VRS OVERSIGHT Report

JOINT LEGISLATIVE AUDIT & REVIEW COMMISSION
OF THE VIRGINIA GENERAL ASSEMBLY

VRS Semi-Annual Investment Report
July 2012

Retirement, disability, and other related benefits are paid to retired or disabled members of the Virginia Retirement System (VRS), and their beneficiaries, out of the VRS trust fund. The trust fund held $54.2 billion in assets as of March 31, 2012. For the one-year period from March 31, 2011 to March 31, 2012, the fund achieved a return of 4.0 percent, but decreased in value by $0.2 billion due to payments out of the fund. Performance indicators are provided in Table 1 (page 2). As of March 31, 2012, the fund experienced positive returns over each of the time periods for which performance was measured. Despite these positive returns, the total fund performed below its established long-term benchmark for the fiscal-year-to-date, one-, three-, and five-year periods. While the fund did outperform this benchmark over the ten-year period by 110 basis points, it did not achieve the assumed rate of return of seven percent over that time. Still, when compared to the intermediate-term benchmark, against which staff performance is measured, the fund performed well.

Profile: Virginia Retirement System Investments (as of March 31, 2012)

Market Value of Assets: $54.2 billion

Number of External Managers:
Public Equity – 25 (14 traditional, 11 hedge funds)
Fixed Income – 12

Number of External Investment Accounts/Mandates:
Public Equity – 27 (16 traditional, 11 hedge funds)
Fixed Income – 24

Total Return on Investments			
10 years	*5 years*	*3 years*	*1 year*
6.2%	**2.1%**	**15.5%**	**4.0%**
Performance/Long-Term Benchmark			
5.1%	**3.4%**	**18.0%**	**7.8%**
Performance/Intermediate Benchmark			
5.8%	**2.1%**	**15.5%**	**3.2%**

Number of VRS Investment Department Staff: 56 authorized FTEs (4 vacant)

FY 2011 Investment Expenses: $302.72 million (55.6 basis points)

FY 2011 Investment Department Operating Expenses: $17.3 million* (3.2 basis points)

Investment Policy Indicators (as of March 31, 2012)

	Asset Allocation (% of Total Assets)		*Asset Allocation* (% of Asset Class)		*Type of Management* (% of Accounts)	
Asset Class	**Policy**	**Actual**	**Domestic**	**Non-U.S.**	**External**	**VRS**
Public Equity	**46.4%**	**46.0%**	**46.6%**	**53.4%**	**63.0%**	**37.0%**
Fixed Income	**19.8%**	**19.6%**	**82.1%**	**17.9%**	**50.9%**	**49.1%**
Credit Strategies	**14.4%**	**14.4%**	**93.0%**	**7.0%**	**98.0%**	**2.0%**
Private Equity	**8.8%**	**8.8%**	**82.9%**	**17.1%**	**100.0%**	**0.0%**
Real Assets	**7.7%**	**7.7%**	**87.0%**	**13.0%**	**98.4%**	**1.6%**
Cash	**0.25%**	**0.73%**	**n/a**	**n/a**	**100.0%**	**0.0%**

***Includes administrative expenses.**

Table 1
VRS Investment Performance for Period Ending March 31, 2012

Program/ Performance Objective	Fiscal Year to Date	1 Year	3 Years	5 Years	10 Years
Total Fund	*2.8%*	*4.0%*	*15.5%*	*2.1%*	*6.2%*
Total Fund Benchmark - Intermediate	*1.8*	*3.2*	*15.5*	*2.1*	*5.8*
Total Fund Benchmark - Long Term	6.9	7.8	18.0	3.4	5.1
Total Public Equity	*0.5*	*0.7*	*20.9*	*0.3*	*5.4*
Public Equity Custom Benchmark	-0.1	-0.3	20.9	0.4	5.3
Total Fixed Income	*5.9*	*7.9*	*10.1*	*7.1*	*6.4*
Fixed Income Custom Benchmark	5.4	8.0	6.5	6.5	5.9
Total Credit Strategies	*1.7*	*1.9*	*17.4*	*5.3*	*n/a*
VRS Credit Strategies Custom Benchmark	3.6	4.2	20.1	5.2	n/a
Total Private Equity	*5.0*	*10.1*	*11.6*	*7.0*	*11.7*
Private Equity Custom Benchmark	-3.4	3.5	17.4	2.6	6.1
Total Real Assets	*8.6*	*12.1*	*10.2*	*0.6*	*9.2*
Real Assets Custom Benchmark	8.9	12.5	7.5	1.9	8.8

Source: VRS investment department data.

According to VRS, the chief reason for the fund's underperformance relative to its long-term benchmark is that the benchmark largely reflects the performance of domestic investments, whereas a substantial portion of the trust fund's investments is in global markets. VRS staff have requested that the Board of Trustees ("the board") consider revising the long-term benchmark by replacing the U.S. equity component with a global equity component. The board's Investment Advisory Committee supports this request, which will be considered by the board's Investment Policy Committee. The Investment Policy Committee is a standing committee of the board created in 2011.

Public Equity. The public equity program continues to be VRS' largest asset class, accounting for $25 billion of the trust fund's assets, or 46 percent of the portfolio as of March 31, 2012. 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 the majority of its investments in non-U.S. holdings.

The public equity program continues to contribute significantly to the fund's recovery from losses experienced in fiscal year (FY) 2009. In all periods for which performance was measured as of March 31, 2012, the public equity program performed at or above its respective benchmark. For the three-year period, the public equity program achieved a return of nearly 21 percent, higher than any of the other VRS asset classes.

Fixed Income. The fixed income program is VRS' second largest asset class, accounting for $12.1 billion of the trust fund's assets, or 19.6 percent of the portfolio as of March 31, 2012. The fixed income program serves as a diversifier for the overall portfolio. Most (82.1 percent) of the fixed income assets are invested domestically.

The fixed income program exceeded its benchmark in the three-, five-, and ten-year periods, as well as the fiscal-year-to-date period. For the one-year period, the fixed income program still performed near the benchmark. Recently, VRS has begun moving more of its assets into the internally managed portfolio. Internal accounts currently represent 49 percent of the asset class.

Credit Strategies. Credit strategies is the third largest VRS asset class and held $7.8 billion in assets, or 14.4 percent of the total fund, as of March 31, 2012. 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.

In the current VRS portfolio, credit strategies are used opportunistically whenever they are expected to provide good risk-adjusted returns relative to traditional stock and bond investment options available to the plan. Through this program, VRS can earn long-term returns comparable to equity investments, but with lower market risk. Benefits of this asset class include further diversification and increased cash flows, as well as lower volatility compared to equities. Almost all (93 percent) of VRS' credit strategies are invested domestically.

With the exception of the five-year period, the credit strategies program has underperformed its established benchmark in all periods as of March 31, 2012. Still, the program has outperformed a mix of stocks and bonds over the five-year period, and VRS considers it to have been successful.

Private Equity. As of March 31, 2012, private equity constituted nearly nine percent of the total fund, or $4.8 billion.* Private equity is an alternative to traditional public equity. Through active equity management, VRS expects to earn a meaningful return on its private equity investments. Most (83 percent) of VRS' private equity assets are invested domestically.

The private equity program far exceeded established benchmarks in all but the three-year period ending March 31, 2012. Over the long term, VRS staff expect the program to outperform its benchmark and continue to earn a premium over the public equity program. As of March 31, 2012, the private equity program has earned higher returns than the public equity program in all periods but the three-year period. Notably, the dollar-weighted annualized performance from the inception of the program in April 1989 through December 31, 2011, was 21.89 percent.

Real Assets. The total value of the VRS real assets portfolio as of March 31, 2012, was $4.2 billion, or 7.7 percent of the total fund.* (The Real Estate Program was renamed the Real Assets Program last year to reflect the focus of VRS staff over the past several years on potential investments in timberland, infrastructure, and farmland, in addition to commercial real estate.) The majority (87 percent) of the real assets portfolio is invested domestically. This asset class outperformed its benchmark over the three- and ten-year periods as of March 31, 2012.

Hedge Funds. In total, hedge fund investments constituted $4.7 billion, or 8.7 percent of the total portfolio as of March 31, 2012. While not an asset class, VRS considers hedge funds to be active investment strategies that can be used within any of the investment programs, subject to a total policy limit currently set by the board at ten percent. VRS staff report that assets in its hedge funds continue to perform well and that the strategic use of hedge funds has been successful. Most of the hedge

* Whereas performance figures for the real estate and private equity programs reflect data on cash flow into the program as of March 31, 2012, 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, 2011 valuations, adjusted for cash flows during the quarter ended March 31, 2012.

funds are managed by public equity managers, but there are also hedge fund managers in the credit strategies and fixed income programs.

VRS to Modify Investment Options for Defined Contribution Plans

Effective July 23, 2012, the current tiered structure of investment options available to defined contribution plan participants will be replaced with a new "path" structure. According to VRS, the new structure will better accommodate members' varying levels of knowledge about and interest in actively managing their investments than the existing structure.

The new structure includes three investment paths, and participants will be able to select investment options in each. VRS characterizes the first path as a "Do-It-For-Me Path," in which diversification, asset allocation, and rebalancing decisions are made by investment professionals, but guided by a member's personal circumstances and anticipated retirement date. The second path has been characterized as a "Help-Me-Do-It Path," in which members who are interested in more actively managing their investments may do so through a menu of core fund options across asset classes. The third path has been characterized as a "Do-It-Myself Path," in which members are able to fully manage their investments through a Self-Directed Brokerage Account. According to VRS staff, the proposed path approach has been well received by focus group participants. In addition to a new structure, VRS also initiated a competition for the management of each fund. The competition resulted in a substantial change in managers and in a lower fee structure.

These changes only affect employees participating in the 457 Deferred Compensation Plan, the Virginia Cash Match Plan, the Optional Retirement Plans for Political Appointees and School Superintendents, and/or the Virginia Supplemental Retirement Plan. The upcoming changes are currently being communicated to defined contribution plan participants through mailings, presentations, and the VRS website.

Excess Retirement Benefits Paid From 2010 to 2012

Effective July 1 of the second calendar year after retirement (reflected in the August 1 paycheck), VRS members are entitled to receive a Cost of Living Adjustment (COLA) to their retirement benefits. The COLA is routinely calculated by the VRS actuary each year and approved by the board. For current retirees, the *Code of Virginia* provides for a COLA that equals 100 percent of the first three percent of the annual increase in the Consumer Price Index-Urban and half of the increase above three percent, up to a maximum COLA of five percent.

In 2012, VRS staff discovered that the COLA had been miscalculated in 2009. Under the statutory formula, retirees were entitled to a COLA in 2009 of 3.42 percent. However, the VRS actuary incorrectly calculated the COLA as 3.84 percent and reported it to the board. The incorrect COLA was applied to retirees' benefits effective July 1, 2009 (August 1, 2009 paycheck).

As a result, excess payments were made to approximately 129,000 retirees and survivors over the three-year period from fiscal year 2010 to fiscal year 2012. The excess payments totaled $28.7 million over the three-year period and averaged $239 cumulatively for individual retirees and survivors. In addition, there are approximately 1,885 state employees on long-term disability (LTD) who received excess payments related to the COLA.

Section 51.1-124.9 of the *Code of Virginia* requires that errors in payments be corrected by the Board of Trustees. In cases where a VRS member or beneficiary receives more or less than the benefit they are entitled to due to an error in his or her record, the *Code* requires the board to "correct the error and as far as practicable adjust the payments so that the actuarial equivalent of the correct benefit shall be paid." At its June 2012 meeting, the board voted to adjust the affected retirees' as well as LTD recipients' benefit payments prospectively so that the 2012 COLA will be applied on the benefit that retirees would have received had the correct 2009 COLA of 3.42 percent been applied.

Three sections of the *Code of Virginia* permit VRS to recover overpayments (§51.1-124.9, §51.1-510, §51.1-124.22). The *Code* further states that "if a member has been overpaid through no fault of his and could not reasonably have been expected to detect the error the Board may waive any repayment which it believes would cause hardship." Because of the relatively small amounts of the individual overpayments, the board determined that the *Code's* hardship provision would not need to be invoked and that collection of the overpayment would be pursued.

At its June 2012 meeting, the board voted to collect the overpayments made over the three-year period. However, rather than deducting these amounts from retirees' future benefit payments, the board voted to collect the majority of the overpaid sum from the affected members' and LTD recipients' group life insurance benefits at the time they are paid. Section 51.1-510 of the *Code* permits the use of this method to collect overpayments. Retirees and survivors who are not covered by group life insurance will have their benefits actuarially reduced to recover the overpayments. Future retirement benefits for affected LTD recipients without group life insurance will be adjusted.

According to VRS staff, this method will recover the current value of approximately $26.6 million of the $28.7 million in overpayments. Approximately $1 million of the remainder cannot be recovered through group life insurance because it is largely attributed to already deceased members and, to a lesser extent, some closed claims related to LTD. The VRS actuary has agreed to pay VRS for this unrecoverable amount.

Despite the board's actions, the trust fund will still experience losses as a result of the COLA miscalculation. This is because the method of recovering the bulk of the overpayments through group life insurance distributions results in the State losing the benefit of the compounding interest that would have been earned on those assets. While VRS has not calculated the impact of this method on the fund's future assets, the board determined that it is least disruptive to active retirees' benefits and does still allow the trust fund to at least recover the current value of the overpayments.

VRS staff reviewed COLA calculations back to 1979 and confirmed that this miscalculation was an isolated incident. Going forward, VRS staff will more closely review the actuary's calculations, and the agency's internal audit department will ensure that the correct COLA is applied to retirees' benefits.

General Assembly Enacted Substantial Retirement Plan Changes in 2012

Legislation enacted by the 2012 General Assembly significantly changed the structure of the retirement benefits provided to most future and active State and local employees. As a result of these changes, it is estimated that VRS employers will save approximately $3.6 billion ($1.5 billion in general funds) in reduced retirement costs for State employees and teachers over the next 20 years.

The most significant change to the retirement benefits' structure will affect future employees hired by the State, local governments, and school divisions. Employees hired on or after January 1, 2014, will not participate in the traditional defined benefit retirement plan that has been provided to public employees, but will instead be enrolled in a "hybrid" retirement plan that combines elements of a traditional defined benefit pension with a 401(k)-style defined contribution plan. (The design of the hybrid plan is based on a plan which was proposed in JLARC's 2011 *Review of Retirement Benefits for State and Local Government Employees.*) Current employees will have the option to join the hybrid plan in lieu of their existing defined benefit plan, and this decision will be irrevocable. (Active and future employees in hazardous duty positions that qualify for enhanced retirement benefits under the State Police Officers Retirement System, the Virginia Law Officers Retirement System, and the local Law Enforcement Officers Retirement System are exempt from this new plan design.) This legislation is effective January 1, 2014.

The legislation that created the hybrid retirement plan for future new hires also enacted changes to the defined benefit plan structure for "Plan 1" employees with less than five years of service as of January 1, 2013, and "Plan 2" employees. (Plan 2 employees are VRS members hired on or after July 1, 2010, who were placed in a different tier of retirement benefits pursuant to plan changes that were enacted in 2010.) These changes, most of which already apply to Plan 2 members, will go into effect January 1, 2013, and include modifications to the retirement benefit multiplier and the calculation of an employee's average final compensation, both of which are used to calculate the amount of a member's retirement benefit. The legislation also modified age and service requirements for this group of employees and reduces the maximum COLA that can be applied to benefit payments after retirement. These changes will result in lower benefits at retirement.

Finally, the legislation also requires that to be eligible for a COLA, all VRS members with fewer than 20 years of service who retire with a reduced benefit must wait until they reach the age and years of service at which they would have been eligible for an unreduced benefit. There is an exception to this provision for members who are within five years of unreduced retirement eligibility as of January 1, 2013. As with the hybrid plan, these changes are based on defined benefit plan modifications proposed in the 2011 JLARC report referenced above.

Other legislation enacted in 2012 requires VRS members who are school division or political subdivision employees to contribute five percent of their salaries on a pre-tax basis to the cost of their defined benefit retirement plans. Employers have the option of phasing in this requirement for their existing employees, but are required to provide an offsetting salary increase to employees hired prior to July 1,

2012. In addition, all new hires who are hired on or after July 1, 2012, must contribute the five percent member contribution. This legislation is effective July 1, 2012.

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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