VRS OVERSIGHT Report

JOINT LEGISLATIVE AUDIT & REVIEW COMMISSION OF THE VIRGINIA GENERAL ASSEMBLY

Semi-Annual VRS Investment Report July 2007

As of March 31, 2007, the market value of the VRS pension fund was $55.1 billion. The return for the total fund for the one-year period ending March 31, 2007, was 13.5 percent. The fund's performance exceeded established benchmarks for the one-, three-, five-, and ten-year periods ending March 31, 2007. The fund also exceeded the assumed actuarial rate of return, 7.5 percent, for all of these periods. Performance indicators are provided in Table 1.

Public Equity. The public equity program continues to be VRS' largest asset class comprising 64.7 percent of the portfolio or $35.6 billion. Non-U.S. public equities constituted 20.2 percent of the total fund portfolio or $11.1 billion with 14 percent of non-U.S. equities in emerging and 86 percent in developed markets. The public equity program exceeded established benchmarks for the three- and five-year periods ending March 31, 2007. Performance for the one-year period ending March 31, 2007, slightly lagged behind the benchmark. As reported in December 2006, this performance is due in part to active managers having a difficult time

Profile: Virginia Retirement System Investments (as of March 31, 2007)

Market Value of Assets: $55.1 billion

Number of External Managers:
Public Equity – 48 (24 traditional, 34 hedge funds - 24 hedge funds are active)
Fixed Income – 7

Total Return on Investments			
10 years	*5 years*	*3 years*	*1 year*
9.8%	**10.4%**	**12.9%**	**13.5%**
Performance/Intermediate Benchmark			
9.2%	**9.8%**	**11.9%**	**13.0%**

Number of External Investment Accounts:
Public Equity – 55 (30 traditional, 35 hedge funds - 25 hedge funds are active)
Fixed Income – 7

Number of VRS Investment Department Staff: 48 authorized FTEs (8 vacant)

FY 2006 Investment Expenses: $226.6 million (46.7 basis points)

FY 2006 Investment Department Operating Expenses: $9.4 million (1.9 basis points)

Investment Policy Indicators (as of March 31, 2007)

	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	**64.8%**	**64.7%**	**67.2%**	**32.8%**	**68.6%**	**31.4%**
Fixed Income	**20.0%**	**19.9%**	**99.0%**	**1.0%**	**63.0%**	**37.0%**
Private Equity	**≤ 7.0%**	**6.1%**	**73.3%**	**26.7%**	**100.0%**	**0.0%**
Real Estate	**≤ 7.0%**	**5.0%**	**87.0%**	**13.0%**	**95.7%**	**4.3%**
Credit Strategies	**≤ 6.0%**	**4.0%**	**94.3%**	**5.7%**	**100.0%**	**0.0%**
Cash	**0.25%**	**0.46%**	**n/a**	**n/a**	**100.0%**	**0.0%**

Table 1
VRS Investment Performance for Period Ending March 31, 2007

Program/ Performance Objective	Fiscal Year to Date	1 Year	3 Years	5 Years
Total Fund	*14.3%*	*13.5%*	*12.9%*	*10.4%*
Total Fund Benchmark - Intermediate	13.6%	13.0%	11.9%	9.8%
Total Fund Benchmark - Long Term	11.5%	9.9%	8.6%	6.9%
Total Public Equity	*15.9%*	*14.1%*	*14.7%*	*10.7%*
Public Equity Custom Benchmark	15.8%	14.3%	14.4%	10.5%
Total Fixed Income	*6.8%*	*6.7%*	*3.6%*	*5.6%*
Total VRS Custom	6.7%	6.6%	3.3%	5.3%
Total Private Equity	*23.2%*	*29.9%*	*26.5%*	*16.6%*
Private Equity Custom Benchmark	11.5%	18.2%	13.7%	9.7%
Total Real Estate	*21.8%*	*23.5%*	*23.1%*	*18.4%*
Real Estate Custom Benchmark	18.6%	20.9%	20.5%	16.2%
Total Credit Strategies	*9.9%*	*9.2%*	*n/a*	*n/a*
VRS Credit Strategies Custom	11.1%	11.0%	n/a	n/a

Source: VRS investment department data.

outperforming the benchmark during a transition period in the overall economy. However, the return for the fiscal-year-to-date exceeded the benchmark (15.9 versus 15.8 percent.)

Fixed Income. As of March 31, 2007, the fixed income program comprised 19.9 percent of the portfolio or $11 billion. Almost all, or 99 percent, of fixed income assets were domestically invested with 76 percent of the portfolio invested in AAA credit rated instruments. Most fixed income assets are invested in treasuries, mortgage-backed securities, and corporate bonds. The fixed income program exceeded established benchmarks for the one-, three-, and five-year periods ending March 31, 2007.

Private Equity. Private equity is an opportunistic substitute for public equity. Through active equity management, VRS expects to earn a meaningful return premium on its private equity investments. As an early institutional adopter to the asset class, VRS has enjoyed the benefit of association with top quartile managers and holds an advantage in developing new relationships in an increasingly crowded asset class. VRS focuses on allocating its capital to managers and strategies in which a high degree of confidence has developed, versus simply allocating capital to the asset class as a whole.

The private equity program continues to add value to the overall portfolio and exceeded established benchmarks for the one-, three-, and five-year periods ending March 31, 2007. In addition, the dollar weighted annualized performance since the inception of the program in April 1989 through December 31, 2006, was 24 percent.

Credit Strategies. The credit strategies program began July 1, 2004. As of March 31, 2007, the program had $2.2 billion in assets and represented 4.0 percent of the total fund. The credit strategies program fell short of meeting its benchmark for the one-year period ending March 31, 2007 (9.2 percent versus 11.0 percent). Several factors have contributed to the program's underperformance relative to its benchmark. First, VRS places a larger emphasis on upper quality investments. Recent strong drivers of performance in the benchmark have been distressed- and CCC-rated credits, which are underrepresented in the program. Secondly, VRS has a significant amount of money in limited partnerships. These investments experience a “j curve” effect whereby investments tend to post lower or negative early returns and produce higher returns in later years.

VRS believes that the credit strategies program is well positioned to outperform the credit benchmark over a credit cycle. Many of the riskiest investments, in which VRS has less exposure, traditionally suffer outsized losses as the credit cycle turns negative. Additionally, VRS expects its limited partnerships to start contributing larger returns relative to long-term averages as the portfolios mature and investment gains are realized in the latter years of the investments.

Real Estate. The VRS real estate program continued to outperform its benchmark for the one-, three-, and five-year periods ending March 31, 2007 (23.5 percent, 23.1 percent, and 18.4 percent, respectively). The total value of the real estate portfolio as of March 31, 2007, was $2.7 billion or 5.0 percent of the total fund. Thirteen percent of the real estate program was invested internationally.

Hedge Funds. VRS considers hedge funds active investment strategies that can be used within any of the investment programs, subject to a total policy limit set by the Board at five percent. Most of the hedge fund managers are public equity managers. While not considered a separate asset class, investments in hedge fund strategies constituted $2.2 billion or 4.1 percent of the total portfolio. As of March 31, 2007, there were 35 public equity hedge funds of which 25 were active (21 equity funds and four multi-strategy funds). VRS is waiting to redeem approximately $112 million from 10 managers. There was one credit strategies hedge fund manager with $106 million invested or 0.19 percent of the total portfolio.

The total fees associated with hedge funds are generally higher than those applied to other asset classes, but the majority of these fees are performance-based. The annualized performance of VRS' public equity hedge fund exposure since the inception of the program in July 2003 was 11.8 percent. The custom benchmark was 9.9 percent. In comparison, during the same period the Russell 3000 returned 13.7 percent. After reducing the number of funds and managers, the annualized performance (net of associated fees) of VRS' public equity hedge fund exposure since its inclusion in the public equity program on January 1, 2006, was 15.6 percent. The custom benchmark returned 14.5 percent. In comparison, during the same period the Russell 3000 returned 13.5 percent. The credit strategies hedge fund, established in July 2006, returned 6.3 percent compared to a benchmark return of 11.3 percent and the Russell 3000 return of 12.7 percent. VRS reports that this credit-related hedge fund investment vehicle is positioned to provide six to eight percent returns in a steady credit environment, with significant upside in a deteriorating environment. The performance to date has been in line with this portfolio’s profile. Due to the strong credit market performance, however, the account has lagged on a relative basis.

Appointments to the Board of Trustees Announced

The Joint Rules Committee reappointed Raymond B. Wallace, Jr., to the VRS Board of Trustees for a term of five years beginning March 1, 2007, and ending February 29, 2012. In addition, the Governor appointed Frankie D. Hughes, President and Chief Investment Officer of Hughes Capital Management, Inc., to the Board of Trustees for a five-year term ending February 29, 2012. Ms. Hughes replaces Mr. Vernard C. Henley.

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VRS Oversight Report is published periodically by the Joint Legislative Audit and Review Commission (JLARC) in fulfillment of Section 30-78 *et seq.* of the *Code of Virginia*. This statute requires JLARC to provide the General Assembly with oversight capability concerning the Virginia Retirement System (VRS) and to regularly update the Legislature on oversight findings.

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