



COMMONWEALTH of VIRGINIA

Hal E. Greer
Director

Joint Legislative Audit and Review Commission
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JLARC Meeting – Minutes

July 11, 2016

Attending

JLARC Members:

Delegate Robert Orrock, Chairman; Delegate David B. Albo, Delegate M. Kirkland Cox, Senator Janet Howell, Delegate Chris Jones, Delegate James P. Massie, Senator Ryan McDougle, Senator Thomas K. Norment, Delegate John M. O'Bannon, Delegate Kenneth Plum, Senator Frank Ruff, Delegate Lionell Spruill, Ms. Martha Mavredes, Ex Officio.

JLARC Staff:

Hal Greer, Director; Nathalie Molliet-Ribet, Senior Associate Director; Justin Brown, Associate Director; Kimberly Sarte, Assistant Director; Lauren Axselle, Erik Beecroft, Sarah Berday-Sacks, Susan Bond, Kathy DuVall, Nicole Gaffen, Nick Galvin, Maria Garnett, Mark Gribbin, Nia Harrison, Paula Lambert, Jeff Lunardi, Bridget Marcek, Joe McMahon, Ellen Miller, Jordan Paschal, Nathan Skreslet, Tracey Smith, Nichelle Williams, Christine Wolfe.

Others:

Robert Greene, Patricia Bishop, Ronald Schmitz, Jeanne Chenault, Rory Badura, Curt Mattson, Cindy Wilkinson, K.C. Howell, JT Grier (Virginia Retirement System); Mary Morris, Gary Ometer, Vivian Shields, Chris McGee, Betsy Mullins, Carey Stagg, Sherri Wyatt, Michael Swink (Virginia College Savings Plan); Mark Smith (George Mason University); Phil Leone (Virginia Tech); Rob Jones (Virginia Education Association); Michael Martz (Richmond Times-Dispatch); Anne Marie Morgan (Virginia Public Radio); Heidi Abbott (Hunton & Williams); Michael Jay (House Appropriations Committee); Sarah Herzog (Senate Finance Committee).

The meeting was called to order at 10:01 a.m. by Delegate Orrock, Chairman. Delegate Orrock recognized Hal Greer, JLARC staff Director, who provided the Commission with an overview of the meeting agenda and introduced Mark Gribbin who presented a briefing of the *VRS Oversight Report*. Delegate Cox asked if the new option available under the higher education retirement plan will be optional or required. Mr. Gribbin explained that the new option will not be required. Participants in the plan will be allowed to choose from the plan's two current providers (TIAA or Fidelity) or the new option. Delegate O'Bannon asked why the plan needed to have an additional option. Mr.

Gribbin explained that the option was added to be consistent with industry best practices. It allows for greater fee transparency and improves VRS's ability to secure lower fees. Delegate Jones asked what the administrative cost (in basis points) is for the standard Commonwealth 457 plan and how it compares to the old options offered under the higher education plan. Mr. Gribbin said that the 457 plan charged a flat fee of around \$35 per year. Ms. Patricia Bishop, Director of VRS, explained that the fees for the old options under the higher education plan come out to about 18 basis points for the administrative component. Delegate Massie asked if VRS separates investment from administration contracts and fees because of the audit and control function. Mr. Gribbin indicated that VRS separates fees and contracts as much as possible to maximize transparency and their contract negotiating position. Delegate O'Bannon asked if JLARC staff weigh in on contribution rates. Mr. Gribbin explained that the contribution rates are determined by the VRS actuary and JLARC staff do not directly weigh in on the rates. However, staff oversee a quadrennial actuarial audit every four years that looks at the assumptions used by the VRS actuary to determine the rates and if those assumptions are reasonable.

At the conclusion of Mr. Gribbin's presentation, Delegate Orrock requested a motion to receive the report and authorize printing. A motion was made by Delegate Jones. There being no objections, the motion was approved unanimously by the Commission.

Delegate Orrock then welcomed Mr. Robert Greene, Chairman of the VRS Board of Trustees, who provided the Commission with an overview of VRS. The Commission did not have any questions for Mr. Greene.

Following Mr. Greene's remarks, Mr. Ronald Schmitz, VRS Chief Investment Officer, presented an overview of VRS' investments and answered several questions from the Commission members. Delegate Cox asked if the 7% rate of return rate assumed by VRS is reasonable. Mr. Schmitz explained that he actually expects a return of 7.3% over the next 20 years, based on VRS projections. He further stated that there are a lot of calculations that go into the assumed rate of return. Delegate Jones stated that he does not see how the 20-year average assumed rate of return will be 7%, and that VRS might have to look at lowering the assumed rate from a budget standpoint. Delegate O'Bannon asked if there is any anticipated downward pressure on the Commonwealth's public pension plan as a result of the British exit from the European Union. Mr. Schmitz stated that the United Kingdom will suffer from this recent event but VRS does not have many investments in U.K. companies. Mr. Schmitz further noted that if VRS were to lower the assumed rate of return, then it would result in higher contribution rates.

Delegate Massie asked about the duration and yield of fixed income investments. Mr. Schmitz explained that the duration is 4.5 years and the yield ranges between 2% and 2.5%. Delegate Massie then asked if public equity includes real estate investment trusts. Mr. Schmitz stated that those investments are in the real assets category not the public equity category. He also explained that there are no private equity investments in commercial real estate, which is in compliance with their investment guidelines. Delegate Massie asked if the public equity excess return above the benchmark is attributable to asset performance or lower fees. Mr. Schmitz explained that approximately 30 basis points is fees and the

remainder is attributable to the performance of the investment managers. He also stated that all of the numbers are reported net of fees.

Delegate O'Bannon asked about whether VRS intends to increase the proportion of investments that are managed internally versus externally. Mr. Schmitz explained that VRS manages investments internally if they can, but that it takes a lot of research to implement an investment portfolio. He stated that a good portion of public equity is managed in house. Within that asset class, VRS recently implemented an internal emerging markets strategy, but it took about two years of preparation before they could go live. VRS could expand internal management of public equity further, but any increases will be incremental. Fixed income is all already managed internally so there is no room for increasing internal management there. He said that VRS is not likely to extend internal management into the private equity and real assets classes because it can be very difficult to build and retain expertise in those areas. Delegate Massie noted that internally managed public equity provided 117 basis points in excess return (over 10 years), which is worth about 190 million per year.

During Mr. Schmitz's final remarks, Delegate Massie indicated that the concerns over the 7% long-term return assumption are founded. The next few years may be bumpy and we don't yet know how recent policies, such as quantitative easing, will ultimately play out.

After Mr. Schmitz's presentation, Ms. Patricia Bishop, VRS' Director, provided the Commission with an overview of VRS membership, pension reform efforts in Virginia, hybrid retirement plan status, funded status, and contribution rates. Delegate Jones asked about the state match for the voluntary contributions of hybrid employees. Ms. Bishop explained that the state matches 100% for the first 1% in voluntary contributions, then 50% until the voluntary contribution reaches 3.5%. Delegate Albo asked about the funded status of state employees, which was shown on slide 33 of the VRS presentation. Ms. Bishop explained that the contribution rates will lower over time as there are fewer Plan 1 retirees and more hybrid members. Delegate Jones requested additional data extrapolating the funded status further over time.

At the conclusion of Ms. Bishop's presentation, Delegate Orrock stated that no action was required by the Commission on this presentation. Mr. Greer recognized Mark Gribbin who presented a briefing of the *VA529 Oversight Report*. The Commission did not have any questions for Mr. Gribbin. Delegate Orrock requested a motion to receive the report and authorize printing. A motion was made by Delegate Jones and seconded by Delegate O'Bannon. There being no objections, the motion was approved unanimously by the Commission.

Subsequently, Mr. Gribbin introduced Mary Morris, CEO for the Virginia College Savings Plan (VA529), who provided the Commission with an overview of the VA529 and its programs. Delegate Massie asked why VA529 is under-performing in its investments for the prePAID program when VRS is over-performing by 50-60 basis points; he further asked why not have VRS handle the VA529 investments. Ms. Morris explained that VA529's investment strategy for prePAID is more conservative than the strategy used by VRS. She

stated that there may be more volatility and risk in some of VA529's investments, but it is expected to perform well in market downturns. She said that VA529's Investment Advisory Committee is comfortable with their asset allocation strategy. Delegate Massie stated that it does not seem to be the most efficient model and seems duplicative of VRS. Ms. Morris stated that the allocation strategy for VA529 is very different from VRS, and that the recent return numbers were not indicative of the prePAID fund's long term performance. She said that VA529's 15-year investment returns were comparable to those of VRS. She also mentioned that VA529 is reviewing some of VRS's benchmarks. She noted that, in addition to prePAID, VA529 also oversees the investments held in the inVEST program. Together, these programs hold a total of \$6 billion in assets.

Senator Norment asked if the fixed-tuition pricing approaches used by schools such as William & Mary will have an impact on the pricing of prePAID contracts. Ms. Morris stated that the fixed-pricing models will have an impact on pricing along with several other factors (listed on slide 17 of the VA529 presentation). Delegate Albo asked if the SOAR program was created by the General Assembly. Ms. Morris explained that the 2009 General Assembly enacted legislation to allow VA529 to provide scholarship programs and matching grant programs, and SOAR falls under that authority. Delegate Orrock asked if the SOAR program allows for individual contributions. Ms. Morris indicated that individual contributions are allowed but have not been historically solicited or received. VA529 is looking at ways to allow such contributions to be made more easily in the future. At the conclusion of Ms. Morris' presentation, Delegate Orrock stated that no action was required by the Commission on this presentation.

Lastly, Mr. Greer announced that the next Commission meeting is scheduled for September 12, 2016, which will include a presentation on the findings and recommendations from the report on manufacturing regulations and an update on the Commonwealth's central IT structure and disentanglement from Northrup Grumman.

There being no further business, the Commission rose at 12:07 p.m.

Approved by: Hal E Greer
Hal E. Greer, Director

Date: 7/15/16

Prepared by: Paula Lambert
Paula C. Lambert
Manager, Fiscal and Administrative Services &
Senior Legislative Analyst