VRS OVERSIGHT Report

JOINT LEGISLATIVE AUDIT & REVIEW COMMISSION
OF THE VIRGINIA GENERAL ASSEMBLY

VRS Semi-Annual Investment Report
July 2011

The VRS trust fund had $54.3 billion in assets as of March 31, 2011, recovering most of the losses experienced in 2008 and 2009. As a result of the national recession, by March 2009 the fund's assets had decreased in value to $38.9 billion. The fund's recovery is attributed to the uniformly positive performance of the trust fund's asset classes, which was led by the public equity program. The public equity program's gains were driven by the recovery of equity values experienced in the broader market.

For the one-year period between March 31, 2010 and March 31, 2011, the fund achieved a return of 13 percent and increased in value by $4.2 billion. The total fund performed at or near established benchmarks across all periods, but did not earn the assumed rate of return of seven percent over the longer term. This is primarily due to the investment losses experienced in 2008 and 2009. However, while not achieving the assumed rate of return, the fund did add value (130 basis points) over the long-term benchmark for the ten-year period. Performance indicators are provided in Table 1. Figure 1 compares the fund's performance over time to the assumed rate of return. While VRS did not meet the assumed rate of return for the ten-year period, the annualized return from fiscal year 1990 is 8.5 percent.

Profile: Virginia Retirement System Investments (as of March 31, 2011)

Market Value of Assets: $54.3 billion

Number of External Managers:
Public Equity – 24 (13 traditional, 11 hedge funds)
Fixed Income – 12

Total Return on Investments			
10 years	*5 years*	*3 years*	*1 year*
5.9%	**3.9%**	**1.7%**	**13.0%**
Performance/Intermediate Benchmark			
5.7%	**3.9%**	**2.2%**	**13.0%**

Number of External Investment Accounts/Mandates:
Public Equity – 30 (18 traditional, 12 hedge funds)
Fixed Income – 20

Number of VRS Investment Department Staff: 57 authorized FTEs (11 vacant)

FY 2010 Investment Expenses: $285.46 million (59.9 basis points)

FY 2010 Investment Department Operating Expenses: $13.9 million* (2.9 basis points)

Investment Policy Indicators (as of March 31, 2011)

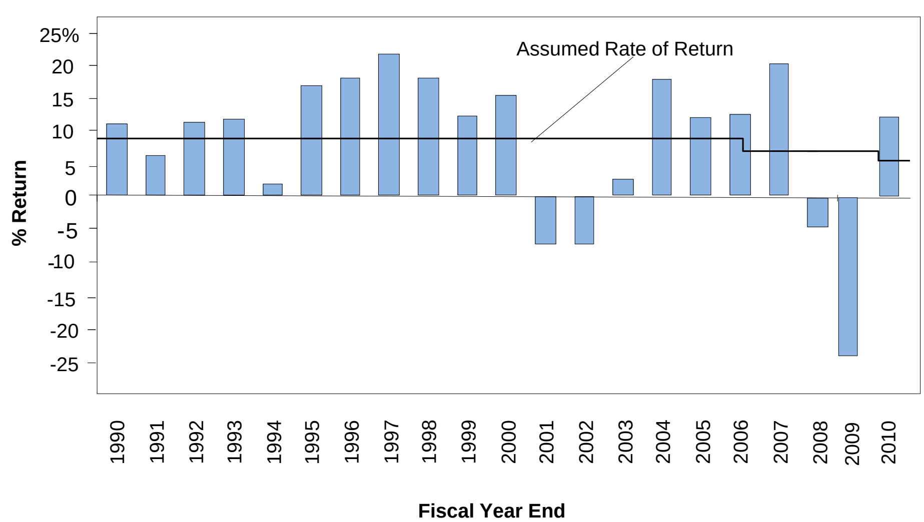
	Asset Allocation (% of Total Assets)		*Asset Allocation* (% of Asset Class)		*Type of Management* (% of Asset Class)	
Asset Class	**Policy**	**Actual**	**Domestic**	**Non-U.S.**	**External**	**VRS**
Public Equity	**49.3%**	**48.9%**	**43.7%**	**56.3%**	**66%**	**34%**
Fixed Income	**19.0%**	**19.0%**	**93.3%**	**6.7%**	**69%**	**31%**
Credit Strategies	**15.8%**	**15.8%**	**94.3%**	**5.7%**	**98%**	**2%**
Private Equity	**8.6%**	**8.6%**	**81.8%**	**18.2%**	**100%**	**0%**
Real Estate	**6.3%**	**6.3%**	**83.6%**	**16.4%**	**94%**	**6%**
Cash	**0.3%**	**0.7%**	**n/a**	**n/a**	**100%**	**0%**

***Includes allocated administrative expenses**

Table 1 VRS Investment Performance for Period Ending March 31, 2011					
Program/ **Performance Objective**	**Fiscal Year to Date**	**1 Year**	**3 Years**	**5 Years**	**10 Years**
Total Fund	*17.7%*	*13%*	*1.7%*	*3.9%*	*5.9%*
Total Fund Benchmark - Intermediate	17.8	13.0	2.2	3.9	5.7
Total Fund Benchmark - Long Term	19.3	11.1	3.6	3.8	4.6
Total Public Equity	*26.9*	*13.8*	*1.4*	*2.8*	*5.4*
Public Equity Custom Benchmark	28.1	13.9	2.0	3.2	5.4
Total Fixed Income	*3.9*	*7.9*	*7.1*	*6.9*	*6.1*
Fixed Income Custom Benchmark	1.3	5.1	5.3	6.2	5.6
Total Credit Strategies	*14.4*	*13.5*	*8.8*	*6.8*	*n/a*
VRS Credit Strategies Custom Benchmark	15.4	14.2	8.5	6.5	n/a
Total Real Estate	*19.3*	*20.4*	*-5.1*	*2.6*	*9.2*
Real Estate Custom Benchmark	15.3	14.9	-3.2	3.4	8.6
Total Private Equity	*12.2*	*15.2*	*0.2*	*10.6*	*9.1*
Private Equity Custom Benchmark	11.8	19.4	0.6	5.3	4.7

Source: VRS investment department data.

Figure 1
VRS Annual Performance



Source: VRS investment department data.

Public Equity. The public equity program continues to be VRS' largest asset class, constituting 48.9 percent of the portfolio or $26.5 billion. Public equity investments are typically higher risk investments that are expected to provide long-term capital growth and inflation protection. Both of these expectations assume a long-term time horizon. Public equity is the only asset class with a majority of its investments in non-U.S. holdings.

The public equity program continues to recover from its FY 2009 losses, having achieved a fiscal year to date return of 26.9 percent and a one-year return of 13.8 percent. The public equity program met its established benchmark for the ten-year period ending March 31, 2011, but underperformed in the three- and five-year periods by 60 and 40 basis points, respectively. While achieving a nearly 27 percent return for the fiscal year to date period, the asset class still underperformed its benchmark for that period by 120 basis points. According to VRS staff, this is because the fund is invested at a lower risk level than exhibited by the benchmark. VRS staff also predict that because the public equity program has more exposure to higher quality stocks than the market as a whole, it may not perform quite as well as the overall public markets in periods of substantial gains.

Fixed Income. The fixed income program serves as a diversifier for the overall portfolio. As of March 31, 2011, the program constituted 19 percent of the portfolio or $10.3 billion. Almost all (93 percent) of VRS' fixed income assets are domestically invested. The fixed income program is the only program to have exceeded its benchmark for all periods.

Credit Strategies. The credit strategies program is relatively new, having begun on July 1, 2004. In the current VRS portfolio, credit strategies are used opportunistically whenever they are expected to provide good risk-adjusted returns relative to other investment options available to the plan. Benefits of this asset class include further diversification and cash flow benefits, as well as lower volatility compared to equities. VRS credit strategies include investments in areas such as public high-yield debt, private debt, convertible bonds, bank loans, and high-yield asset-backed securities. Almost all (94 percent) of VRS' credit strategies are domestically invested.

As of March 31, 2011, the program had $8.6 billion in assets and represented 15.8 percent of the total fund. The credit strategies program slightly exceeded established benchmarks in the three- and five-year periods, but underperformed in the one-year period.

Real Estate/Real Assets. This year, the VRS investment department expanded its real estate program to include real assets, such as timberland and infrastructure. In March 2011, the investment department made its first commitment to a timberland strategy.

The total value of the VRS real assets portfolio as of March 31, 2011, was $3.4 billion or 6.3 percent of the total fund.* This asset class added 550 points over its benchmark in the one-year period and 400 basis points for the fiscal year to date, but it underperformed in the three- and five-year periods. The majority (83.6 percent) of the real estate portfolio is invested in U.S. holdings.

Private Equity. Private equity is an opportunistic substitute for public equity. Through active equity management, VRS expects to earn a meaningful return premium on its private equity investments.

As of March 31, 2011, private equity represented 8.6 percent of the total fund or $4.7 billion.* The private equity program exceeded established benchmarks for the five- and ten-year periods ending March 31, 2011, as well as the fiscal year to date. According to VRS, the underperformance relative to the benchmark in other periods is due to the caution that private equity fund managers have exhibited in marking up the value of their assets. In all periods but the fiscal year to date and the three-year period, the private equity program earned higher returns than the public equity program, consistent with its objective.

* Whereas performance figures for the real estate and private equity programs reflect data on cash flow into the program as of March 31, 2011, they do not reflect managers' actual valuations of these investments as of that date because these data have not yet been made available to VRS. Instead, their performance is based on December 31, 2010 valuations, adjusted for cash flows during the quarter ended March 31, 2011.

Over the long term, VRS staff expect the program to outperform its benchmark and continue to earn a premium over the public equity program. Notably, the dollar-weighted annualized performance since the inception of the program in April 1989 through December 31, 2010, was 22.16 percent.

Hedge Funds. VRS considers hedge funds active investment strategies that can be used within any of the investment programs, subject to a total policy limit currently set by the VRS Board of Trustees ("the Board") at ten percent. Since being used in this manner, as opposed to being a separately designated asset class, the number of hedge fund mandates has decreased, but the average size of the mandates has grown.

VRS staff report that assets in its hedge funds continue to perform well and that the strategic use of hedge funds has been successful. In total, hedge fund investments constituted $4.3 billion or 7.9 percent of the total portfolio as of March 31, 2011. Most of the hedge fund managers are public equity managers, but there are also hedge fund managers in the credit strategies and fixed income programs.

Search for New Chief Investment Officer Continues

On September 1, 2010, VRS announced that its Chief Investment Officer (CIO) would not seek reappointment by the Board after the expiration of his contract in August 2011. Following an unsuccessful initial recruitment effort that was fairly limited in scope, the Board announced at its October 28, 2010 meeting that it would create a formal search committee for the purpose of hiring a new CIO. At the November 18, 2010 meeting, the Board formally created a search committee consisting of Board members as well as the chairman of the Investment Advisory Committee. The search committee has met four times. In February, the Board entered into a contract with the executive search firm Korn/Ferry International to conduct the search for the next VRS CIO. The existing CIO, a VRS employee since 1995, has remained in the position throughout the search process and intends to assist the Board and VRS staff with the transition of responsibilities when a suitable replacement is found.

Board Defers Review of Asset Allocation Policy to Spring 2012

VRS' asset allocation policy defines the basic risk and return characteristics of the investment portfolio. The asset allocation policy is determined by the Board. While VRS is a long-term investor and its asset allocation policy is not expected to change significantly over time, the policy of conducting an asset allocation and liability study on an annual basis ensures that VRS reviews its risk tolerance and its forward expectations at least once each year. While the study is conducted annually, asset allocation targets can be reconsidered any time market conditions or the underlying assumptions undergo a substantial change.

At the June 16, 2011 Board of Trustees meeting, the CIO presented the customary annual asset-liability analysis, which typically includes recommendations for how the asset allocation policy should be changed. However, in order to allow the incoming CIO an opportunity to provide input, the Board deferred further consideration of the policy to 2012.

Changes Approved to Investment Structure for Unbundled Defined Contribution Plans

VRS has six defined contribution plans, five of which are structured in an "unbundled" manner. (In a "bundled" plan, investment options are restricted to funds that are available through the plans' record-keeper, which results in less flexibility for the plan administrator. In an unbundled plan, the investment options include funds that are managed by companies besides that of the record-keeper, giving the plan administrator greater discretion regarding the investment platform.) At its February 17, 2011 meeting, the Board approved three substantial changes to the structure of its unbundled plans: (1) replace the risk-based asset allocation funds with target date funds, (2) simplify the options available for the stand-alone core investments, and (3) expand the self-directed brokerage account beyond just mutual funds. Target date funds would serve as the default investment option for participants. The objectives of the changes are to simplify the investment choices that participants have, thereby improving participation levels, and helping participants better align their investment and retirement goals with their actual portfolios.

As a result of these changes, the investment structure for the unbundled plans will now be based on "paths" that more clearly help participants reach their investment goals. One path will include target date funds, a second will allow participants to be more proactive than the first path and will include a more simplified menu of individual core options, and the third will allow participants to actively manage their own investments through the self-directed brokerage accounts. The changes to the self-directed brokerage account will go into effect in August 2011. An effective date has not yet been established for the other changes.

FY 2012 Contribution Rates Approved for Line of Duty Act Fund

The 2010 Appropriation Act established the Line of Duty Act Fund as a funding mechanism for payments to State and local employees who qualify for benefits under the State's Line of Duty Act. The fund is administered and invested by VRS. The benefits themselves are administered by the Department of Accounts. The State and localities are required by the *Code of Virginia* to pay Line of Duty Act benefits, but localities can opt out of paying for these benefits through the newly created fund. To opt out of participation in the fund, localities are required to submit an irrevocable resolution to VRS by July 1, 2012.

Future payments into the fund will be generated by employer contributions and investment returns. (For FY 2011, claims and other expenses paid out of the fund were capitalized through a loan from the Group Life Insurance Program.) At its December 16, 2010, meeting the VRS Board approved the FY 2012 per capita rate that the State and participating local governments will be required to contribute toward the Line of Duty Act fund. The approved rate is $233.89 for each full-time equivalent position. According to the VRS actuary, future per capita rates will be set through an annual valuation and will vary based on the number of participating localities and plan experience.

Appointments to the Board of Trustees and Investment Advisory Committee Announced

The Board of Trustees reappointed three members of the VRS Investment Advisory Committee for two-year terms. These members are Thomas Gayner, Deborah Allen-Hewitt, and Rod Smyth, who serves as chairman. The Board also appointed Lawrence Kochard to serve on the committee for a two-year term.

The terms of two Board of Trustees members – Marshall Acuff, Jr. and Paul Timmreck – expired in April. The Governor reappointed Mr. Acuff to the Board for a second five-year term. The Joint Rules Committee has not yet made an appointment to fill the position held by Mr. Timmreck. Mr. Timmreck has served two five-year terms and will continue to serve on the Board until a replacement trustee is appointed.

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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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