



**JOINT LEGISLATIVE AUDIT
& REVIEW COMMISSION**
OF THE VIRGINIA GENERAL ASSEMBLY

VRS Semi-Annual Investment Report December 2007

As of September 30, 2007, the market value of the VRS pension fund was \$59.4 billion. The return for the total fund for the one-year period ending September 30, 2007, was 18.6 percent. The fund's performance exceeded established benchmarks for the one-, three-, five-, and ten-year periods ending September 30, 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 63.6 percent of the portfolio or \$37.8 billion. Non-U.S. public equities constituted 20.7 percent of the total fund portfolio or \$12.3 billion. The public equity program exceeded established benchmarks for the one-, three- and five-year periods ending September 30, 2007.

Fixed Income. As of September 30, 2007, the fixed income program comprised 19.8 percent of the portfolio or \$11.8 billion. Almost all (94.9 percent) of fixed income assets were domestically invested. Most fixed income assets (80 percent)

Profile: Virginia Retirement System Investments (as of September 30, 2007)

Market Value of Assets: \$59.4 billion

Number of External Managers:

Public Equity – 46 (24 traditional, 27 hedge funds – 22 hedge funds are active)

Fixed Income – 7

Number of External Investment Accounts:

Public Equity – 51 (28 traditional, 28 hedge funds – 23 hedge funds are active)

Fixed Income – 7

Number of VRS Investment Department Staff: 48 authorized FTEs (7 vacant)

FY 2007 Investment Expenses: \$241.9 million (40.7 basis points)

FY 2007 Investment Department Operating Expenses: \$11.4 million* (1.9 basis points)

Total Return on Investments			
10 years	5 years	3 years	1 year
8.7%	15.9%	15.6%	18.6%
Performance/Intermediate Benchmark			
8.1%	15.2%	14.4%	17.1%

Investment Policy Indicators (as of September 30, 2007)

Asset Class	Asset Allocation (% of Total Assets)		Asset Allocation (% of Asset Class)		Type of Management (% of Asset Class)	
	Target	Actual	Domestic	Non-U.S.	External	VRS
Public Equity	63.9%	63.6%	67.8%	32.2%	70.2%	29.8%
Fixed Income	20.0%	19.8%	94.9%	5.1%	64.7%	35.3%
Private Equity	≤ 7.0%	6.6%	73.0%	26.7%	100.0%	0.0%
Real Estate	≤ 7.0%	5.3%	88.0%	12.0%	96.6%	3.4%
Credit Strategies	≤ 6.0%	4.0%	94.0%	6.0%	100.0%	0.0%
Cash	0.25%	0.7%	n/a	n/a	100.0%	0.0%

*Includes allocated administrative expenses

Table 1
VRS Investment Performance for Period Ending September 30, 2007

<i>Program/ Performance Objective</i>	<i>Fiscal Year to Date</i>	<i>1 Year</i>	<i>3 Years</i>	<i>5 Years</i>
<i>Total Fund</i>	2.7%	18.6%	15.6%	15.9%
Total Fund Benchmark - Intermediate	2.8%	17.1%	14.4%	15.2%
Total Fund Benchmark - Long Term	2.0%	13.1%	10.8%	12.6%
<i>Total Public Equity</i>	1.8%	21.6%	18.2%	19.7%
Public Equity Custom Benchmark	2.4%	21.0%	17.8%	19.5%
<i>Total Fixed Income</i>	2.8%	5.0%	4.0%	4.5%
Total VRS Custom	3.0%	5.2%	3.9%	4.1%
<i>Total Private Equity</i>	10.6%	39.8%	30.0%	22.3%
Private Equity Custom Benchmark	6.3%	22.6%	14.9%	14.1%
<i>Total Real Estate</i>	5.2%	22.3%	23.9%	19.8%
Real Estate Custom Benchmark	4.2%	17.2%	20.4%	17.4%
<i>Total Credit Strategies</i>	-0.2%	9.5%	7.5%	n/a
VRS Credit Strategies Custom	0.6%	10.1%	8.3%	n/a
Source: VRS investment department data.				

are invested in mortgage-backed securities (42%), corporate credits (22%), and U.S. Treasuries (16%). In terms of the program's credit quality, 80 percent of the program is either in government and agency bonds or AAA-rated instruments. The fixed income program exceeded established benchmarks for the three- and five-year periods ending September 30, 2007, but fell short of the benchmark for the one-year period.

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 of September 30, 2007, private equity represented 6.6 percent of the total fund or \$3.9 billion.

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 September 30, 2007. In addition, the dollar-weighted annualized performance since the inception of the program in April 1989 through June 30, 2007, was 24.2 percent.

Credit Strategies. The credit strategies program began July 1, 2004. As of September 30, 2007, the program had \$2.4 billion in assets and represented four percent of the total fund. In the VRS portfolio, credit strategies are considered an alternative to the domestic equity market. Over the long term, VRS expects its credit strategies program to provide returns that are competitive with its long-term expectations for domestic equity investments. The program also provides diversification and cash flow benefits, as well as lower volatility than equities.

The credit strategies program fell short of meeting its benchmark for the one- and three-year periods ending September 30, 2007. In establishing the program, VRS anticipated returns between six and eight percent. While the program lagged its benchmark, VRS believes that the credit strategies program is well positioned to outperform the credit benchmark over a credit cycle. One factor contributing to the program's current underperformance relative to its benchmark is that VRS places 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.

Real Estate. The VRS real estate program continued to outperform its benchmark for the one-, three-, and five-year periods ending September 30, 2007 (22.3 percent, 23.9 percent, and 19.8 percent, respectively). The total value of the real estate portfolio as of September 30, 2007, was \$3.1 billion or 5.3 percent of the total fund. Twelve 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. While not considered a separate asset class, investments in hedge fund strategies constituted \$2.6 billion or 4.5 percent of the total portfolio. Most of the hedge fund managers are public equity managers, but there is one hedge fund manager in the credit strategies program.

The annualized performance of VRS' public equity hedge fund exposure since the inception of the program in July 2003 was 12.8 percent. The custom benchmark was 10.6 percent. In comparison, during the same period the Russell 3000 returned 13.9 percent.

The credit strategies hedge fund, established in July 2006, returned 4.2 percent compared to a benchmark return of 9.6 percent and a Russell 3000 return of 17.1 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 previously strong credit market performance, however, the account has lagged on a relative basis.

VRS' Direct Subprime Exposure. Recently, much has been written about the subprime issue and its effect on the financial markets. As of September 30, 2007, VRS held approximately 1.4 percent of the total fund in securities collateralized by subprime mortgages. While these securities, along with most other types of credit-related securities, have suffered some mark-to-market losses in recent months, the majority of this exposure continues to be highly rated, and VRS does not expect any material long-term defaults or losses. On September 30, VRS did not have direct exposure to subprime collateralized debt obligations (CDOs), where much of the losses have occurred.

Automatic Enrollment in Deferred Compensation Plan. Starting January 1, 2008, newly hired and re-hired salaried State employees will be enrolled automatically in the 457 Deferred Compensation Plan (457 Plan). House Bill 1830, passed by the 2007 General Assembly, made enrollment in the 457 Plan automatic.

Unless they opt out of participation, employees who are enrolled automatically defer \$20 per pay period and will receive a \$10 employer match to the 401(a) Cash Match Plan, for a total of \$30 to the employee's accounts per pay period. Automatic deferrals and the employer cash match begin the first pay date occurring 90 days after Great-West Retirement Services, the recordkeeper for the plan, sends the new employee an automatic enrollment notice. Employees have 90 days from the date of the notice to opt out of the 457 Plan. After deferrals begin, new employees have an additional 90 days to opt out and receive a refund of any deferrals made.

Employees who are enrolled automatically in the 457 Plan will be invested in the default investment fund, the VRS Balanced Growth Fund, which is a mixture of stocks and bonds. However, employees may change their investment options at any time.

MEMBERS OF THE JOINT LEGISLATIVE AUDIT AND REVIEW COMMISSION**Chairman**

Senator Thomas K. Norment, Jr.

Vice-Chairman

Delegate Leo C. Wardrup, Jr.

Delegate Vincent F. Callahan, Jr.

Senator John H. Chichester

Senator Charles J. Colgan

Delegate M. Kirkland Cox

Delegate H. Morgan Griffith

Delegate Frank D. Hargrove, Sr.

Delegate Johnny S. Joannou

Delegate Dwight C. Jones

Delegate Robert D. Orrock, Sr.

Delegate Lacey E. Putney

Senator Walter A. Stosch

Senator Martin E. Williams

Walter J. Kucharski,

Auditor of Public Accounts

Director

Philip A. Leone



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.

JLARC Staff Assigned to VRS Oversight:

Glen S. Tittermary, Deputy Director

Patricia S. Bishop, Principal Legislative Analyst

Martha Erwin, *VRS Oversight Report* Editor