OVERSIGHT VRS Report

JOINT LEGISLATIVE AUDIT & REVIEW COMMISSION
OF THE VIRGINIA GENERAL ASSEMBLY

VRS Semi-Annual Investment Report
July 2010

While the recent global recession created significant investment challenges for the Virginia Retirement System (VRS), economic conditions have shown gradual improvement, and VRS assets have recovered some of the losses experienced in 2008 and 2009. With $50 billion in assets as of March 31, 2010, the VRS pension fund achieved a return of 31.2 percent for the one-year period. The value of the total fund increased by $11.1 billion between March 31, 2009 and March 31, 2010. Despite these gains, the fund's performance was lower than established benchmarks for the one- and three-year periods ending March 31, 2010. However, it exceeded benchmarks for the five- and ten-year periods. Moreover, the fund did not earn the assumed actuarial rate of return, 7.5 percent, for the three-, five-, and ten-year periods ending March 31, 2010. Over the ten-year period, however, the fund did add value (130 basis points) over the long-term benchmark. Performance indicators are provided in Table 1.

Profile: Virginia Retirement System Investments (as of March 31, 2010)

Market Value of Assets: $50 billion

Number of External Managers:
Public Equity – 33 (13 traditional, 20 hedge funds)
Fixed Income – 10

Total Return on Investments			
10 years	*5 years*	*3 years*	*1 year*
3.5%	**4.4%**	**-1.9%**	**31.2%**
Performance/Intermediate Benchmark			
3.1%	**4.2%**	**-1.7%**	**32.3%**

Number of External Investment Accounts:
Public Equity – 40 (19 traditional, 21 hedge funds)
Fixed Income – 14

Number of VRS Investment Department Staff: 57 authorized FTEs (12 vacant)

FY 2009 Investment Expenses: $274.4 million (63.6 basis points)

FY 2009 Investment Department Operating Expenses: $13.8 million* (3.2 basis points)

Investment Policy Indicators (as of March 31, 2010)

	Asset Allocation (% of Total Assets)		*Asset Allocation* (% of Asset Class)		*Type of Management* (% of Asset Class)	
Asset Class	Policy	Actual	Domestic	Non-U.S.	External	VRS
Public Equity**	**46.6%**	**46.3%**	**43.1%**	**56.9%**	**70.5%**	**29.5%**
Fixed Income**	**23.2%**	**23.2%**	**92.7%**	**7.3%**	**71.2%**	**28.8%**
Credit Strategies**	**≤ 13.5%**	**14.9%**	**94.7%**	**5.3%**	**100.0%**	**0.0%**
Private Equity	**≤ 10.0%**	**8.3%**	**82.7%**	**17.3%**	**100.0%**	**0.0%**
Real Estate	**≤ 10.0%**	**6.6%**	**88.8%**	**11.2%**	**95.0%**	**5.0%**
Cash	**0.25%**	**0.53%**	**n/a**	**n/a**	**100.0%**	**0.0%**

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

Table 1: VRS Investment Performance for Period Ending March 31, 2010

Program/ Performance Objective	Fiscal Year to Date	1 Year	3 Years	5 Years	10 Years
Total Fund	*18.9%*	*31.2%*	*-1.9%*	*4.4%*	*3.5%*
Total Fund Benchmark - Intermediate	20.3	32.3	-1.7	4.2	3.1
Total Fund Benchmark - Long Term	22.5	37.3	-0.5	3.7	2.2
Total Public Equity	*28.0*	*54.2*	*-3.9*	*3.8*	*1.4*
Public Equity Custom Benchmark	28.4	55.5	-3.5	4.1	1.3
Total Fixed Income	*10.0*	*14.6*	*6.7*	*5.8*	*6.6*
Fixed Income Custom Benchmark	5.2	6.4	6.4	5.6	6.4
Total Credit Strategies	*23.1*	*39.7*	*3.8*	*5.8*	*n/a*
VRS Credit Strategies Custom Benchmark	23.7	45.8	2.7	5.4	n/a
Total Real Estate	*0.6*	*-0.9*	*-8.6*	*4.6*	*8.5*
Real Estate Custom Benchmark	-1.1	-3.8	-5.3	5.6	8.6
Total Private Equity	*14.3*	*9.6*	*3.4*	*12.4*	*9.0*
Private Equity Custom Benchmark	45.1	30.8	-2.8	3.3	2.4

Source: VRS investment department data.

Public Equity. Public equity investments are typically 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 has recovered some of its FY 2009 losses, having achieved a fiscal year to date return of 28 percent and a one-year return of 54.2 percent. The public equity program continues to be VRS' largest asset class, constituting 46 percent of the portfolio or $23.2 billion. The public equity program exceeded established benchmarks for the ten-year period ending March 31, 2010, but slightly underperformed benchmarks for the fiscal year to date, one-, three-, and five-year periods. VRS staff predict that because the public equity program has more exposure to higher quality stocks than the market as a whole, it may not perform quite as well as the overall public markets in periods of substantial gains.

Fixed Income. The fixed income program serves as a diversifier for the overall portfolio. As of March 31, 2010, the fixed income program constituted 23.2 percent of the portfolio or $11.6 billion. Almost all (92.7 percent) of fixed income assets were domestically invested. The fixed income program exceeded its benchmark for all periods. In fact, fixed income is one of only two programs to have outperformed its benchmark for the fiscal year to date and one-year periods.

Credit Strategies. In the current VRS portfolio, credit strategies are used opportunistically and are considered an alternative to the domestic equity market. The credit strategies program is fairly new, having begun on July 1, 2004. Benefits of this asset class include further diversification and cash flow benefits, as well as lower volatility compared to equities. VRS credit strategies include investments in areas such as public high yield debt, private debt, convertible bonds, bank loans, and high yield asset-backed securities. As of March 31, 2010, the program had $7.5 billion in assets and represented 14.9 percent of the total fund. The credit strategies program exceeded established benchmarks in the three- and five-year periods, but underperformed in the fiscal year to date and one-year periods.

Real Estate. The total value of the VRS real estate portfolio as of March 31, 2010, was $3.3 billion or 6.6 percent of the total fund*. Along with fixed income, the real estate program is the only other program to have outperformed its benchmark for the fiscal year to date and one-year periods ending March 31, 2010. Real estate underperformed its benchmark for the three-, five-, and ten-year periods. The majority (89 percent) of the real estate portfolio is invested in U.S. holdings.

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, 2010, private equity represented 8.3 percent of the total fund or $4.2 billion*.

The private equity program exceeded established benchmarks for the three-, five-, and ten-year periods ending March 31, 2010. However, the program performed well below the benchmark for the fiscal year to date and one-year periods. VRS staff attributed this recent underperformance to the nature of its private equity benchmark; the program's benchmark comprises public assets, and the benchmark's 45 percent return for the fiscal year to date is indicative of the recent upswing in the public markets. While the VRS private equity program achieved positive performance in that period, it did not experience gains of similar magnitude. According to VRS staff, in a given time period, gains (or losses) in the value of private equity investments may not occur to the same degree as changes in public equity asset values.

Over the long term, VRS staff still expect the program to outperform its benchmark and continue to earn a premium over the public equity program. Notably, the dollar-weighted annualized performance since the inception of the program in April 1989 through December 31, 2009, was 22.3 percent.

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. While not considered a separate asset class, investments in hedge fund strategies constituted $4.1 billion or 8.1 percent of the total portfolio as of March 31, 2010. VRS staff report that assets in its hedge funds continue to perform well, particularly compared to public markets. 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.

Board Approves Changes to Asset Allocation Policy

VRS' asset allocation policy defines the basic risk and return characteristics of the investment portfolio. The asset allocation policy is determined by the VRS Board of Trustees. While VRS is a long-term investor and its asset allocation policy is not expected to change significantly over time, the policy of conducting an asset allocation and liability 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 undergo a substantial change.

* Whereas performance figures for the real estate and private equity programs reflect data on cash flow into the program as of March 31, 2010, they do not reflect managers' actual valuations of these investments as of that date because these data have not yet been made available to VRS.

The Board conducted its annual asset allocation review at its June 17, 2010 meeting. Following input from the investment staff and the Investment Advisory Committee (IAC), the Board voted to alter the baseline long-term benchmark and risk target for the fund from a policy mix of 70 percent domestic stocks and 30 percent domestic bonds to a mix of 60 percent stocks and 40 percent bonds. This change was recommended by both the staff and the IAC. Additionally, the Board voted to lower the long-term return assumption of the fund from 7.5 percent to seven percent. The primary factors that influenced this change include (1) expectations of below-normal equity returns and a narrow risk premium compared to bonds as well as a negative skew to the intermediate-term economic and market outlook, (2) a consensus among the staff and the IAC that the economy is in a "new normal" environment characterized by slower economic growth in the developing economies, (3) the maturing of the plan and corresponding shortening of its liability duration and net increasing cash outflow, and (4) the decreased funded status of the plan, which has left less tolerance for continuing to take on the same degree of investment risk.

The change in the baseline long-term benchmark made by the Board will reduce the amount of risk to the portfolio and will put VRS more in line with the risk characteristics of other public pension funds. Since the makeup of the actual portfolio is already similar to the risk level reflected in the new policy mix, the change is unlikely to result in substantial changes to the composition of the actual portfolio. According to the VRS chief investment officer, "The long-term benchmark does not reflect how the fund is invested at any particular time. The actual portfolio typically consists of a more diversified set of asset classes and strategies, and the actual mix changes over time based on relative value considerations. Over time, the aggregate level of risk in the actual portfolio is expected to be similar to the risk of the long-term benchmark."

New Investment Professionals' Pay Plan Approved

The Board approved a new compensation plan for its professional investment staff. Revisions to the previous approach stemmed from uncertainty about the manner in which investment staff should be compensated in light of the historic asset losses of 2008 and 2009 and the State's declining revenues, which resulted in no salary increases for State employees. Considering these circumstances, the Board declined to award planned incentive payments payable in fiscal year 2010 for the fiscal year 2009 performance year. The previous compensation plan awarded annual incentives to investment professionals under a formula that considered the fund's performance over the past three- and five-year periods.

Rather than relying strictly on a formula, the new compensation approach grants the Board and the chief investment officer flexibility in determining and awarding annual incentives for the investment staff. The Board believes this new flexibility is needed given the significant changes underway among institutional investment firms regarding compensation philosophy and practice. Incentives remain based on a variety of input factors, including investment performance as well as market-based salary comparisons. Given these factors, VRS staff anticipate that little or no incentives will be awarded in some years, while other years will see larger payouts. Moreover, during years in which the Appropriation Act does not authorize salary increases for general State employees, the Board will cancel any scheduled market-based salary increases for the investment staff.

The Board and VRS staff are comfortable with the ability of the new approach to reward favorable performance fairly and ensure that VRS is able to attract and retain talented investment professionals. According to the Board chair, the changes "will again put the VRS in a leadership position in the public pension fund industry for competitive compensation practices, while allowing the Board of Trustees broad flexibility."

Investment Fees

Externally managed investments constitute the bulk of the VRS portfolio, and the fees paid to external asset managers come out of the trust fund. VRS staff review investment management fees on an ongoing basis, and in December, staff were asked by the Board's Audit and Compliance Committee to provide a summary of these investment fees. Fees in fiscal year 2009 amounted to $274 million, or 63.6 basis points of the total assets in the fund. Absolute fees in 2009 were slightly higher than fees paid in 2008, despite the asset losses experienced during this period. VRS investment staff indicated to the committee and to JLARC staff that they continually negotiate fees with their external account managers to help minimize the costs of managing these assets.

To address trustee interest in the reasonableness of these costs, the VRS investment department is participating in a comparison study of public pension fund fees and performance that is being conducted by CEM Benchmarking Inc. CEM conducts annual benchmarking analysis on pension investments and administration. CEM will produce a final report later in 2010, and VRS staff have agreed to make a copy of the report available to JLARC staff.

Appointments to the Board of Trustees and Investment Advisory Committee Announced

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 chair. 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. In April, the Governor appointed Diana F. Cantor to serve on the Board of Trustees. The Governor subsequently appointed Ms. Cantor to the position of chair, a position previously held by trustee A. Marshall Acuff, Jr. Ms. Cantor is the former executive director of the Virginia College Savings Plan.

To enhance the Board's access to investment expertise, the General Assembly created the Investment Advisory Committee (IAC). The statutory responsibility of the IAC is to provide the Board of Trustees with "sophisticated, objective, and prudent investment advice." The members of the IAC are required to have extensive investment experience. The *Code of Virginia* also requires that the IAC carry out specific responsibilities including reviewing and evaluating investments and investment opportunities and making recommendations to the Board of Trustees regarding investments and asset allocation policies. The two-year appointments of three members of the IAC – Hance West, Donald Lindsey, and Joe Grills – have been renewed by the Board. Mr. West is the managing director of an investment firm, Mr. Lindsey is the chief investment officer of George Washington University, and Mr. Grills is the former chief investment officer of IBM Retirement Funds. Additionally, in December the Board appointed Gregory Fairchild to serve a two-year term on the IAC – he replaces Patricia Gerrick, whose term had expired. Dr. Fairchild is an associate professor of business administration at the University of Virginia.

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
Tracey R. Smith, Senior Legislative Analyst
Martha Erwin, *VRS Oversight Report* Editor