AUDIT & REVIEW COMMISSION
OF THE VIRGINIA GENERAL ASSEMBLY

Semi-Annual Investment Report
December 2005

As of September 30, 2005, the market value of the Virginia Retirement System (VRS) pension fund was $45.79 billion. The return for the fiscal year through September 30, 2005 is 5.0 percent and 16.6 percent for the one-year period ending September 30, 2005. The fund's performance exceeded established benchmarks for the one-, three-, five-, and ten-year periods ending September 30, 2005. However, during the five-year period ending September 30, 2005, the VRS' investment return fell short of the current actuarially assumed investment rate of return of 7.5 percent. Performance indicators are provided in Table 1 (page 2).

Public Equity. The public equity program continues to be VRS' largest asset class comprising 62.7 percent of the portfolio or $28.7 billion. The public equity program exceeded established benchmarks for the fiscal year to date and the one-, three-, and five-year periods ending September 30, 2005.

Fixed Income. Returns for the fixed income program have declined since the last semi-annual report. For example, returns for the program from July 1,

Profile: Virginia Retirement System Investments (as of September 30, 2005)

Market Value of Assets: **$45.8 billion**

Number of External Managers:
Public Equity – 27 Fixed Income - 6

Number of External Investment Accounts:
Public Equity – 33 Fixed Income - 6

Total Return on Investments			
10 years	*5 years*	*3 years*	*1 year*
9.7%	**3.9%**	**16.5%**	**16.6%**
Performance/Intermediate Benchmark			
9.0%	**3.5%**	**15.8%**	**14.8%**

Time periods ending 9/30/2005

Number of VRS Investment Department Staff: 39 authorized FTE positions (5 vacant)

FY 2005 Investment Expenses: $165.1 million (37.5 basis points)

FY 2005 Investment Department Operating Expenses: $7.6 million (1.7 basis points)

Investment Policy Indicators (as of September 30, 2005)

	Asset Allocation (% of Total Assets)		*Asset Allocation* (% of Asset Class)		*Type of Management* (% of Asset Class)	
Asset Class	**Target**	**Actual**	**Domestic**	**Non-U.S.**	**External**	**VRS**
Public Equity	**62.6%**	**62.7%**	**69.0%**	**31.0%**	**74.0%**	**26.0%**
Fixed Income	**20.0%**	**19.7%**	**97.2%**	**2.8%**	**62.9%**	**37.1%**
Hedge Funds	**≤ 4.0%**	**3.8%**	**80.0%**	**20.0%**	**100%**	**0%**
Private Equity	**≤ 6.0%**	**5.2%**	**80.6%**	**19.4%**	**100%**	**0%**
Real Estate	**≤ 6.0%**	**4.4%**	**96.5%**	**3.5%**	**94.0%**	**6.0%**
Credit Strategies	**≤ 5%**	**3.8%**	**94.2%**	**5.8%**	**100%**	**0%**

Table 1

VRS Investment Performance for Period Ending September 30, 2005

Program / Performance Objective	*Fiscal Year to Date*	*1 Year*	*3 Years*	*5 Years*
Total Fund	*5.0%*	*16.6%*	*16.5%*	*3.9%*
Total Fund Benchmark - Intermediate	4.4%	14.8%	15.8%	3.5%
Total Fund Benchmark - Long Term	2.9%	12.0%	14.4%	2.1%
Total Public Equity	*6.7%*	*20.5%*	*21.6%*	*1.6%*
Public Equity Custom Benchmark	6.5%	19.5%	21.2%	1.2%
Total Fixed Income	*-0.6%*	*3.2%*	*4.6%*	*6.9%*
Lehman Total VRS Custom	-0.7%	2.8%	3.9%	6.6%
Total Private Equity	*8.7%*	*27.2%*	*16.5%*	*2.5%*
Private Equity Custom Benchmark	2.8%	10.6%	12.1%	1.3%
Total Real Estate	*6.1%*	*25.5%*	*17.6%*	*14.2%*
Real Estate Custom Benchmark	4.8%	21.5%	15.8%	12.5%
Total Hedge Funds	*4.3%*	*12.2%*	*n/a*	*n/a*
Custom Hedge Funds Benchmark	2.2%	8.2%	n/a	n/a
Total Credit Strategies	*1.6%*	*5.8%*	*n/a*	*n/a*
VRS Credit Strategies Custom	1.5%	6.8%	n/a	n/a

Source: JLARC staff analysis of VRS data.

2005, to September 30, 2005, were negative (-0.6 percent). However, the program generated positive returns (3.2 percent, 4.6 percent, and 6.9 percent, respectively) for the one-, three-, and five-year periods ending September 30, 2005. The program also outperformed its benchmark in all of these periods.

Private Equity. The private equity program continued to perform well, had strong returns, and substantially outperformed its benchmark for the fiscal year to date and the one-, three-, and five-year periods ending September 30, 2005. The private equity program's dollar-weighted return, since the inception of the program in April 1989, is 23.8 percent. The private equity benchmark (the dollar-weighted Russell 3000 plus 250 basis points) for this same period was 19.9 percent. Similarly, the program outperformed the Russell 3000 Index (public market) over this period by 6.4 percent.

Credit Strategies. Credit strategies are an alternative to the domestic equity market. VRS credit strategies include investments in areas such as public high yield debt, private debt, convertibles, bank loans, and high yield asset backed securities. VRS uses credit strategies opportunistically when the expected returns of the asset category are competitive with the expected returns of domestic equities. Credit strategies also offer diversification and cash flow benefits. The investments in this program are not part of the plan's fixed income allocation.

The credit strategies program started on July 1, 2004. As of September 30, 2005, the program had $1.7 billion in assets and represented 3.8 percent of the total fund. The credit strategies program fell short of its benchmark for the one-year period ending September 30, 2005 (5.8 percent versus 6.8 percent).

Hedge Funds. The hedge fund program began in July of 2003, and currently has two components. The larger component consists of hedge fund investments selected and monitored with the assistance of two hedge fund advisors (Ivy Asset Management and The Rock Creek Group). The second component involves non-advisory hedge fund investments by VRS staff without the assistance of a third party advisor. The hedge fund program seeks broad diversification across managers, strategies, and styles. Hedge funds generally have low correlation to the equity market, and thereby provide the total fund with additional diversification benefits.

The hedge fund program outperformed its benchmark for the fiscal year to date and the one-year period ending September 30, 2005. As of September 30, 2005, the total appreciated value of the hedge fund program was $1.7 billion, representing 3.8 percent of the total VRS portfolio.

Real Estate. The VRS real estate program had strong returns and outperformed its benchmark for the fiscal year to date and the one-, three-, and five-year periods ending September 30, 2005 (6.1 percent, 25.5 percent, 17.6 percent, and 14.2 percent, respectively). The total value of the real estate portfolio as of September 30, 2005 was $2.0 billion or 4.4 percent of the total fund. Concerns have been raised that recent real estate performance is a "bubble." In order to address concerns, staff will continue to manage the portfolio opportunistically and investigate alternative property types. In addition, VRS has been an active seller in this market environment, and is being selective in the investments made. Further, VRS staff noted that the strong return levels are not likely to be sustainable going forward and their long-run, forward-looking expected returns for both the public and private real estate markets are in the seven percent to ten percent range.

Review of VRS Alterative Investments

At the direction of the VRS Board of Trustees, the investment staff recently completed an evaluation and review of VRS' alternative investments, including hedge funds, private equity, real estate, and credit strategies. At the October 12, 2005, VRS Board of Trustees meeting, staff provided an explanation of the rationale for each of the investment programs and an overview of the staff's implementation approach for these investments. The staff also made recommendations for program changes. VRS staff explained that the alternative asset classes are generally viewed as alternatives to domestic equity. In order to buy alternative investments, for example, VRS has to sell domestic equity holdings. The staff also discussed the need to be mindful of VRS' cash flow needs, because some alternative investments are less liquid than other publicly traded asset classes. The hedge fund program was an area of particular focus during this review.

After this review was presented to the Board, a number of changes to the hedge fund program were implemented. These include reducing the number of managers, making larger allocations to the best managers, continuing to work for better transparency and more reasonable fees, expecting a higher return, and utilizing VRS management committee expertise in managing and maintaining the program.

One of the most significant changes to the hedge fund program will be the reduction in the number of hedge fund managers. Previously, there were as many as

51 managers, but VRS has recently reduced the number of managers to 40. The reduction in the number of managers is designed to decrease exposure redundancy and to increase individual manager due diligence activities. Further, reducing the number of managers will improve VRS' ability to target investments with the best managers rather than spreading risk across many managers. Because hedge funds are a collection of active strategies rather than a separate asset class and because the hedge fund program is funded from equities, VRS will be integrating hedge funds within the public equity program and its risk budget.

The new hedge fund program structure should serve to encourage more strategic decision making about the costs and benefits of funding hedge funds with their associated high fees, lock-ups, and low transparency versus keeping the money in the equity market. As hedge funds are a substitute for public equity, they should produce a meaningful return premium to the Russell 3000 over a market cycle. As a result of this revised mission for the hedge fund program, the benchmark for the hedge fund program will also change from a custom hedge fund benchmark to the Russell 3000 plus 100 basis points over a market cycle. By moving the program under public equity, VRS can leverage the knowledge and expertise of existing staff for use in investing in hedge fund opportunities. VRS also plans to change the role and terms of engagement with its outside hedge fund advisors. Going forward, VRS staff anticipates maintaining the program's current exposure and will consider further investments on an opportunistic basis.

Leadership Changes at VRS

The VRS Board of Trustees selected Charles W. Grant as chief investment officer (CIO) on August 18, 2005. Since March, Mr. Grant has served as acting CIO after the departure of the former CIO. Mr. Grant joined VRS in 1995 as the chief fixed income officer. Prior to joining VRS, Mr. Grant was the senior vice president at Commonwealth Investment Counsel, in Richmond.

On July 26, 2005, Governor Warner appointed J. Alfred Broaddus, Jr., to fill an unexpired term on the VRS Board of Trustees. Mr. Broaddus' term will expire on February 28, 2006. Mr. Broaddus recently retired from the Federal Reserve Bank of Richmond, where he served as bank president from 1993 until 2004.