VRS OVERSIGHT Report

JOINT LEGISLATIVE AUDIT & REVIEW COMMISSION
OF THE VIRGINIA GENERAL ASSEMBLY

VRS Semi-Annual Investment Report
July 2008

As of March 31, 2008, the market value of the VRS pension fund was $55.7 billion. The return for the total fund for the one-year period ending March 31, 2008, was 1.5 percent. The fund's performance exceeded established benchmarks for the one-, three-, five-, and ten-year periods ending March 31, 2008. However, the fund did not earn the current assumed actuarial rate of return, 7.5 percent, for the one- and ten-year periods ending March 31, 2008. Performance indicators are provided in Table 1.

Public Equity. Public equity investments are higher risk investments that are expected to provide long-term capital growth and inflation protection. Both of these expectations assume a long-term time horizon. The public equity program continues to be VRS' largest asset class comprising 58.5 percent of the portfolio or $32.6 billion. Non-U.S. public equities constituted 20.3 percent of the total fund portfolio or $11.3 billion. The public equity program exceeded established bench-

Profile: Virginia Retirement System Investments (as of March 31, 2008)

Market Value of Assets: $55.7 billion

Number of Public Equity and Fixed Income External Managers:
Public Equity – 41 (23 traditional, 22 hedge funds – 18 hedge funds are active)
Fixed Income – 9 (1 of the 9 traditional managers also manages a hedge fund)

Total Return on Investments			
10 years	*5 years*	*3 years*	*1 year*
7.0%	**13.9%**	**10.1%**	**1.5%**
Performance/Intermediate Benchmark			
6.4%	**13.1%**	**9.2%**	**0.5%**

Number of Public Equity and Fixed Income External Investment Accounts:
Public Equity – 46 (27 traditional, 23 hedge funds – 19 hedge funds are active)
Fixed Income – 13 (12 traditional, 1 hedge fund)

Number of VRS Investment Department Staff: 48 authorized FTEs (6 vacant)

FY 2007 Investment Expenses: $241.9 million (41.7 basis points)

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

Investment Policy Indicators (as of March 31, 2008)

	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**	**59.0%**	**58.5%**	**65.0%**	**35.0%**	**73.0%**	**27.0%**
Fixed Income**	**20.0%**	**20.0%**	**94.6%**	**5.4%**	**68.0%**	**32.0%**
Private Equity	**≤ 10.0%**	**7.9%**	**74.8%**	**25.2%**	**100.0%**	**0.0%**
Real Estate	**≤ 10.0%**	**7.0%**	**87.0%**	**13.0%**	**94.6%**	**5.4%**
Credit Strategies**	**≤ 10.0%**	**5.9%**	**94.8%**	**5.2%**	**100.0%**	**0.0%**
Cash	**0.25%**	**0.73%**	**100.0%**	**0.0%**	**100.0%**	**0.0%**

***Includes allocated administrative expenses**
****Figures include hedge funds**

Table 1
VRS Investment Performance for Period Ending March 31, 2008

Program/ Performance Objective	Fiscal Year to Date	1 Year	3 Years	5 Years
Total Fund	*-3.6%*	*1.5%*	*10.1%*	*13.9%*
Total Fund Benchmark - Intermediate	-3.7%	0.5%	9.2%	13.1%
Total Fund Benchmark - Long Term	-5.4%	-1.7%	6.1%	9.9%
Total Public Equity	*-9.9%*	*-3.2%*	*9.6%*	*16.1%*
Public Equity Custom Benchmark	-9.4%	-3.5%	9.5%	15.8%
Total Fixed Income	*7.5%*	*6.7%*	*5.3%*	*4.7%*
Fixed Income Custom Benchmark	9.1%	8.4%	5.7%	4.7%
Total Private Equity	*18.1%*	*26.5%*	*27.0%*	*25.6%*
Private Equity Custom Benchmark	5.5%	7.6%	11.4%	16.1%
Total Real Estate	*5.7%*	*7.6%*	*20.7%*	*19.1%*
Real Estate Custom Benchmark	6.9%	7.4%	18.4%	17.4%
Total Credit Strategies	*-4.5%*	*-1.3%*	*5.4%*	*n/a*
VRS Credit Strategies Custom	-5.2%	-3.2%	5.1%	n/a

Source: VRS investment department data. All returns are time weighted.

marks for the one-, three- and five-year periods ending March 31, 2008, but lagged the benchmark for the fiscal year to date. Absolute returns for the fiscal year and one-year periods ending March 31, 2008, were negative (-9.9 percent and -3.2 percent, respectively), but the three- and five-year period performance was positive (9.6 percent and 16.1 percent, respectively).

Fixed Income. As of March 31, 2008, the fixed income program comprised 20 percent of the portfolio or $11.1 billion. The program serves as a diversifier for the overall portfolio. Almost all (94.6 percent) of fixed income assets were domestically invested. The fixed income program underperformed its benchmark for the fiscal year to date as well as the one- and three-year periods ending March 31, 2008.

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 March 31, 2008, private equity represented 7.9 percent of the total fund or $4.4 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 March 31, 2008. In addition, the dollar-weighted annualized performance since the inception of the program in April 1989 through December 31, 2007, was 24.1percent.

After several years of favorable conditions for private equity, attractive exits are now harder to achieve, the pace of new investment has slowed, funding has become more expensive, and internal rates of return are coming down. As a result, returns in the asset class are not likely to be as high as they have been previously. However, VRS intends to continue concentrating its private equity investments with the best managers who can effect beneficial changes in the operational and financial structures of the companies purchased and thereby continue to generate a meaningful return over the public market.

Credit Strategies. VRS credit strategies include investments in areas such as public high yield debt, private debt, convertibles, bank loans, and high yield asset backed securities. The credit strategies program began July 1, 2004. As of March 31, 2008, the program had $3.3 billion in assets and represented 5.9 percent of the total fund. In the current VRS portfolio, credit strategies are used opportunistically and are considered an alternative to the domestic equity market. While the VRS credit strategies program has performed better than the established benchmarks, it experienced losses of 1.3 percent over the one-year period and 4.5 percent for the fiscal year to date.

Real Estate. The VRS real estate program continued to outperform its benchmark for the one-, three-, and five-year periods ending March 31, 2008 (7.6 percent, 20.7 percent, and 19.1 percent, respectively). The total value of the real estate portfolio as of March 31, 2008, was $3.9 billion or 7.0 percent of the total fund. Approximately 25 percent of the real estate portfolio is invested in public real estate equities (REITs). Thirteen percent of the real estate program was invested internationally.

Active Cash Management. VRS adopted an active cash strategy in 2007 with the goal of enhancing the return on cash balances through the use of highly rated, but less liquid, short duration debt instruments. Many of these debt instruments came under pricing pressure as liquidity dried up in the money market. While VRS expected to earn a yield premium with this strategy, short-term performance has been negatively impacted by market conditions, and the strategy is experiencing more volatility than expected.

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 currently set by the Board at ten percent. Previously, the policy limit was five percent. While not considered a separate asset class, investments in hedge fund strategies constituted $3.2 billion or 5.7 percent of the total portfolio. Most of the hedge fund managers are public equity managers, but there are also hedge fund managers in the credit strategies and fixed income programs. Hedge funds have exceeded performance benchmarks for every period ending March 31, 2008. Absolute performance for the quarter and fiscal year to date periods ending March 31, 2008, was negative (-4.3 percent and -0.9 percent respectively), but the one- and three-year, as well as the since inception period returns, were positive (6.9 percent, 11.2 percent and 10.7 percent, respectively).

Board Increases Policy Limits for Alternative Asset Classes

At its February 2008 meeting, the VRS Board approved changes to its investment policy by increasing the policy limits on VRS' alternative asset classes. Specifically, the Board approved increasing the policy limits on credit strategies from six percent to ten percent and on real estate and private equity from seven percent to ten percent of the total fund. Further, the Board approved an increase to the policy limit on hedge funds from five percent to ten percent of the total fund.

These policy limits are not considered targets; VRS practice has been to invest when and if opportunities in these asset classes materialize versus allocating assets in order to simply meet hard targets or predetermined goals. If opportunities arise, the new policy limits afford staff increased flexibility to invest in alternative asset classes. Similarly, using limits rather than setting hard targets, allows staff to not only add new investments when they believe that they are priced attractively, but also allows staff to pull back when the value prospect is not considered as desirable.

Board Approves Additional Changes to Asset Allocation Policy

VRS' asset allocation policy defines the expected risk and return characteristics of the investment portfolio. While VRS is a long-term investor and its asset allocation policy is not expected to change significantly year to year, the policy of conducting an asset allocation study on an annual basis ensures that VRS reviews its risk tolerance and its forward expectations at least once each year. While the study is conducted annually, asset allocation targets can be reconsidered any time market conditions or the underlying assumptions change in a material way. For example and as noted above, earlier in the year the Board granted staff additional flexibility in the form of increased policy limits for credit strategies, real estate, private equity and hedge funds. As a result of this year's annual review, the Board maintained some of the major components of its current policy, but also made a number of changes to the asset allocation policy.

First, the Board voted to maintain the current policy mix of 70 percent domestic stocks and 30 percent domestic bonds as the baseline long-term benchmark and risk target for the fund. With the current long-term benchmark expected return of 7.5 percent and expected annualized volatility of 12 percent, the fund can still be expected to lose money approximately one in every four years. The Board also voted to maintain the current total fund tracking error limit of 200 basis points on a rolling three-year basis. The Board also approved maintaining the ten percent limits for alternative investments, including private equity, real estate, credit strategies, and hedge funds.

While the baseline portfolio remained the same, the Board approved several changes to the public equity program. The Board voted to adopt a global equity benchmark weight for the emerging markets allocation. The current target would be 6.5 percent compared to the current allocation of 3.9 percent. The move to increase emerging markets will be implemented in two steps on the quarters ending September 2008 and March 2009. In addition, VRS will apply the current non-U.S. equity policy weight of 20 percent of the total fund to only non-U.S. developed markets. Previously, the 20 percent weight applied to the total of developed and emerging markets. Now, the emerging market policy limit will be treated separately, which will result in a total policy weight for non-U.S. equity of approximately 27 percent (20 percent developed plus 6.5 percent emerging). In addition, the VRS board has changed the way it thinks about "home base" for funding alternative investments. Previously, VRS funded alternatives out of domestic equity. Going forward, the funding source for alternative investments will be total public equity.

Another significant change to the asset allocation policy deals with the 20 percent policy weight for fixed income. High quality fixed income is expected to perform reasonably well when the economy comes under stress, and this has generally been the case over the last year. However, VRS does not expect that robust returns will be produced by the fixed income portfolio over the next few years. VRS staff believe that reducing fixed income in favor of higher risk assets has the potential to add significant returns, but would also involve adding risk to the portfolio. At its Board and Investment Advisory Committee meetings, VRS discussed the possibility of selectively moving out of fixed income into additional credit strategies or equity. At its June 19, 2008, meeting, the Board approved providing the Chief Investment Officer with discretionary authority to reduce the fixed income target by up to five percent, with constraints that the reduction must be matched by an equivalent increase in credit strategies and/or public equity, and that such a reduction must not increase the expected total fund volatility estimate by more than one percent. Similarly, the credit strategies policy limit would remain at ten percent, but could increase by an additional five percent corresponding to a contingent reduction in the fixed income weight. Again, any such change would be contingent upon not increasing the expected total fund volatility by more than one percent.

Virginia Retirement System Investment Portfolio (VRSIP) Option Offered to Participants in VRS' Defined Contribution Plans

VRS now offers defined contribution plan participants an opportunity to purchase shares in the unitized VRS Trust Fund, called the VRS Investment Portfolio (VRSIP). The VRSIP will be invested on a commingled basis with the large VRS Trust Fund, using the exact same investment strategies and managed by the same VRS professionals. Certain VRS investments, such as private equity and private real estate, are not liquid, so trading in and out of the VRSIP will only be allowed quarterly.

Appointments to the Board of Trustees Announced

In May, Governor Timothy M. Kaine appointed A. Marshall Acuff, Jr., as chairman of the Virginia Retirement System Board of Trustees to serve a two-year term, ending May 2010. Mr. Acuff succeeds Paul W. Timmreck whose term as chairman expired in May, although Mr. Timmreck remains a member of the board through February 28, 2011.

The Governor also appointed Robert L. Greene and Mitchell L. Nason as members of the board, effective April 25 and April 28, respectively. Mr. Greene, who succeeds Ms. Frankie Hughes, is a principal in Syncom Venture Partners, a venture capital firm. Mr. Greene's term on the board expires February 2012.

Mr. Nason, whose term expires February 2013, is a firefighter and an emergency medical technician with Prince William County Department of Fire and Rescue. Prior to this, he served as an analyst with the Virginia Department of Taxation. Mr. Nason succeeds former board member J. Douglas Conway, Jr., whose term expired.

In addition, the Joint Rules Committee reappointed John M. Albertine, Ph.D. to the Virginia Retirement System Board of Trustees to serve a five-year term, beginning March 2008. Dr. Albertine was first appointed to the board in February 2003 by the Joint Rules Committee and currently serves as the board's vice chairman.

Nine members serve on the VRS Board of Trustees. Their appointment is shared between the executive and legislative branches of State government. The Governor appoints five members, including the chairman. The Joint Rules Committee of the Virginia General Assembly appoints four members and the General Assembly confirms all appointments. Of the nine board members, four must be investment experts; one must be experienced in employee benefit plans; one must be a local government employee; one must be an employee of a Virginia public institution of higher education; one must be a State employee; and one must be a public school teacher. The public employee members may be either active or retired.

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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