



VRS Overview for the Joint Legislative Audit and Review Commission

Presenters: **Diana F. Cantor, Chairman of the VRS Board of Trustees**
Ronald D. Schmitz, Chief Investment Officer
Robert P. Schultze, VRS Director

July 8, 2013



Agenda



VRS Overview

- *Diana F. Cantor, Chairman, VRS Board*

Investments Overview

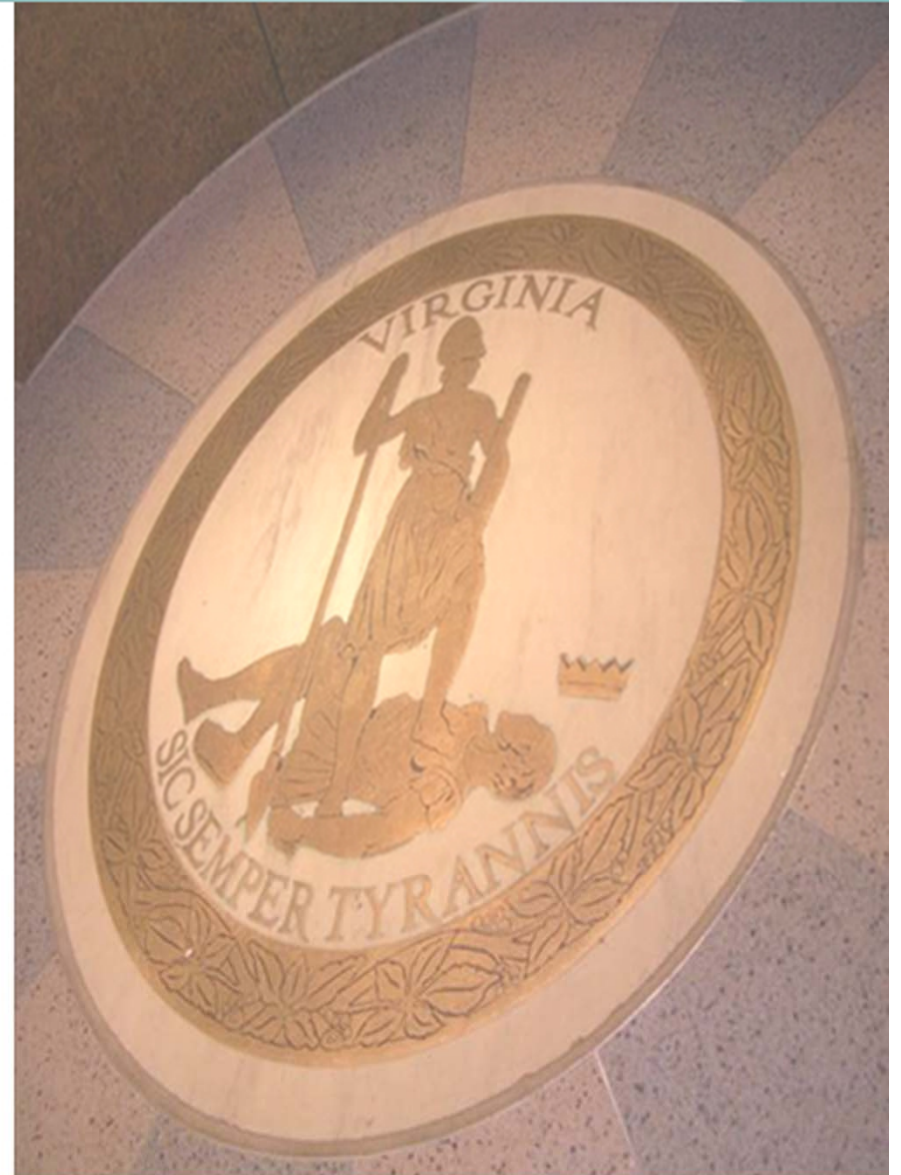
- *Ronald D. Schmitz, CIO*

Administration Overview

- *Robert P. Schultze, Director*

Remarks

Diana F. Cantor
VRS Board Chairman



Board Members



Diana F. Cantor, *Chairman*

Robert L. Greene, *Vice Chairman*

A. Marshall Acuff, Jr.

Edwin T. Burton III, Ph.D.

Wallace G. Harris, Ph.D.

W. Brett Hayes

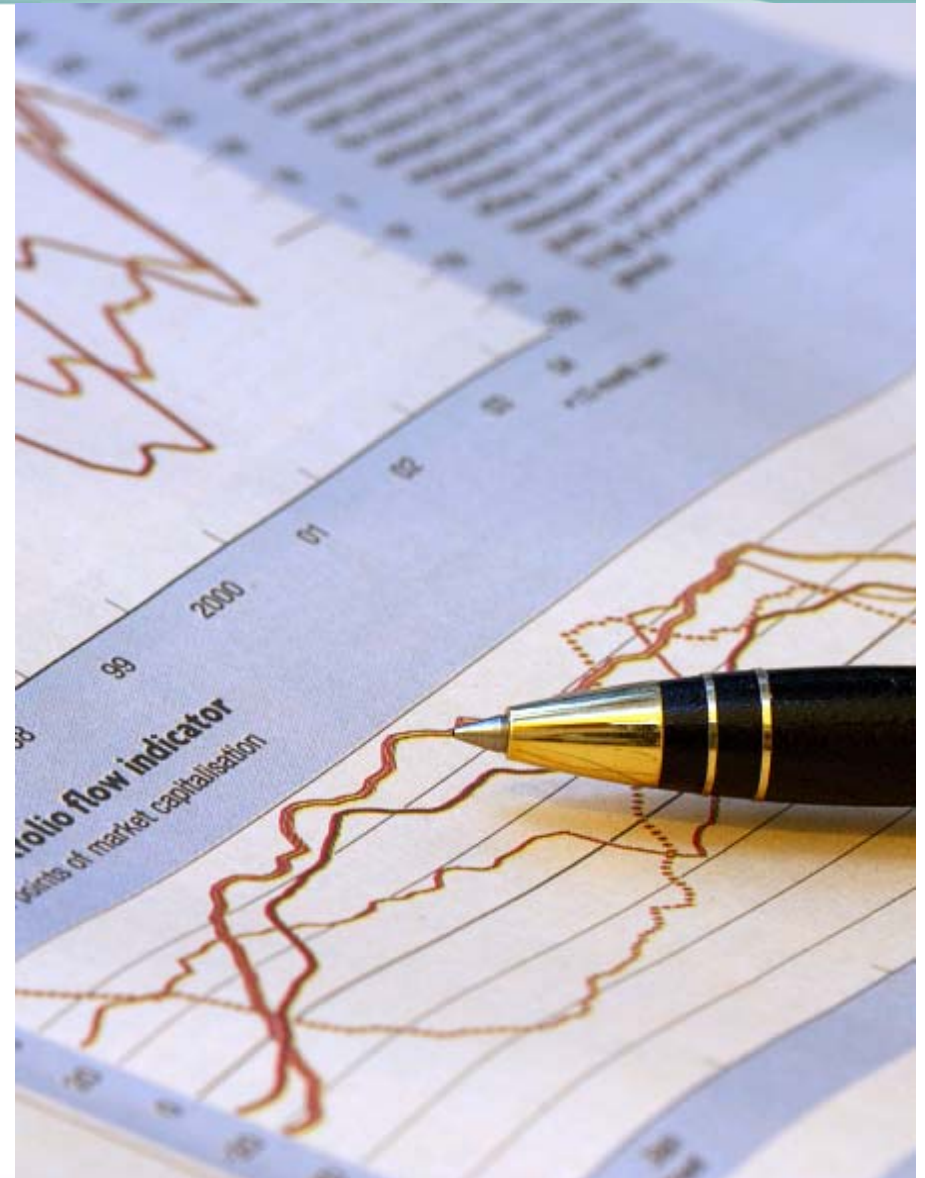
Mitchell L. Nason

Troilen Gainey Seward, Ed.S.

Colette Sheehy

Investments

Ronald D. Schmitz
Chief Investment Officer



VRS Investment Presentation Outline



- Solid absolute & relative performance coming out of the 2008/2009 crisis
- Total fund risk tolerance project
- Asset class strategy reviews
- Increase in internally managed assets
- Outlook is for returns to moderate from robust CYTD 2013 results

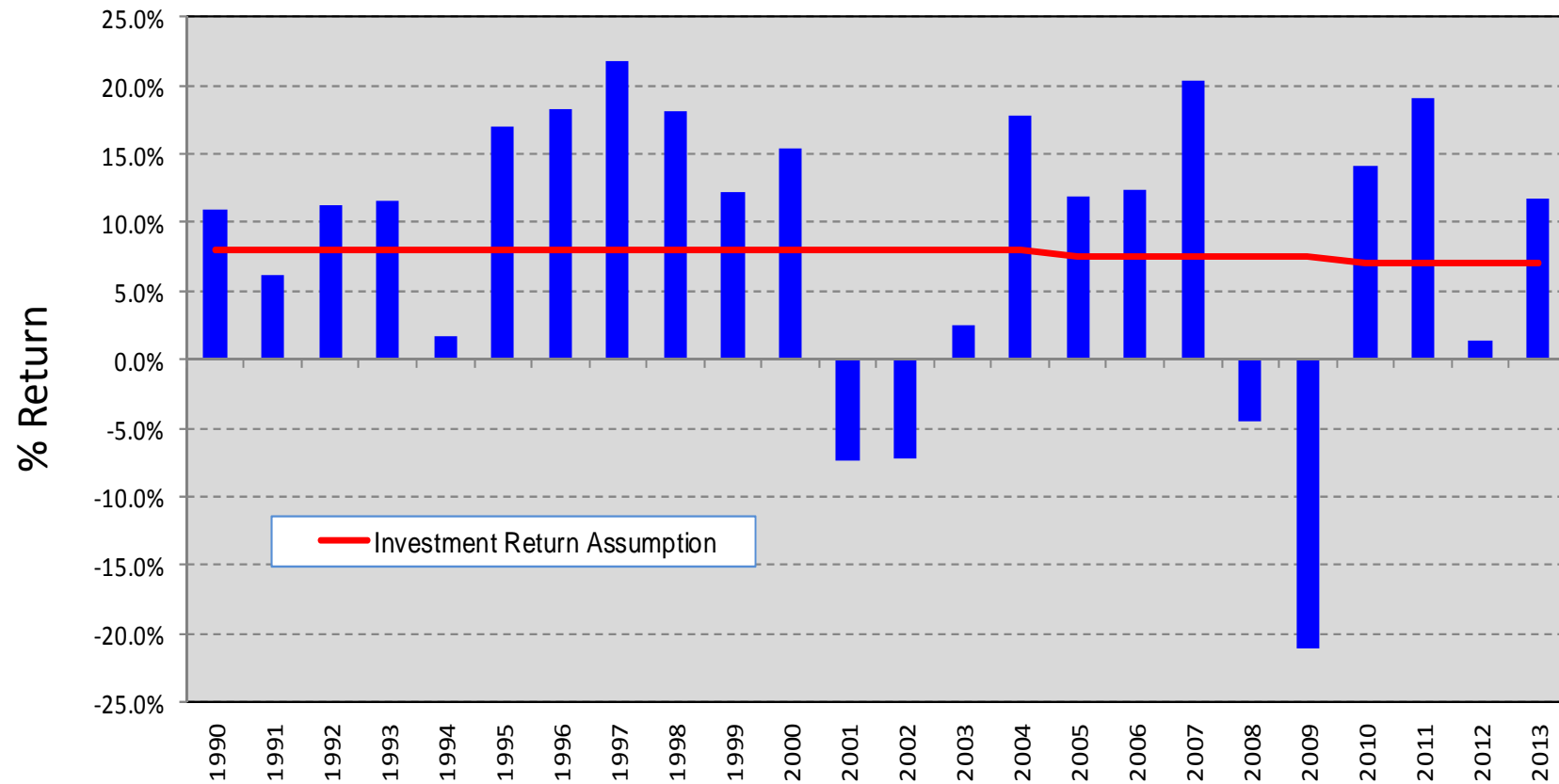
Total Fund Performance Ending 3/31/13



	VRS (%)	Intermediate Benchmark (%)	Long-Term Benchmark (%)
1 Yr	10.2	10.4	
3 Yr	9.0	8.8	
5 Yr	3.8	4.0	
10 Yr	8.7	8.5	7.8
15 Yr	6.0	5.6	5.2
20 Yr	8.3	7.9	8.0

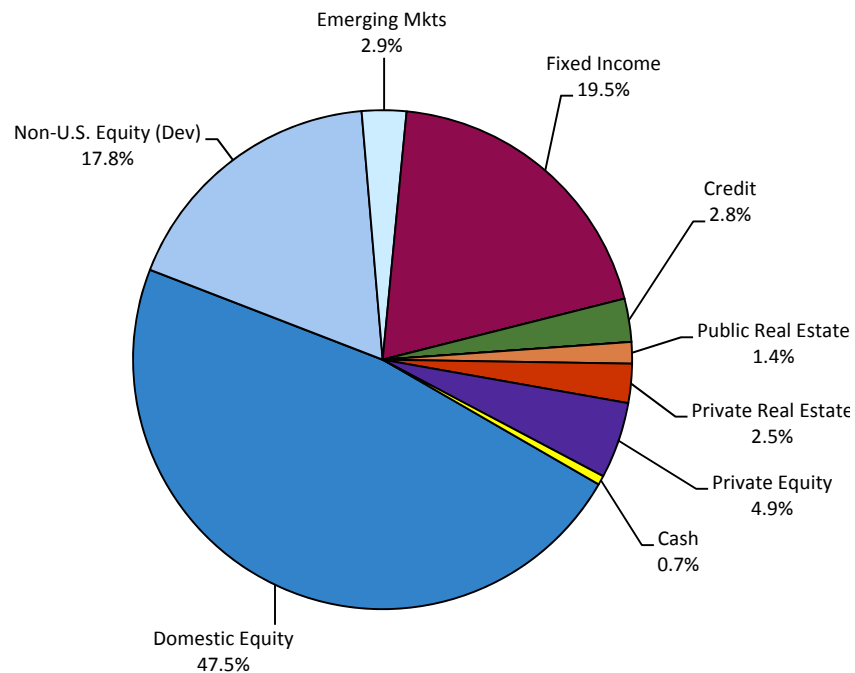
Performance is annualized and net of fees

VRS Fiscal Year Returns

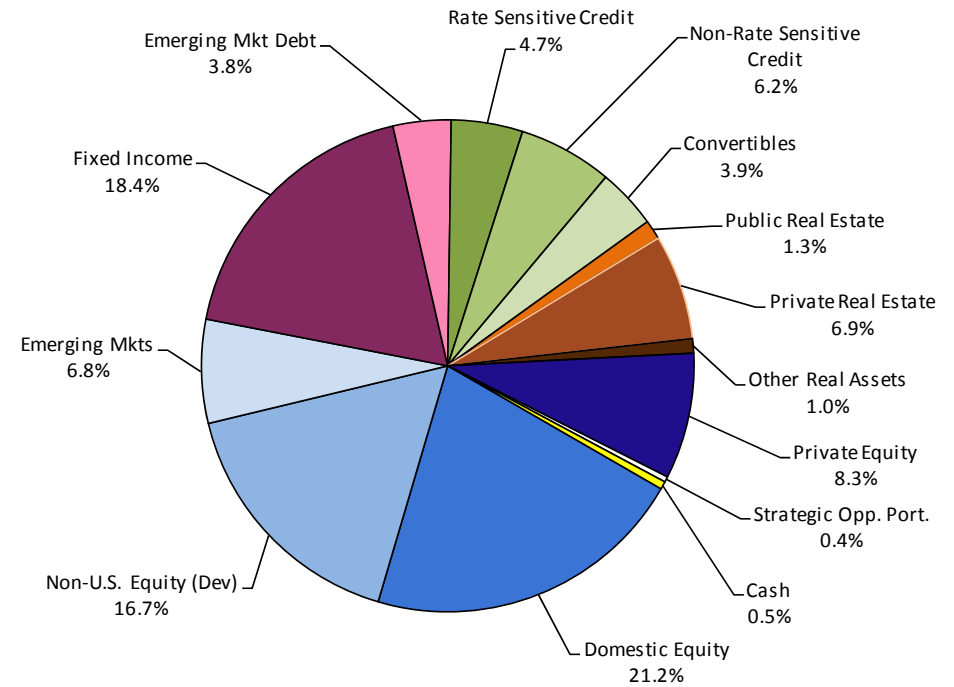


* FY 2013 thru 3/31

Asset Allocation: March 2005 vs. March 2013



March 2005
\$43.1 billion



March 2013
\$58.1 billion



Important New Developments CY 2012

- The Board initiated a risk tolerance review facilitated by an outside expert, Pension Consulting Alliance.
- Key Decisions:
 - Eliminate dual benchmarks
 - Adopt global equity benchmark
 - Establish 5 asset class portfolio targets & allowable ranges
 - increases private market exposure
 - decreases fixed income and credit positions
 - 5-year phase-in

Intermediate Term Benchmark vs. New Policy

	<u>Old ITB</u>	<u>New Policy</u>	<u>Change</u>
Public Equity	43%	42%	- 1%
Credit	20%	15%	- 5%
Fixed Income	20%	15%	- 5%
Real Assets	8%	15%	+ 7%
Private Equity	9%	12%	+ 3%
Cash	-	1%	+ 1%
Est. Returns	6.7%	7.4%	+ 0.7%
Est. Volatility	12.1%	12.5%	+ 0.4%
Return/Risk	.554	.592	+ .038
Stock/Bond			
Equivalent *	63/37	65/35	N/A

* Long term benchmark currently: 60/40 (prior to 2010: 70/30)

New Asset Mix Phase in Schedule



IPC Approved Mix Reached in FY 17

	Current	Jun-13	Jun-14	Jun-15	Jun-16	Jun-17	Policy Ranges	
							Min	Max
Pub Eq	42.0%	42.0%	42.0%	42.0%	42.0%	42.0%	-5%	+5%
Priv Eq	8.5%	9.0%	9.5%	10.5%	11.0%	12.0%	-5%	+5%
FI	19.5%	19.0%	18.0%	17.0%	16.0%	15.0%	-1%	+5%
Credit	20.0%	19.0%	18.0%	17.0%	16.0%	15.0%	-5%	+5%
RA	9.0%	10.0%	11.5%	12.5%	14.0%	15.0%	-5%	+5%
Cash	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	-1%	+4%
TOTAL	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%		

Note:

IAC suggests Inv Grade FI be a floor at 15% as the anchor to windward asset class.

Staff suggests that each year the CIO confer with the Board before authorizing the next step of the phase in.

Risk Tolerance Project – Next Step



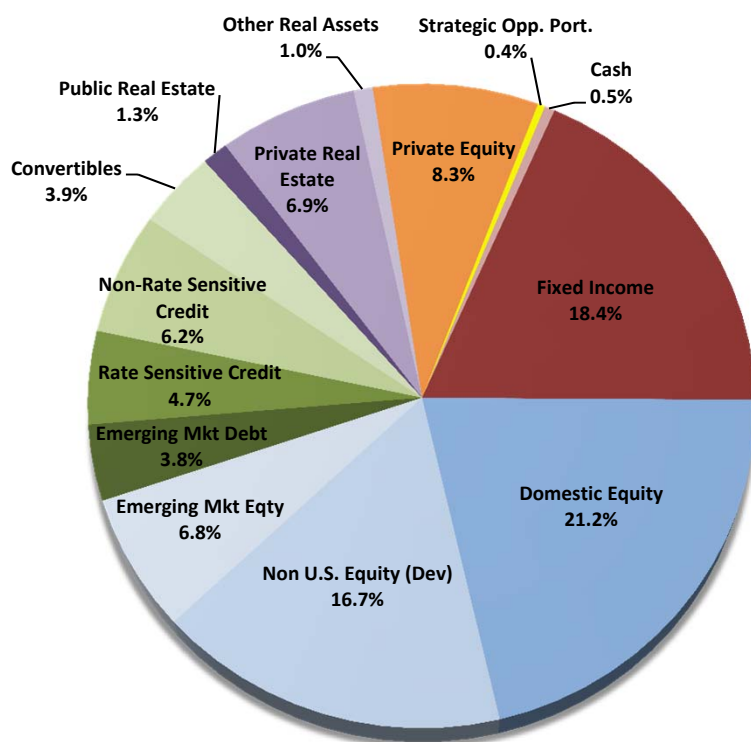
- In June 2013, the Board approved a new Investment Policy Statement (based on results of 2012 risk tolerance project).
- Staff will begin the process of re-evaluating the risk/reward portfolio structure of each individual asset class (active/passive, internal/external, strategy tilts, etc.).

Result: By fall, 2013 we will have recalibrated policy statements by asset class.

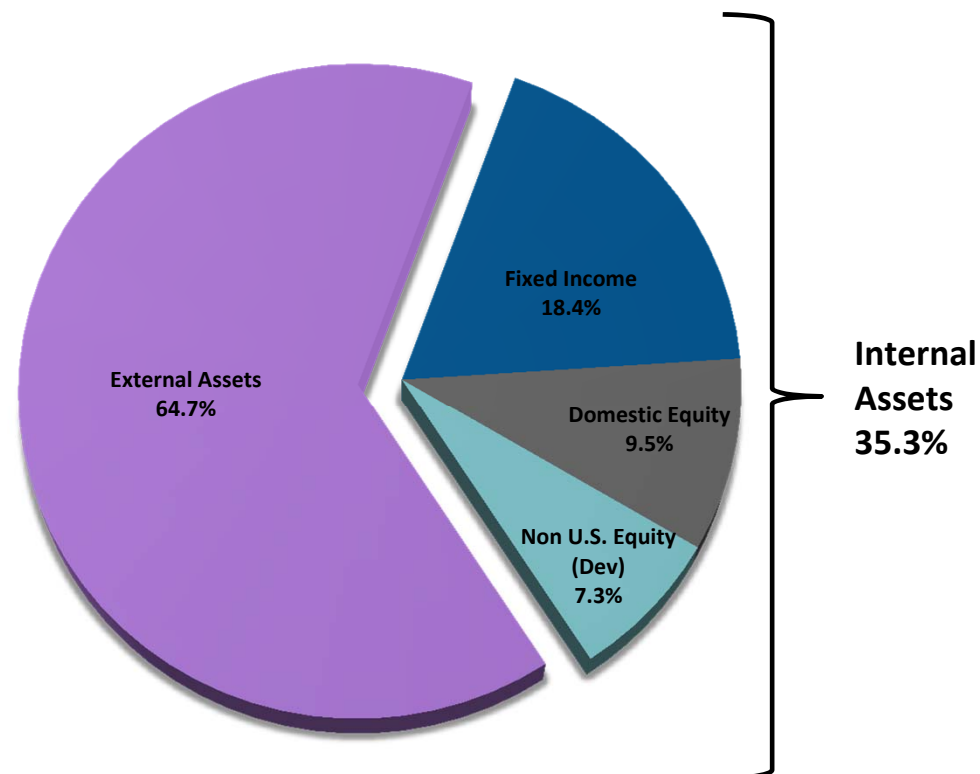
VRS Asset Allocation as of March 31, 2013



VRS Asset Allocation



Internal vs. External Assets



VRS Internal Mandates as of March 31, 2013



Asset Class	Objective	Assets (MM)
Equity	Passive U.S. Large	\$176.9
	Passive Non-U.S. Large	\$1,488.7
	Active U.S. Large	\$2,442.4
	Active Non-U.S. Large	\$1,629.7
	Active U.S. Small	\$279.7
	Active U.S. Small Synthetic	\$123.5
	Active U.S. REIT	\$77.0
	Active U.S. Large Low Volatility	\$1,946.0
	Active Non-U.S. Large Low Volatility	\$800.2
	Rebalancing Account	\$792.0
	Currency Hedge (Overlay)	\$2,608.0
Subtotal		\$12,364.1
Fixed Income	Collateralized	\$3,798.2
	Credit	\$3,121.3
	Government Related	\$3,739.6
	Subtotal	\$10,659.1
Total		\$23,023.2

Internal Asset Management Track Record (through March 31, 2013)



		1 year	3 years	5 years	10 years	Inception*
Equity†	Return	14.51	13.49	6.74	9.45	5.04
	Benchmark	13.02	10.77	5.21	8.55	4.19
	Excess	1.48	2.72	1.53	0.90	0.86
	Risk (TE)	1.04	1.37	1.27	1.01	1.04
	Info Ratio	1.43	1.98	1.21	0.89	0.82
Fixed Income	Return	4.78	5.79	6.05	5.33	6.41
	Benchmark	3.77	5.51	5.50	5.02	6.10
	Excess	1.00	0.28	0.56	0.31	0.31
	Risk (TE)	0.40	0.44	0.59	0.42	0.34
	Info Ratio	2.50	0.64	0.95	0.74	0.91

*Inception dates are based on current management tenure (Equity inception April 2001, Fixed Income inception August 1995).

†Equity performance shown for Active Composite index.

VRS Internal Asset Management: Financial Impact



	Annual Fee Savings*	Cumulative Fee Savings*	Cumulative Value Added vs. Benchmark*
Equity	\$4.5	\$52.3	\$157.0
Fixed Income	\$6.85	\$30.01	\$199.83
Total	\$11.35	\$82.31	\$356.83

All figures assume conservative assumptions on internal costs versus external fees.

Cumulative savings and value added are estimated since inception (April 2001 for Equity, and August 1995 for Fixed Income).

*Shown in MM

Economic/Market Outlook



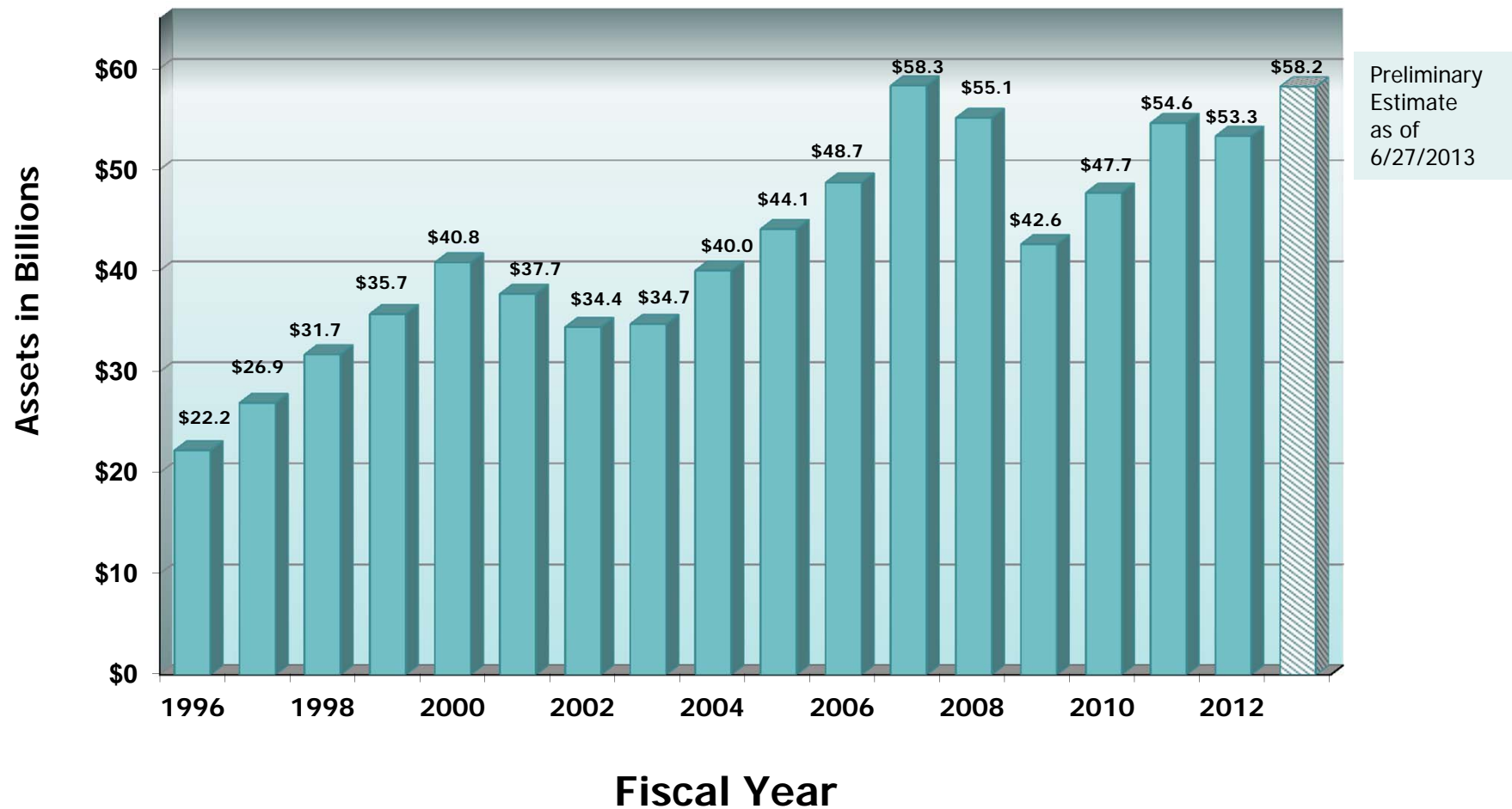
- Austerity is giving way to stimulus everywhere – in the U.S., in the EU and now Japan. The pace of deleveraging will therefore slow as governments attempt to revitalize growth.
- Equity returns will likely come down from recent highs as earnings forecasts moderate on slower anticipated growth.
- Fed's bond purchasing program will likely remain intact but possibly be scaled down in the second half of 2013. That would ordinarily be good news but markets may begin to price in lower returns as the stimulus is being withdrawn.
- 2013/2014 forecasted growth:
 - U.S. - 2%/3%
 - EU - 0%/1%
 - EM - 5%/6%
- Interest rates should begin to increase somewhat from recent historic lows.



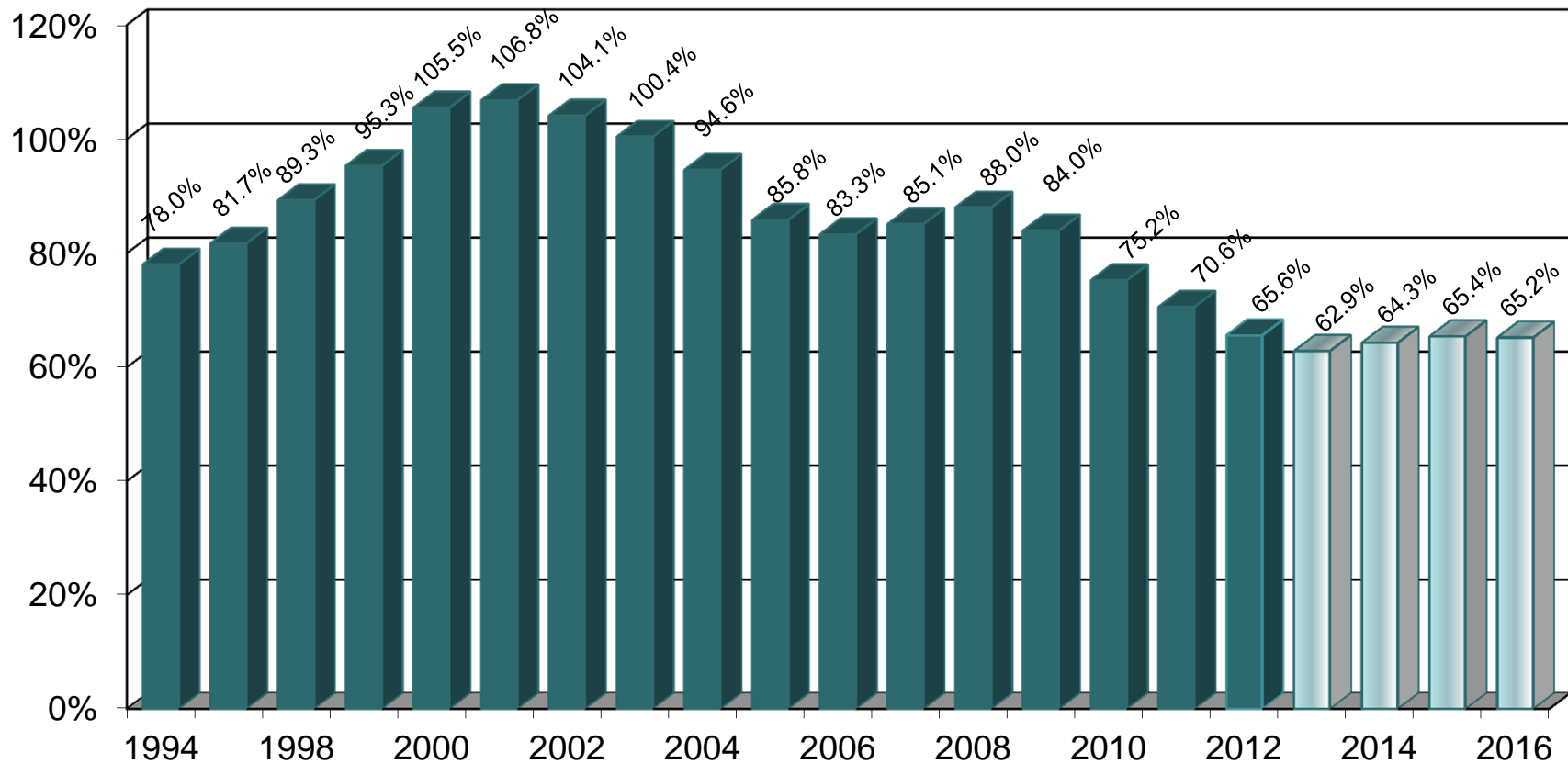
VRS Administration Overview

Robert P. Schultze
Director

Net Assets Available for Benefits



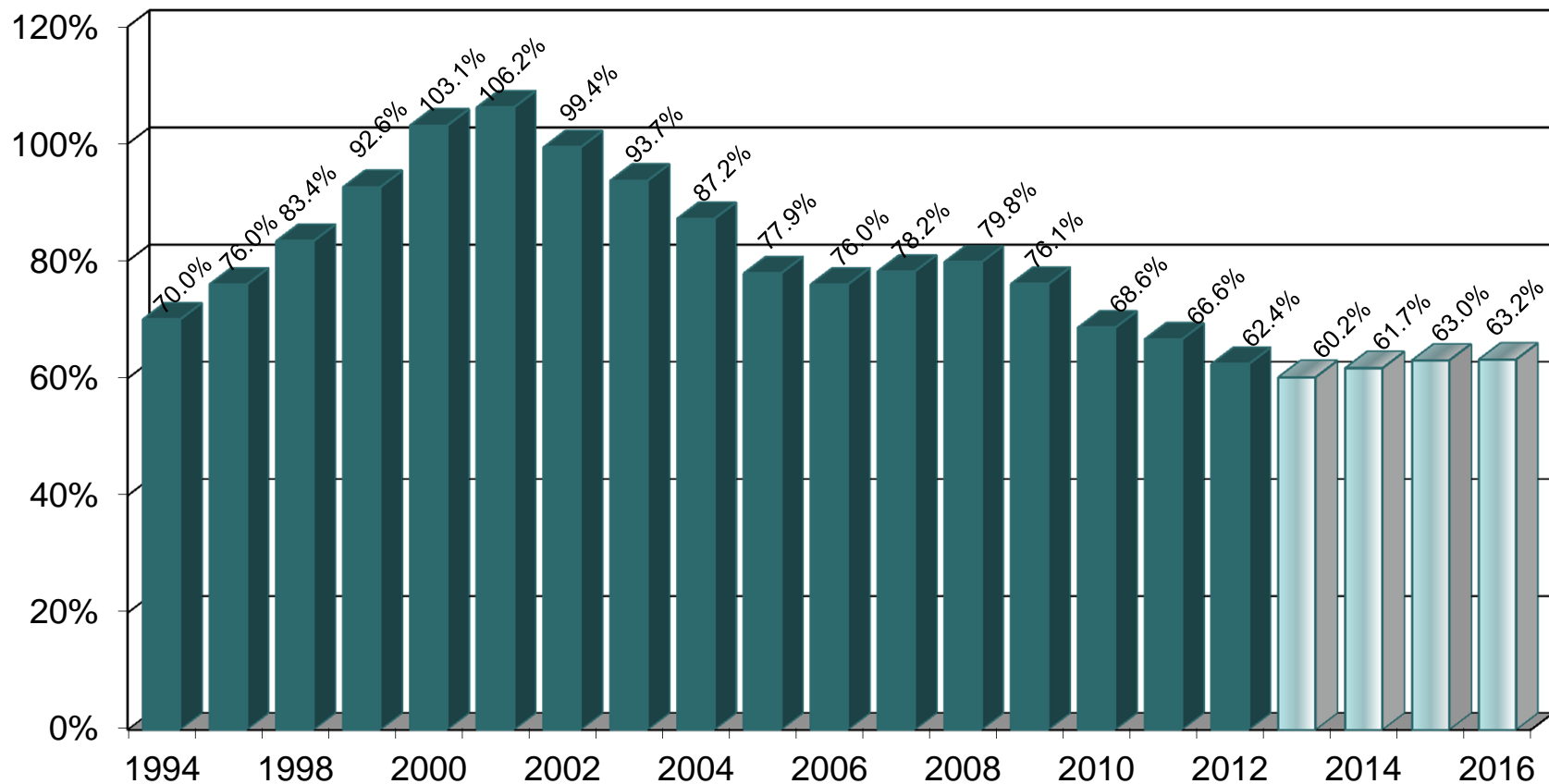
Funded Status: State Employees



Assumptions:

- FY 2013 investment return estimated at 10.0%.
- All projected years' investment return is 7.0% and 2.5% inflation rate.

Funded Status: Teachers



Assumptions:

- FY 2013 investment return estimated at 10.0%.
- All projected years' investment return is 7.0% and 2.5% inflation rate.

Reasons for Decline in Funded Status



Decline in funded status:

- Investment returns affected by two major recessions
- Still recognizing investment losses from FY2009 (five-year smoothing)
- Material savings from pension reform will not be realized for 8-10 years
- Employer contribution rate in FY2012 for the state plan averaged one-third of actuary's required levels

	State	Teachers
2010-2012 Percent of VRS Contributions Funded	31.5%	39.7%
2012-2014 Percent of VRS Contributions Funded	67.0%	69.5%

Pension Reform



Pension Reform Efforts in VA



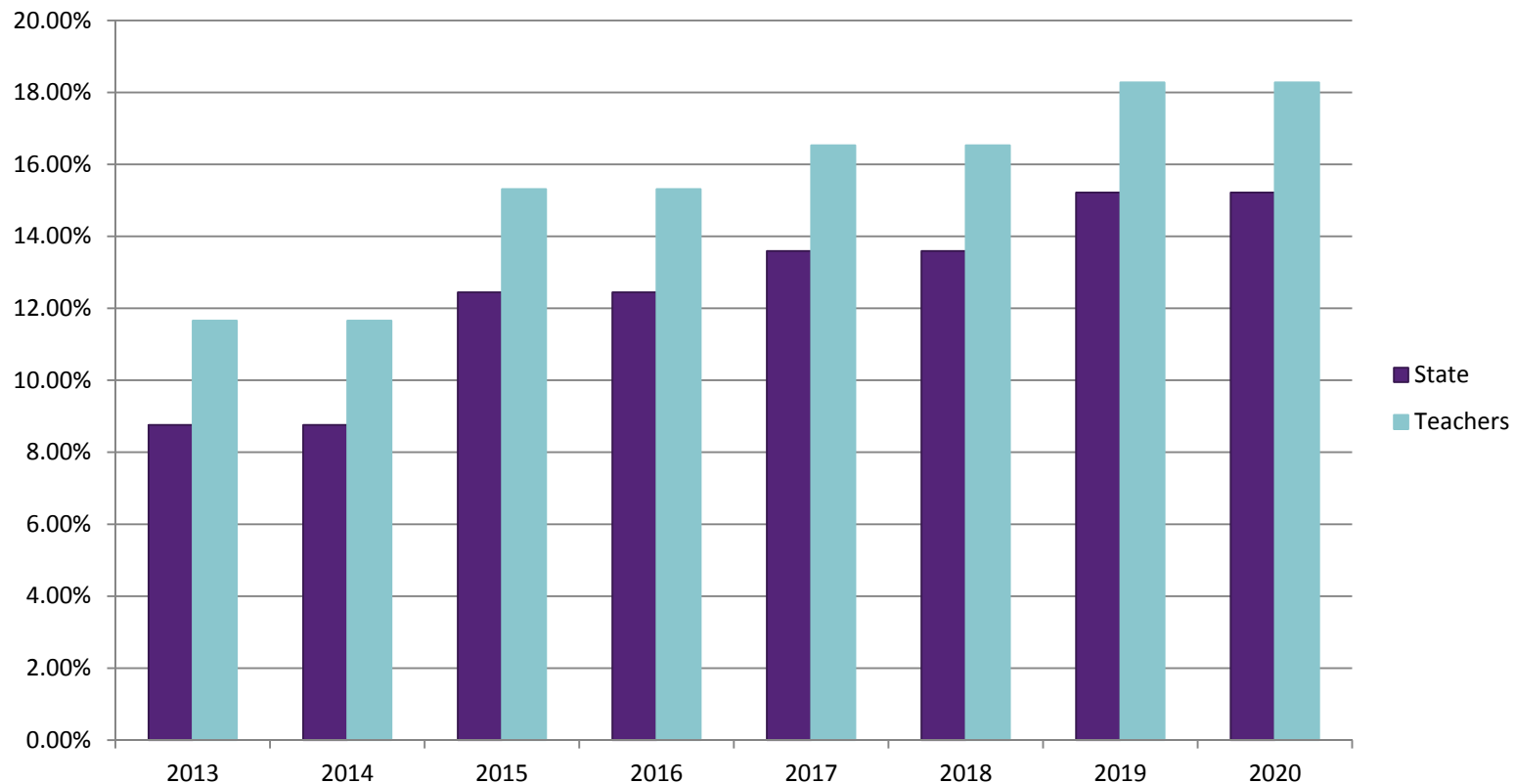
Year	Reform Effort
2008	General Assembly requests JLARC Compensation Study
2010	<p>General Assembly creates Plan 2 for members hired on or after July 1, 2010:</p> <ul style="list-style-type: none">▪ Normal retirement changed to Social Security normal retirement age▪ Unreduced benefits commencing at Rule of 90▪ Reduced retirement moved to age 60 with at least five years of service▪ Members required to pay 5 percent member contribution (Local Option)▪ COLA formula revised▪ Five-year AFC formula
2011	<p>General Assembly enacted 5/5 program for Plan 1 state employees</p> <ul style="list-style-type: none">▪ State employee Plan 1 members pay 5% member contribution▪ Offset with 5% salary increase <p>JLARC updated study on pension reform</p>

Pension Reform Efforts in VA



Year	Reform Effort				
2012	General Assembly requires:				
	<ul style="list-style-type: none">Local employees pay 5% member contribution, phased in by July 1, 2016, with salary offsetNon-vested Plan 1 employees benefit structure change, January 1, 2013; approximately 35,000 active members converted from Plan 1 to Plan 2A hybrid plan for all general state and local employees hired on or after January 1, 2014				
	General Assembly proposes to phase-in contribution rates for the teacher and state plans to the VRS board-certified rates:				
		July 1, 2012	July 1, 2014	July 1, 2016	July 1, 2018
	State	67.02%	78.02%	89.01%	100%
Teachers	69.53%	79.69%	89.84%	100%	

Estimated Employer Contribution Rates in Accordance with Pension Reform



Assumptions:

- FY 2013 investment return estimated at 10.0%.
- Future years' investment return is assumed to be 7.0% with 2.5% inflation rate.
- Employer contribution rates are net of employee contributions.
- Rates include 10-year payback of deferred contributions.

Contribution Impact



Impact of VRS Pension Contributions on State Budget

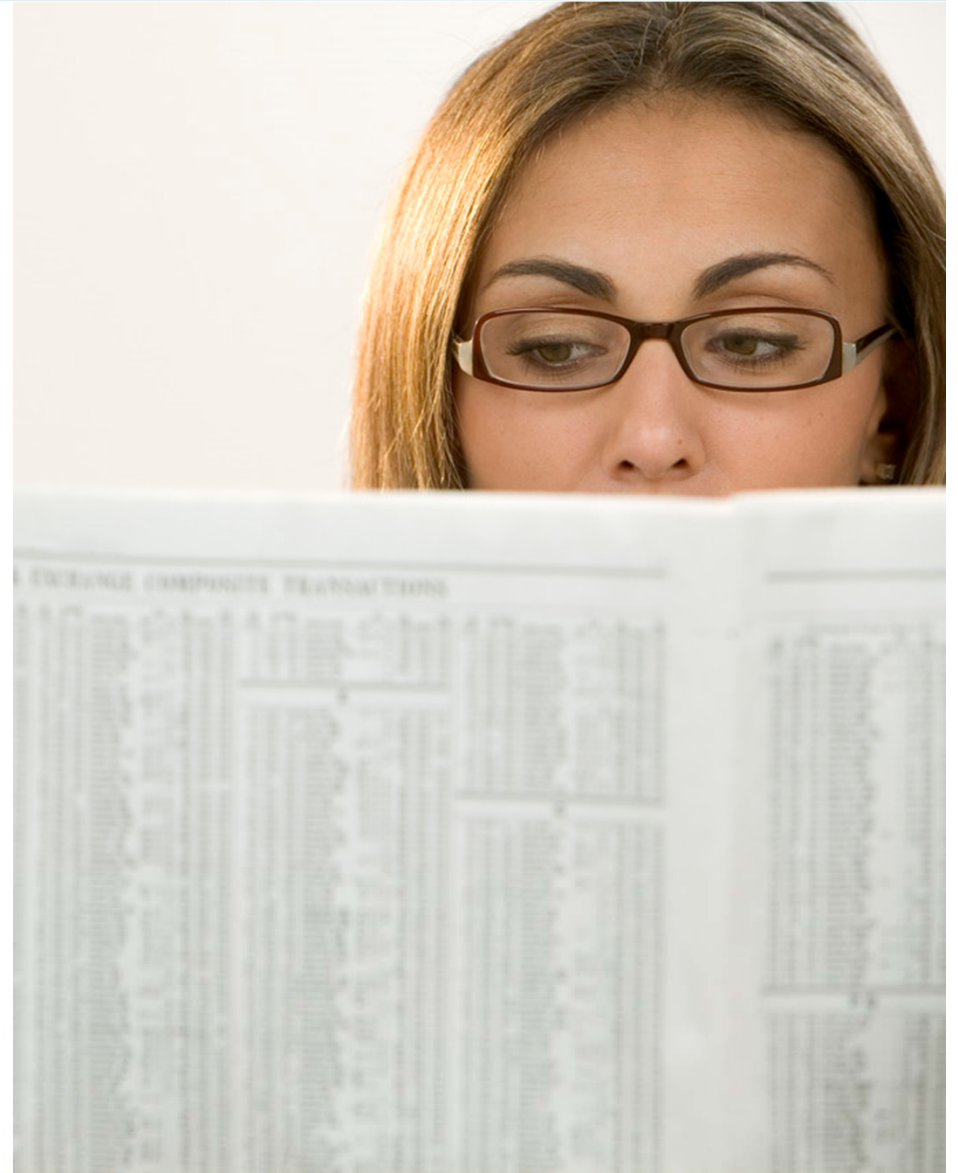
	FY 2012	FY2013	FY2013 Using VRS Certified Rates
General Fund Budget	\$16.3 billion	\$17.1 billion	\$17.1 billion
General Fund Allocation for Retirement: State Employee VRS Contributions Teacher VRS Contributions Total:	\$107.2 million <u>\$166.2 million</u> \$273.4 million	\$233.7 million <u>\$302.8 million</u> \$536.5 million	\$327.0 million <u>\$435.5million</u> \$762.5 million
Percent of General Fund Allocated for VRS Pension Costs	1.67%	3.13%	4.46%

Changes Scheduled for January 1, 2014



- VRS conducted competitive procurement for hybrid record keeper; awarded to ICMA-RC; resulted in lower fees
- System modifications underway:
 - VRS
 - Third-party Administrators: Minnesota Life, Unum, Univita, ICMA-RC
 - VRS employers
- Employer communication efforts:
 - Website information, VLDP resolutions packages, webinars, outreach sessions, special outreach to Top 50 employers
- Member communication efforts:
 - Hybrid election window promotion begins at the end of the year with a calculator tool available; election Jan. 1 – April 30, 2014
 - Development of handbooks and other communications underway

Upcoming GASB Accounting Changes



Upcoming GASB Accounting Changes



- GASB changing standards for financial reporting for pension plans:
 - Standards are effective for actuarial valuations as of June 30, 2013, for VRS and as of June 30, 2014, for employers
- Reported liabilities may increase if the General Assembly doesn't stick with phasing in the contribution rates. A discount rate that blends long-term investment assumption with municipal bond rate would be required if full contribution is not funded.
- Standards will require mark to market (asset smoothing no longer used)
- Unfunded liabilities of cost-sharing plans (school teachers) must be apportioned among participating employers

VRS Liabilities



Unfunded Liabilities by Plan

Plan	6/30/2012 Funding (in billions)	6/30/2012 GASB * (in billions)
State Employees (includes SPORS, JRS, VaLORS)	\$8.70	\$9.00
Teachers	\$14.70	\$15.16
Local Political Subdivisions	\$4.74	\$4.96
Total	\$28.14	\$29.12

* GASB unfunded liabilities are estimates based on guidance provided to date.

Teacher Cost-sharing Plan Unfunded Liabilities

School Board	Estimated GASB NPL	Percent of Total Payroll	FY 2012 Creditable Compensation
Fairfax County	\$ 2,658,222,600	17.52%	\$ 1,227,329,600
Prince William County	967,109,900	6.37%	446,524,900
Loudoun County	885,260,500	5.83%	408,734,200
Virginia Beach	816,243,600	5.37%	376,868,300
Chesterfield	543,905,600	3.59%	251,127,000
Henrico County	507,381,000	3.35%	234,263,200
Arlington County	490,038,900	3.23%	226,256,200
Chesapeake	450,935,900	2.97%	208,201,900
Norfolk	431,111,600	2.84%	199,048,800
Newport News	328,252,800	2.17%	151,557,800
Total Teacher Plan	\$ 15,160,259,000		\$ 6,999,652,800
Aggregate Funded Status	61.22%		

Impact of Changes



- Significant liability will be brought onto the face of the financial statements
- Funded ratios will be impacted, particularly by Moody's proposed changes
- Mark-to-market will increase volatility of accounting expense and liabilities
- Impact to local governments:
 - Apportionment of teacher cost-sharing plan liabilities will add to local liabilities, reflected on financial statements
 - Could affect local government bond ratings
- Accrued pension expenses will increase significantly due to shorter amortization and unfunded liabilities

Conclusion



- Pension reform communication and systems development on target for hybrid implementation January 1, 2014
- Long-range plan for sustaining VRS has three critical components:
 - Plan design changes will produce significant cost reductions in 8-10 years
 - Optimized investment portfolio will achieve reasonable future returns
 - Future General Assemblies will increase contribution rates to actuarially required levels

Additional VRS Information



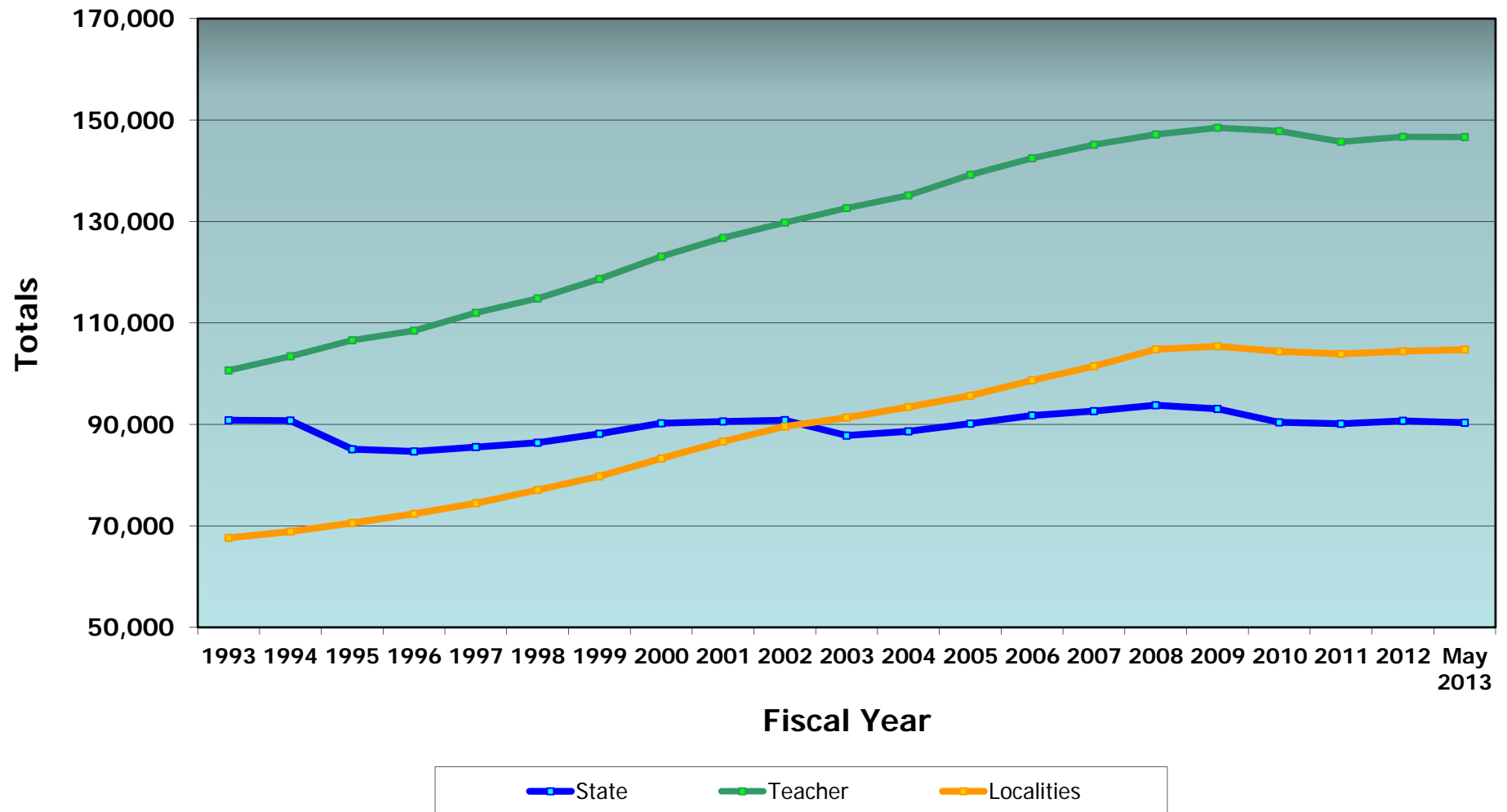
VRS Total Membership



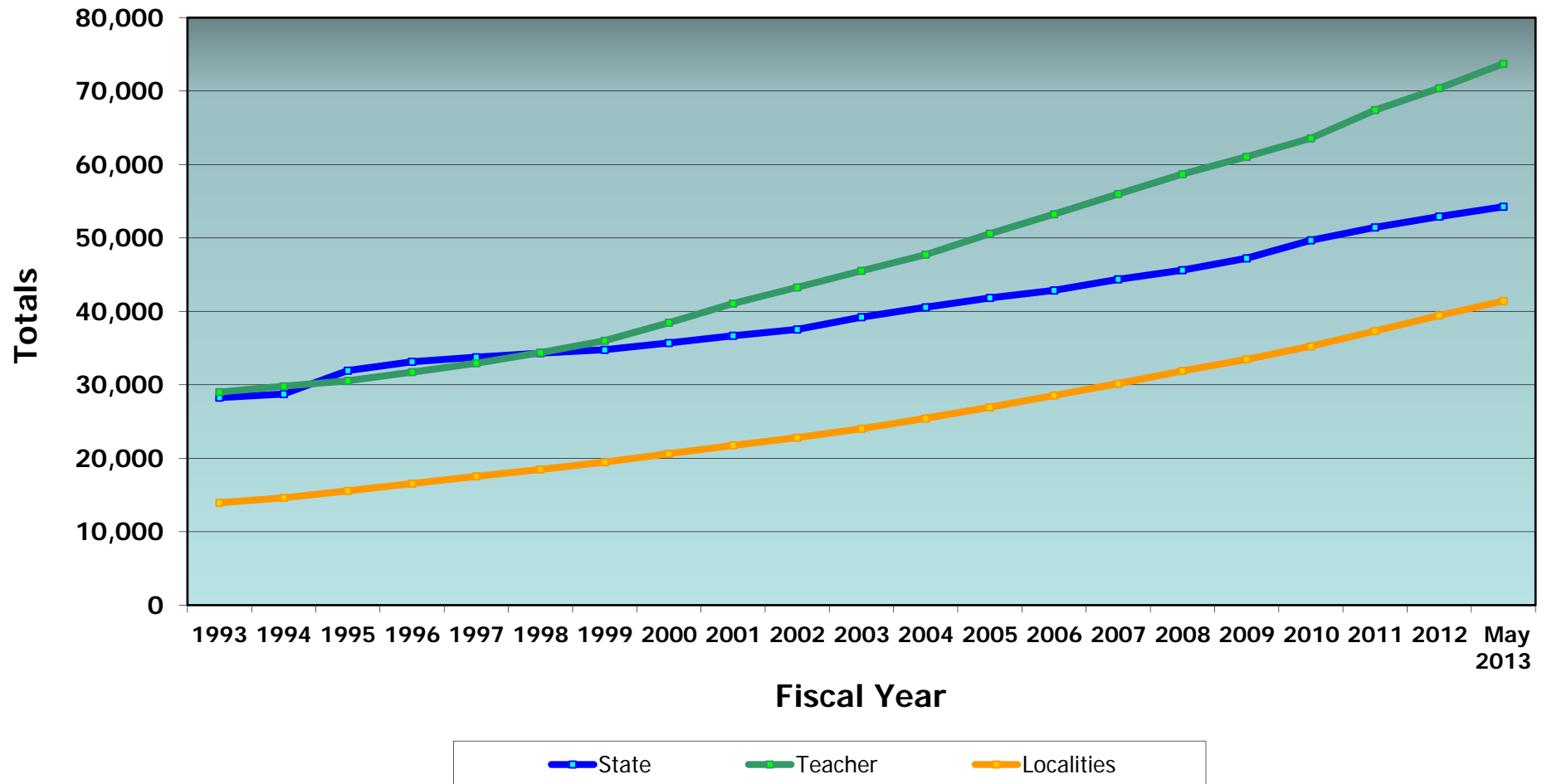
Teachers	146,634
Political Subdivisions	104,752
State Employees	78,666
State Police Officers' Retirement System (SPORS)	1,972
Judicial Retirement System (JRS)	385
Virginia Law Officers' Retirement System (VaLORS)	9,307
Total Active Members	341,716
Retirees/Beneficiaries	169,384
Inactive/Deferred Members	118,019
VRS Overall Impact	629,119

As of May 31, 2013

Active Members



Retirees



Benefit Comparison



	State	Teachers	Local
Actives:			
Average Age	48.1	45.2	46.2
Average Service	12.8	11.9	11.0
Average Salary	\$48,681	\$47,580	\$39,683
Retirees: (in FY 2012)			
Avg. Age @ Retirement	62.9	61.5	62.1
Avg. Service @ Retirement	20.8	23.0	19.9
Avg. Benefit @ Retirement	35.4%	39.1%	33.8%
Avg. Annual Benefit	\$18,324	\$23,048	\$15,135

Information above obtained from the June 30, 2012, Actuarial Valuation.

- Phase 3 Implementation occurred November 5, 2012
 - New systems and data
 - New business processes, especially for employers
- VNAV performance is within expectations
- VRS is back to normal inventories and processing
- Phase 4 will start after Pension Reform implementation



Questions?