



**JOINT LEGISLATIVE AUDIT
& REVIEW COMMISSION**
OF THE VIRGINIA GENERAL ASSEMBLY

Semi-Annual Investment Report July 2005

As of March 31, 2005, the market value of the Virginia Retirement System (VRS) pension fund was \$43.11 billion. The return for the fiscal year through March 31, 2005 is 9.3 percent and 9.4 percent for the one-year period ending March 31, 2005. The fund's performance exceeded established benchmarks for the one-, three-, and five-year periods ending March 31, 2005. However, during the three- and five-year periods ending March 31, 2005, the VRS' investment return fell short of the current actuarially assumed investment rate of return of eight percent. Performance indicators are provided in Table 1 (page 2).

Public Equity. The public equity program continues to be VRS' largest asset class comprising 64.5 percent of the portfolio or \$27.8 billion. The public equity program exceeded established benchmarks for the fiscal year to date and the one-, three-, and five-year periods ending March 31, 2005. Going forward, VRS will seek opportunities to move some of its passive investments into low risk, active strategies that have

Profile: Virginia Retirement System Investments (as of March 31, 2005)

Market Value of Assets: \$43.1 billion

Number of External Managers:

Public Equity – 25 Fixed Income - 6

Number of External Investment Accounts:

Public Equity – 30 Fixed Income - 6

Number of VRS Investment Department Staff: 39 authorized FTE positions (6 vacant)

FY 2004 Investment Expenses: \$118.3 million (29.6 basis points)

FY 2005 Investment Expenses (July-May): \$118.3 million (27.2 basis points)

FY 2004 Investment Department Operating Expenses: \$6.7 million (1.7 basis points)

FY 2005 Investment Department Operating Expenses (July-May): \$6.6 million (1.5 basis points)

Total Return on Investments

10 years	5 years	3 years	1 year
10.4%	2.6%	7.7%	9.4%

Performance/Intermediate Benchmark

9.8%	2.0%	7.2%	8.3%
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Time periods ending 3/31/2005

Investment Policy Indicators (as of March 31, 2005)

Asset Class	Asset Allocation (% of Total Assets)		Asset Allocation (% of Asset Class)		Type of Management (% of Asset Class)	
	Target	Actual	Domestic	Non-U.S.	External	VRS
Public Equity	64.3%	64.5%	67.3%	32.7%	76.8%	23.2%
Fixed Income	20.0%	19.5%	97.2%	2.8%	63.0%	37.0%
Hedge Funds	3.7%	3.7%	77.0%	23.0%	100%	0%
Private Equity	4.9%	4.9%	81.9%	18.1%	100%	0%
Real Estate	3.9%	3.9%	96.4%	3.6%	100%	0%
Credit Strategies	2.8%	2.8%	90.7%	9.3%	100%	0%

Table 1				
VRS Investment Performance for Period Ending March 31, 2005				
<i>Program/ Performance Objective</i>	<i>Fiscal Year to Date</i>	<i>1 Year</i>	<i>3 Years</i>	<i>5 Years</i>
<i>Total Fund</i>	9.3%	9.4%	7.7%	2.6%
VRS Performance Benchmark – Intermediate	8.1%	8.3%	7.2%	2.0%
VRS Performance Benchmark- Long Term	5.6%	5.9%	5.0%	0.9%
<i>Total Public Equity</i>	10.2%	10.7%	6.9%	-1.0%
Public Equity Custom Benchmark	9.3%	10.1%	6.6%	-1.4%
<i>Total Fixed Income</i>	4.0%	1.7%	6.3%	7.4%
Lehman Total VRS Custom	3.7%	1.2%	6.0%	7.1%
<i>Total Private Equity</i>	18.9%	24.9%	10.0%	5.7%
Private Equity Custom Benchmark	11.1%	14.4%	7.4%	1.4%
<i>Total Real Estate</i>	14.5%	14.1%	12.6%	12.7%
Real Estate Custom Benchmark	12.6%	13.0%	11.0%	11.7%
<i>Total Hedge Funds</i>	7.6%	7.7%	n/a	n/a
Hedge Funds Custom Benchmark	4.7%	6.0%	n/a	n/a
<i>Total Credit Strategies</i>	5.1%	n/a	n/a	n/a
Credit Strategies Custom Benchmark	6.3%	n/a	n/a	n/a
Source: JLARC staff analysis of VRS data.				

a high probability of success, which can be managed internally. In addition, VRS will increase its allocation to global equity managers.

Fixed Income. The objectives of the fixed income program are to reduce total fund risk through lower volatility, lower correlation, higher income, and the provision of a deflation hedge. The fixed income program continued to generate positive returns (4.0 percent, 1.7 percent, 6.3 percent, and 7.4 percent, respectively) for the fiscal year to date and the one-, three-, and five-year periods ending March 31, 2005. The program also outperformed its benchmark in all of these periods.

Private Equity. The private equity program performed well, had strong returns, and substantially outperformed its benchmark for the fiscal year to date and the one-, three-, and five-year periods ending March 31, 2005. The private equity program's dollar-weighted return, since the inception of the program in April 1989, is 23.9 percent. The private equity benchmark (the dollar-weighted Russell 3000 plus 250 basis points) for this same period, was 19.7 percent. Similarly, the program outperformed the Russell 3000 Index (public market) over this period by 6.7 percent.

Credit Strategies. VRS uses credit strategies opportunistically when expected returns are competitive with public equity. The credit strategies program started on July 1, 2004. As of March 31, 2005, the program had \$1.2 billion in assets and represented 2.8 percent of the total fund. The credit strategies program fell short of its benchmark for the fiscal-year-to-date period ending March 31, 2005 (5.1 versus 6.3 percent).

Hedge Funds. The hedge fund program began in July of 2003, and currently has two components. The larger component consists of hedge fund investments selected and monitored with the assistance of two hedge fund advisors (Ivy Asset Management and The Rock Creek Group). The second component involves direct hedge fund investments by VRS staff without the assistance of a third party advisor. The hedge fund program outperformed its benchmark for the fiscal year to date and the one-year period ending March 31, 2005. As of March 31, 2005, the total appreciated value of the hedge fund program was \$1.6 billion, representing 3.7 percent of the total VRS portfolio.

Recently, the Board directed the staff to hold the hedge fund allocation at the current level, approximately 4.0 percent. The staff plans to conduct an in-depth program review and evaluation, through which it will either confirm the existing hedge fund program structure or present an alternative plan to the Board. During this evaluation, the staff will re-examine the hedge fund program, including the role and terms of engagement of outside advisors, program benchmarks, the risk management process, and VRS staffing needs. Until the review is complete, VRS staff will continue to manage the existing portfolio and make adjustments as necessary. In addition, the Board plans to hold a special meeting later this summer or in the early fall to review and discuss all of the alternative asset classes.

Real Estate. The VRS real estate program outperformed its benchmark for the fiscal year to date and the one-, three-, and five-year periods ending March 31, 2005. The total value of the real estate portfolio as of March 31, 2005 was \$1.7 billion or 3.9 percent of the total fund. As a result of strong capital flows to the asset class, real estate investing continues to be challenging. VRS will selectively pursue investment expected to perform well in this capital environment, investing when return thresholds are likely to be met using reasonable assumptions.

Actuarial Experience Study and Changes in Assumptions

Section 51.1-124.22(A)(4) of the *Code of Virginia* requires VRS to have an actuarial investigation made of all experience under the Retirement System at least once every four years, including actuarial gain/loss analyses. According to *Code*, the Board shall periodically revise the actuarial assumptions used in the computation of employer contribution rates based upon these analyses. The VRS actuary conducted an experience study for the period July 1, 1999 through June 30, 2004. The experience study reviewed economic and demographic assumptions concerning retirements, termination, disability, mortality, salary increases, CPIU and COLA, and the discount rate. Essentially, the experience study measured the difference between assumptions or expectations and what actually occurred.

Based upon the data collected and the analyses conducted by the VRS actuary during the experience study, the Board will be revising the assumptions used in the 2005 actuarial valuation. Most significantly, the discount rate (also referred to as the investment rate of return) will be revised from 8 percent to 7.5 percent, and the cost-of-living increase assumption (also referred to as the inflation rate assumption) will be changed from 3.0 percent to 2.5 percent. In addition, changes will be made to the demographic

assumptions to facilitate a valuation that more closely represents the actual behaviors and experience of the members. The change in the economic assumptions will likely cause a greater increase in the next year's contribution rates.

Leadership Change at VRS

The VRS Board of Trustees appointed Mr. Robert P. Schultze as Director of the retirement system, effective May 2, 2005. Mr. Schultze succeeds W. Forrest Matthews, Jr. who retired April 1. Prior to his appointment at VRS, Mr. Schultze served as Executive Commissioner with the Virginia Department of Taxation, where he oversaw operations. He has also held a variety of positions during his 29 years in service to the Commonwealth, beginning in 1976 with the State Council of Higher Education. Mr. Schultze's experience includes service with the executive and legislative branches of Virginia government, serving as Deputy Chief of Staff to Virginia Governor L. Douglas Wilder and Staff Director to the House Appropriations Committee.

On March 21, 2005, Ms. Nancy Everett resigned from the position of Chief Investment Officer (CIO). Currently, the Deputy Chief Investment Officer, Mr. Charles Grant, is serving in an acting capacity. Mr. Grant has served as Deputy Chief Investment Officer since January 2005, and has been with VRS for approximately 10 years. The VRS Board has hired a search firm and expects to have a new CIO in place sometime this summer.

On March 23, 2005, Mr. Paul W. Timmreck was named chair of the Board of Trustees by Governor Warner. Mr. Timmreck, Senior Vice President for Finance and Administration at Virginia Commonwealth University (VCU), has been a member of the board since March 2001. Appointed by the Virginia General Assembly to represent State employees, he served most recently as the Vice-Chair of the Board. Mr. Timmreck has served the Commonwealth of Virginia in a variety of capacities for more than 29 years. In his position at VCU, which he began on August 1, 1996, he oversees operations in budget and finance, human resources, facilities management, administrative information technology, and public safety. The Governor also appointed Palmer P. Garson, managing partner at Jefferson Capital Partners, to the VRS Board of Trustees. Ms. Garson replaces Mr. Robert C. Carlson.

The Board of Trustees named Mr. Joe Grills, retired IBM Retirement Funds Chief Investment Officer, as Chairman of the Investment Advisory Committee (IAC). Mr. Grills succeeds Mr. Raymond D. Smoot, Jr. In addition, the VRS board named three new members to the IAC, including Rod Smyth of Wachovia Securities; Erwin H. Will, Jr., former VRS Chief Investment Officer; and Christopher Brightman of the University of Virginia Investment Management Company (UVIMCO). These three individuals fill a vacancy on the IAC and succeed Joseph W. Montgomery and Kenneth G. Lay.

JLARC Reports on the Virginia Retirement System

The Virginia Retirement System's Investment in the RF& P Corporation, December 1993
Review of the Virginia Retirement System, January 1994
Review of the State's Group Life Insurance Program for Public Employees, January 1994
The VRS Investment Program, March 1995
The VRS Disability Retirement Program, March 1995
The 1991 Early Retirement Incentive Program, May 1995
Semi-Annual VRS Investment Report No. 4, September 1995
Semi-Annual VRS Investment Report No. 5, May 1996
Biennial Status Report on the Virginia Retirement System, May 1996
Legislator's Guide to the Virginia Retirement System, First Edition, May 1996
Review of VRS Fiduciary Responsibility and Liability, January 1997
Semi-Annual VRS Investment Report No. 8, May 1997
Semi-Annual VRS Investment Report No. 9, December 1997
Semi-Annual VRS Investment Report No. 10, July 1998
Semi-Annual VRS Investment Report No. 11, December 1998
Legislator's Guide to the Virginia Retirement System, Second Edition, May 1999
Semi-Annual VRS Investment Report No. 12, July 1999
VRS Biennial Status and Semi-Annual Investment Report No. 13, December 1999
Semi-Annual VRS Investment Report No. 14, July 2000
Semi-Annual VRS Investment Report No. 15, December 2000
Semi-Annual VRS Investment Report No. 16, July 2001
Semi-Annual VRS Investment Report No. 17, December 2001
Biennial Status and Semi-Annual VRS Investment Report No. 18, July 2002
Semi-Annual VRS Investment Report No. 19, December 2002
Semi-Annual VRS Investment Report No. 20, July 2003
Semi-Annual VRS Investment Report No. 21, December 2003
Semi-Annual VRS Investment Report No. 22, July 2004
Biennial Status and Semi-Annual VRS Investment Report No. 23, December 2004
Semi-Annual VRS Investment Report No. 24, July 2005
Special Report: Certain Personnel Issues at the Virginia Retirement System, July 2005
Legislator's Guide to the Virginia Retirement System (annually updated and resident on the JLARC Web Site at <http://vrsguide.state.va.us>)

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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.

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