



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

Semi-Annual Investment Report July 2006

As of March 31, 2006, the market value of the Virginia Retirement System (VRS) pension fund was \$49 billion. The return for the total fund for the one-year period ending March 31, 2006, was 15.9 percent. The fund's performance exceeded established benchmarks for the one-, three-, five-, and ten-year periods ending March 31, 2006. Performance indicators are provided in Table 1 (page 2).

Public Equity. The public equity program continues to be VRS' largest asset class comprising 66.2 percent of the portfolio or \$32.4 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, 2006. Non-U.S. public equities constitute 20.6 percent of the total portfolio or \$10.1 billion. As described in the December 2005 Semi-Annual Investment Report, hedge funds will no longer be reported by VRS as a separate asset class. Hedge funds are a collection of active strategies rather than a separate asset class, and the hedge fund program is funded from equities. Therefore, VRS has integrated hedge funds into the public

Profile: Virginia Retirement System Investments (as of March 31, 2006)

Market Value of Assets: \$49.0 billion

Number of External Managers:

Public Equity – 62 (24 traditional, 38 hedge funds)
Fixed Income – 6

| Total Return on Investments | | | |
|------------------------------------|---------|---------|--------|
| 10 years | 5 years | 3 years | 1 year |
| 9.7% | 7.9% | 18.5% | 15.9% |
| Performance/Intermediate Benchmark | | | |
| 9.0% | 7.5% | 17.7% | 14.6% |

Number of External Investment Accounts:

Public Equity – 66 (31 traditional, 35 hedge funds)
Fixed Income – 6

Number of VRS Investment Department Staff: 39 authorized FTE positions (4 vacant)

FY 2005 Investment Expenses: \$165.1 million (37.5 basis points)

Investment Expenses for FY 2006 through 5/31/2006: \$188.2 million

FY 2005 Investment Department Operating Expenses: \$7.6 million (1.7 basis points)

Operating Expenses for FY 2006 through 5/31/2006: \$8.2 million

Investment Policy Indicators (as of March 31, 2006)

| 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 | 65.8% | 66.2% | 67.0% | 33.0% | 74.0% | 26.0% |
| Fixed Income | 20.0% | 19.5% | 99.5% | 0.5% | 63.0% | 37.0% |
| Private Equity | ≤ 6.0% | 5.2% | 79.8% | 20.2% | 100% | 0% |
| Real Estate | ≤ 6.0% | 4.6% | 96.7% | 3.3% | 94.0% | 6.0% |
| Credit Strategies | ≤ 5.0% | 4.1% | 94.2% | 5.8% | 100% | 0% |

| Table 1 | | | | |
|--|------------------------------------|---------------|----------------|----------------|
| VRS Investment Performance for Period Ending March 31, 2006 | | | | |
| <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> | 13.2% | 15.9% | 18.5% | 7.9% |
| Total Fund Benchmark - Intermediate | 12.4% | 14.6% | 17.7% | 7.5% |
| Total Fund Benchmark - Long Term | 7.9% | 10.6% | 14.2% | 5.5% |
| <i>Total Public Equity</i> | 17.1% | 19.3% | 24.1% | 7.9% |
| Public Equity Custom Benchmark | 17.0% | 18.9% | 23.6% | 7.6% |
| <i>Total Fixed Income</i> | -0.6% | 2.4% | 3.4% | 5.3% |
| Lehman Total VRS Custom | -0.7% | 2.3% | 2.9% | 5.1% |
| <i>Total Private Equity</i> | 22.1% | 24.8% | 23.9% | 7.6% |
| Private Equity Custom Benchmark | 10.1% | 8.6% | 18.4% | 4.1% |
| <i>Total Real Estate</i> | 21.7% | 32.3% | 21.7% | 16.2% |
| Real Estate Custom Benchmark | 18.8% | 27.9% | 19.8% | 14.1% |
| <i>Total Credit Strategies</i> | 5.9% | 8.4% | n/a | n/a |
| VRS Credit Strategies Custom | 5.8% | 8.1% | n/a | n/a |
| Source: JLARC staff analysis of VRS data. | | | | |

equity program and its associated risk budget. As of March 31, 2006, hedge funds comprised 4.1 percent of the total portfolio or \$2.0 billion. Since the inception of the program in July 2003, hedge funds have returned 11.1 percent.

Fixed Income. Returns for the program from July 1, 2005, to March 31, 2006, were negative (-0.6). However, the program generated positive returns (2.4 percent, 3.4 percent, and 5.3 percent, respectively) for the one-, three-, and five-year periods ending March 31, 2006. The program also outperformed its benchmark in all of these periods.

Private Equity. The private equity program continued to perform well and substantially outperformed its benchmark for the fiscal year to date as well as the one-, three-, and five-year periods ending March 31, 2006. The private equity program's dollar-weighted return, since the inception of the program in April 1989 through December 31, 2005, is 23.8 percent. The private equity benchmark (the dollar-weighted Russell 3000 plus 250 basis points) for this same period was 19.9 percent.

Credit Strategies. VRS credit strategies include investments in areas such as public high-yield debt, private debt, convertibles, bank loans, and high-yield asset-backed securities. In addition, the investments in this program have different characteristics from those in the fixed income program and are not part of the plan's fixed income allocation. The credit strategies program started on July 1, 2004. As of March 31, 2006, the program had \$2.0 billion in assets and represented 4.1 percent of the total fund. The credit strategies program exceeded its benchmark for the one-year period ending March 31, 2006 (8.4 percent *versus* 8.1 percent).

Real Estate. The VRS real estate program continued to have strong returns and outperformed its benchmark for the fiscal year to date and the one-, three-, and five-year periods ending March 31, 2006 (21.7 percent, 32.3 percent, 21.7 percent, and 16.2 percent, respectively). The total value of the real estate portfolio as of March 31, 2006, was \$2.3 billion or 4.6 percent of the total fund.

Appointments to the VRS Board of Trustees

Governor Kaine reappointed Paul W. Timmreck as chair of the VRS Board of Trustees for a term beginning March 1, 2006, and ending February 28, 2008. Mr. Timmreck is currently Senior Vice President for Finance and Administration at Virginia Commonwealth University (VCU) and has announced his retirement from VCU effective July 1, 2006. In addition, the Governor appointed A. Marshall Acuff, Jr., to serve on the VRS Board of Trustees as a representative with asset management experience. Mr. Acuff's five-year term began March 1, 2006, and will end February 28, 2011. Mr. Acuff succeeded Mr. J. Alfred Broaddus, Jr. Mr. Acuff began his career at Smith Barney and started AMA Investment Counsel, LLC in 2001, where he currently serves as president.

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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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