OVERSIGHT VRS Report

JOINT LEGISLATIVE AUDIT & REVIEW COMMISSION
OF THE VIRGINIA GENERAL ASSEMBLY

Semi-Annual VRS Investment Report: July 1999

The public equity market environment continued to impact the fund's overall investment performance, particularly for the current one-year reporting period. Through April 1999, the fund's one-year return did not meet the established performance benchmark. Nonetheless, the fund's one-year return exceeded the actuarial assumed return of eight percent. In addition, the fund's one-year underperformance also had an impact on the three- and five-year reporting periods so that results for these two periods were slightly under the established benchmarks.

The performance for the one-year period is largely attributable to the fact that a relatively small group of securities — large-cap, growth stocks — were responsible for much of the gain in the public equity markets. This market characteristic negatively impacts more diversified portfolios. For example, VRS' equal weighted S&P 500 index fund, which is very diversified with an inclination toward value stocks, substantially underperformed the fund's public equity benchmark. Moreover, many of VRS' external managers holding more diversified portfolios also failed to achieve expected returns. Interest rate concerns also negatively impacted investment returns for the VRS fixed income program, especially during the first quarter of calendar year 1999.

For the remainder of 1999, the VRS investment department will be involved in a number of initiatives and projects designed to enhance and support the VRS investment program. Examples of initiatives for selected fund asset classes are provided on page 2.

Profile: Virginia Retirement System Investments

Market Value of Assets: $34.6 billion
Number of External Managers: 106
Number of External Investment Accounts, Direct Investments, and Partnerships: 185
Estimated FY 1999 Investment Expenses: $92.8 million (26.8 basis points)
FY 1998 Investment Expenses: $97.8 million (31 basis points)
Number of VRS Investment Staff: 29 positions (2 vacancies)

Total Return on Investments[1]

	10 years	5 years	3 years	1 year
	12.9%	16.7%	17.2%	10%
(Performance/Intermediate Benchmarks:)		17.1%	17.8%	12.8%

[1] Time periods ending 4/31/99

Investment Policy Indicators (as of April 30, 1999)

Asset Class	Asset Allocation (% of Total Assets or $ Amount): Target	Actual	Where Invested (% of Asset Class): Domestic	International	How Managed (% of Asset Class): External	VRS
Public Equity	66.3%	65.6%	75.7%	24.3%	80%	20%
Fixed Income	25%	24.4%	99%	1%	86%	14%
Private Equity	$1.5 billion	$1.78 billion	93%	7%	100%	0%
Real Estate	$1.5 billion	$1.27 billion	95.7%	4.3%	100%	0%

- ***Fixed Income Program:*** Initiate the process to bring all passive fixed income assets in-house for VRS investment staff to manage. This will reduce investment expenses and enhance control.

- ***Non-U.S. Equity Program:*** Conclude the current review of the non-U.S. equity program with recommendations regarding a revised investment policy for approval by the Board of Trustees

- ***Private Equity Program:*** Continue to explore international investment opportunities, and assume responsibility of private equity accounting and reporting activities for the VRS managed partnerships. These initiatives should result in avoidance of more than $750,000 annually in new fees and expenses.

- ***Real Estate Program:*** Continue to shift the focus of the real estate program to more value added and opportunistic investments and refine the program's strategic plan and investment policy.

Finally, during FY 1999, the VRS investment department established and staffed an investment operations unit. Staff in the investment operations unit will provide the investment department with risk management, record keeping and accounting, and administrative support. This will allow the investment staff to focus on administering the fund's current investment program. In addition, it will enable VRS to place more assets under internal management, resulting in lower administrative costs. The investment department's efforts to control fees and expenses are reflected by the projected reduction of about $5 million (four basis points) in expenses between FY 1998 and FY 1999.