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September 30, 2020

The Honorable Ralph S. Northam
Governor of Virginia
1111 East Broad Street
Richmond, Virginia 23219

The Honorable Janet D. Howell
Chair, Senate Finance and Appropriations Committee
Senate of Virginia
P.O. Box 2608
Reston, Virginia 20195-0608

The Honorable Luke E. Torian
Chair, House Appropriations Committee
House of Delegates
4222 Fortuna Plaza, Suite 659
Dumfries, Virginia 22025

Re: Report on Virginia Retirement System Internal Asset Management

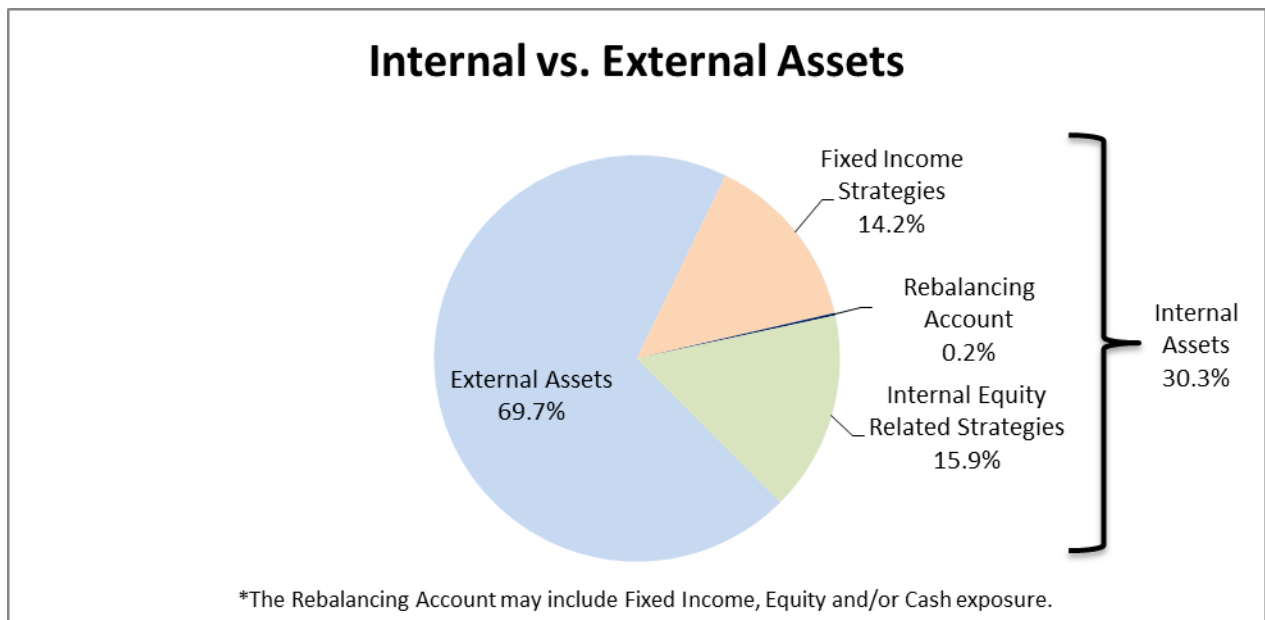
Dear Governor Northam, Chair Howell, and Chair Torian:

Thank you for the opportunity to share information regarding the investment program at the Virginia Retirement System (VRS). In addition, pursuant to Item 493 of Chapter 1289, 2020 Virginia Acts of Assembly (the "Appropriation Act"), I am pleased to provide a report on the fiscal year 2020 results generated by the internal investment management program at VRS.

The investment objective of the VRS defined benefit plan portfolio is to maximize returns while managing risk within an acceptable range. Due to the long-term nature of the plan's liabilities, VRS is a long-term investor with a long planning horizon. The total fund is highly diversified to help mitigate losses from significant market downturns similar to what we saw in the first quarter of 2020. Stocks, bonds, real estate, private equity, private debt, cash and other investment strategies serve to diversify the total portfolio to avoid all assets behaving in the same manner at the same time. Diversification also follows the mandate of the Code of Virginia (§ 51.1-124.30(C)) by helping to prevent frequent shifts in participating employers' contribution rates and providing rate consistency from year to year.

The VRS internal investment management program continues to make an important contribution to the total fund. The staff manages approximately one-third of the total fund in-house and focuses on closely monitoring and managing these assets to provide added value to the fund.

As of June 30, 2020, VRS managed approximately \$25 billion of assets (excluding Currency Hedging and Cash/Rebalance assets) in-house, representing approximately 30% of the total fund. This amount consisted of approximately \$13 billion managed in equity-related strategies and approximately \$12 billion in fixed income strategies. The following chart provides the breakdown between internally and externally managed assets as of June 30, 2020. In addition, please find the attached supplementary exhibit, which provides a schedule that shows the various investment mandates being managed internally by VRS staff at fiscal year-end.



As an investor, the VRS Board of Trustees focuses on a long-term investment horizon, believing that these time frames better match the system's liabilities and are more useful in evaluating performance. Consistent with the investment industry as a whole, the Board believes that investment performance is best reviewed through a longer term lens. With the help of the Investment Advisory Committee and a third-party consultant, the Board has established external benchmarks for analyzing performance.

The internally managed fixed income mandates continued to have strong performance over all time periods. Like many institutional investors, the internally managed equity mandates experienced challenging performance recently due to the extraordinary market movements caused by the COVID-19 crisis. In particular, outperformance by a handful of tech stocks has lifted up the broad index of stocks disproportionately. In fact, the other 99 percent of the index has experienced, on average, negative returns for 2020.

The VRS Internal Equity team adheres to a philosophy of favoring high quality stocks that sell at prices below the intrinsic value suggested by current earnings. (Growth stocks - technology holdings, for example – sell at high prices relative to current earnings because of the belief that strong future growth will occur.) Value-oriented strategies, such as ours, tend to underperform on a relative basis in the current environment. We are confident in the long-term efficacy of these strategies and are making well-reasoned and prudent adjustments as the market conditions evolve. In fact, two-thirds of the time that VRS has run this value-oriented strategy, it has beaten the market. And the outperformance of technology stocks the past two years has exceeded even the period known as the tech bubble in the early 2000s.

Despite recent difficulties in the equity markets, I am pleased to report that the internally managed funds delivered strong performance relative to policy benchmarks over the 10-year period ending on June 30, 2020, as demonstrated in the following table. We estimate the average value added to the total fund from these excess returns over the last 10 years is approximately \$67 million per year or \$667 million cumulatively over the last ten years.

IAM Track Record as of June 30, 2020				
		3 Years	5 Years	10 Years
Fixed Income Mandates *	Internal Core Portfolio	6.1%	5.0%	4.3%
	Benchmark	5.3%	4.3%	3.8%
	Excess	0.8%	0.7%	0.5%
Equity Mandates	Portfolio	5.2%	6.6%	11.5%
	Benchmark	6.7%	7.5%	10.9%
	Excess	-1.5%	-0.9%	0.6%

** Fixed Income Mandates also include Emerging Market Debt and High Yield. As these mandates were added in 2019, they do not yet have a three-, five-, or 10-year performance history. As these mandates mature, their applicable historical performance will be included in the above chart.*

In addition to delivering performance largely consistent with policy benchmarks during a volatile market, the internal asset management team continues to operate at a low level of cost when compared to fees that would be charged by outside managers who offer similar strategies. By managing these strategies internally, VRS is saving approximately \$58 million in fees annually based on an analysis conducted by CEM, an outside consultant. (CEM provides benchmarking information for large pools of capital including pension funds, endowments/foundations and sovereign wealth funds and serves over 350 blue-chip corporate and government clients worldwide.)

The Honorable Ralph S. Northam, The Honorable Janet D. Howell and The Honorable Luke E. Torian

September 30, 2020

Page 4

In summary, during a volatile market the internal asset management team at VRS delivered performance aligned with established benchmarks. Further, these efforts not only generated approximately \$67 million annually in excess returns over the last 10 years, but also achieved significant savings compared to external managers. The Board of Trustees is pleased with the efforts and results of the internal asset management team at VRS, and we are confident that the members and retirees will continue to benefit from their expertise in the years ahead.

Sincerely,

A handwritten signature in black ink that reads "O'Kelly E. McWilliams, III, Esq." with a stylized flourish at the end.

O'Kelly E. McWilliams, III, Esq.
Chairman, VRS Board of Trustees

Attachment

EXHIBIT A

VRS Internal Mandates as of June 30, 2020		
Asset Class	Objective	Assets (MM)
Equity	Passive, Non-U.S. Large Cap	\$0.2
	Passive, Emerging Market Small Cap	\$69.6
	Low Tracking Error, U.S. Large Cap	\$4,829.9
	Low Tracking Error, Non-U.S. Large Cap	\$2,313.1
	Low Tracking Error, U.S. Small Cap	\$526.3
	Low Tracking Error, U.S. REIT	\$652.4
	Low Tracking Error, Emerging Market Large Cap	\$592.2
	Low Volatility, U.S. Large Cap	\$2,243.4
	Low Volatility, Non-U.S. Large Cap	\$1,747.3
	Rebalancing Account	\$178.0
	Global Passive Energy Overlay	\$0.0
	Currency Hedge (Overlay)	\$2,358.6
		Subtotal
Fixed Income	Securitized	\$5,084.8
	Credit	\$4,323.6
	Government Related	\$1,237.5
	Emerging Market Debt	\$489.4
	High Yield	\$276.1
	Opportunistic	\$108.2
	Total FI Overlay	\$27.3
	Core FI Overlay	\$57.9
	Transition	\$15.4
	Subtotal	\$11,620.2
	Total*	\$27,131.2

* Includes the Currency Hedge Overlay Account