



JOINT LEGISLATIVE AUDIT
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Due to both lower contributions into the fund and negative equity market returns, the market value of the VRS pension fund was \$30.8 billion as of September 30, 2002. The return for the fiscal year-to-date is -10.3 percent and -8.9 percent for the one-year period ending September 30, 2002. As shown in Figure 1 on the next page, benefit expenses are approaching, and will likely exceed in the near future, contributions and investment income. While the fund's performance exceeded established benchmarks for the one-, three-, five- and ten-year periods ending September 30, 2002, the VRS' investment returns for the one-, three-, and five-year periods fell short of the current actuarially assumed investment return of eight percent. The public equity program continues to be VRS' largest asset class comprising 58 percent of the portfolio or approximately \$18 billion.

As concerns about the possibility of war, earnings, and the economy became more pronounced, the U.S. equity markets experienced double-digit negative returns during the third quarter of 2002. In this difficult market environment, VRS' domestic public equity program, valued at \$13.7 billion, met its established performance benchmark for the fiscal year-to-date and exceeded the benchmark for the one- and three-year periods ending September 30, 2002. However, the program did not exceed the benchmark for the five-year period.

Profile: Virginia Retirement System Investments

Market Value of Assets: \$30.8 billion

Number of External Managers:

Public Equity – 20 Fixed Income – 4

Number of External Investment Accounts:

Public Equity – 24 Fixed Income – 7

Number of VRS Investment Department Staff:

33 positions (3 vacant)

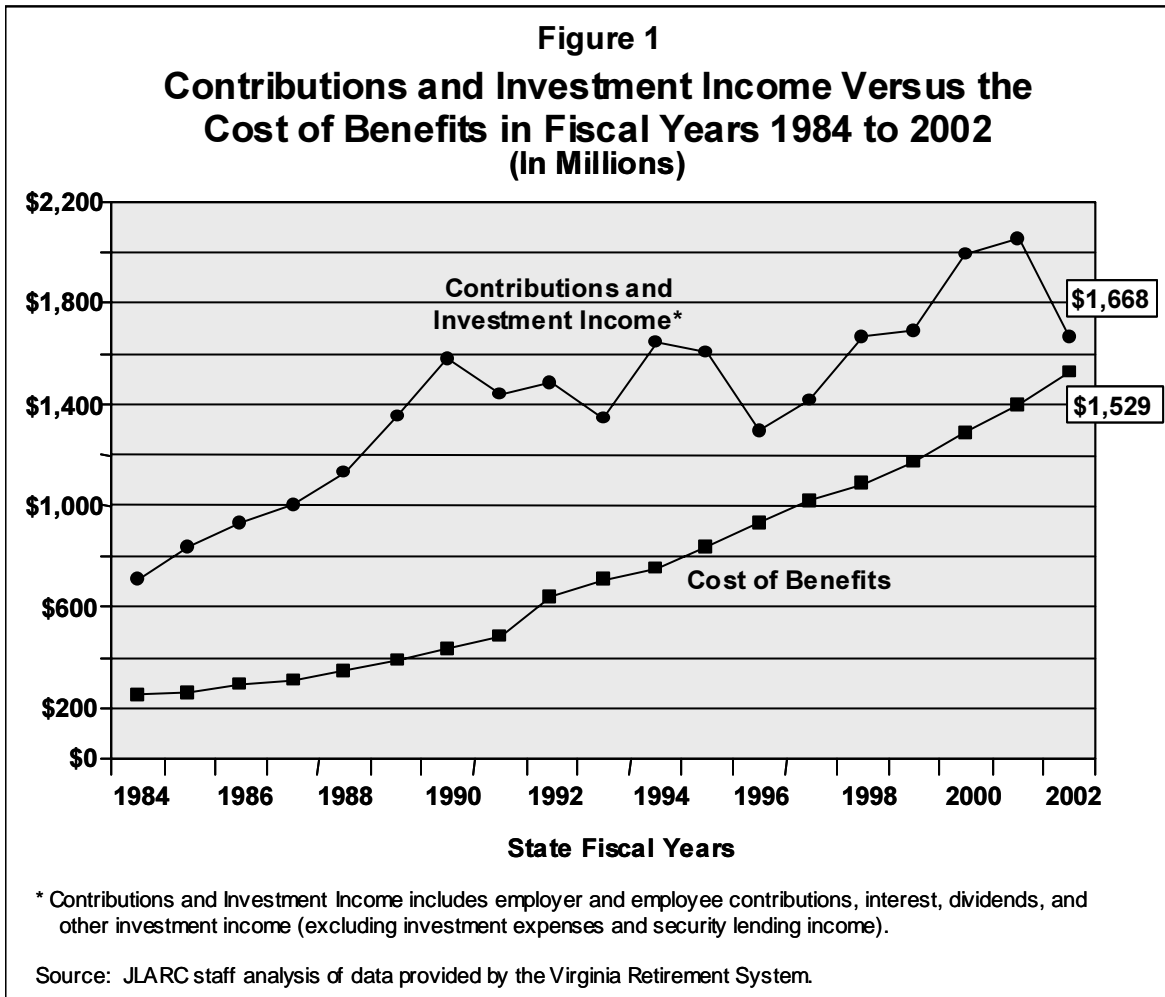
FY 2002 Investment Expenses: \$99.6 million (28.8 basis points)

FY 2002 Investment Department Operating Expenses: \$6.9 million (2.0 basis points)

Total Return on Investments			
10 years	5 years	3 years	1 year
8.2%	2.0%	-3.4%	-8.9%
Performance/Intermediate Benchmarks			
7.9%	1.5%	-4.6%	-9.2%

Investment Policy Indicators (as of September 30, 2002)

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	59.3%	58.4%	76.2%	23.8%	84.9%	15.1%
Fixed Income	25.0%	25.3%	98.2%	1.8%	51.5%	48.5%
High Yield Bonds	2.4%	2.4%	96.9%	3.1%	100%	0%
Private Equity	7.4%	7.4%	87.9%	12.1%	100%	0%
Real Estate	5.7%	5.7%	97.0%	3.0%	91.2%	8.8%



The non-U.S. equity portion of the fund continues to have difficulty in these markets, lagging its benchmark in the one-, three-, and five-year periods. Currency was not a major determinant of overall returns during the quarter ending September 30, 2002.

The Private Equity program exceeded its benchmark for the one-, three-, and five-year periods. While the private equity program provided negative returns for the fiscal year-to-date and the one-year periods ending September 30, 2002, the program continued to provide enhanced returns relative to the public equity program. For example, as of June 30, 2002, the annualized rate of return since the inception of the Private Equity program in November 1988 is 25.2 percent, exceeding its benchmark (Russell 3000 plus 250 basis points) for the period by 5.3 percent. Going forward, returns for private equity will likely not be as robust as those achieved in 1999 and 2000. For example, one-fifth of all start-ups that received venture capital funding during 1999 and 2000 have already closed or filed for bankruptcy.

Real Estate and Fixed Income continue to provide necessary fund diversification and helped alleviate some of the impact of negative equity returns by providing positive returns for the one-, three-, and five-year periods ending September 30, 2002. Fixed Income was the only asset class that provided positive returns for the fiscal-year-to-date period ending September 30, 2002. However, Real Estate and High Yield joined Fixed Income in providing positive returns for the one-year period ending September 30, 2002. Similarly, Fixed Income, Private Equity, and Real Estate, provided positive returns and outperformed equities for the three- and five-year periods.

Table 1
VRS Investment Performance
(for Periods Ending September 30, 2002)

Program/ Performance Objective	Fiscal Year to Date	One Year	Three Years	Five Years
Total Fund	-10.3%	-8.9%	-3.4%	2.0%
<i>VRS Performance Benchmark - Intermediate</i>	<i>-10.7%</i>	<i>-9.2%</i>	<i>-4.6%</i>	<i>1.5%</i>
<i>VRS Performance Benchmark - Long Term</i>	<i>-10.9%</i>	<i>-10.9%</i>	<i>-5.3%</i>	<i>1.4%</i>
Total U.S. Equity	-17.2%	-18.2%	-11.5%	-2.4%
<i>Russell 3000</i>	<i>-17.2%</i>	<i>-18.8%</i>	<i>-11.6%</i>	<i>-1.8%</i>
Total Non-U.S. Equity	-19.1%	-12.1%	-13.2%	-7.0%
<i>Salomon BMI Global ex U.S.</i>	<i>-18.7%</i>	<i>-11.7%</i>	<i>-12.5%</i>	<i>-6.7%</i>
Total Fixed Income	4.0%	7.8%	9.3%	7.7%
<i>Lehman VRS Custom</i>	<i>4.7%</i>	<i>8.7%</i>	<i>9.5%</i>	<i>7.9%</i>
Total Private Equity	-4.8%	-13.8%	14.6%	20.8%
<i>Russell 3000 plus 250 Basis Points</i>	<i>-12.1%</i>	<i>-14.7%</i>	<i>-5.4%</i>	<i>6.4%</i>
Total Real Estate	-1.3%	7.7%	10.2%	8.5%
<i>Blend of NCREIF and NAREIT Indexes</i>	<i>-2.3%</i>	<i>4.7%</i>	<i>10.1%</i>	<i>10.4%</i>
Total High Yield	-2.7%	1.9	n/a	n/a
<i>VRS Custom High Yield</i>	<i>-1.2%</i>	<i>1.2</i>	<i>n/a</i>	<i>n/a</i>

Source: JLARC staff analysis of VRS data.

Real Estate has exceeded its custom performance benchmark for the one-, three-, and fiscal year-to-date period ending September 30, 2002. However, the Real Estate program has not met its benchmark for the five-year period. In addition, the strong positive returns previously provided by the Real Estate program have turned negative as evidenced by the return for real estate, -1.3 percent, for the fiscal year-to-date period ending September 30, 2002. The real estate downturn is attributable to the lack of tenant demand rather than oversupply. The real estate markets tend to be driven by economic activity. In general, demand will not resume until employment growth is renewed and increased corporate spending and investment takes place.

Overall, the Fixed Income program has continued to benefit from the low-inflation environment. Record low interest rates have produced strong price appreciation and above average absolute returns. Over the three-year period ending September 30, 2002, the VRS fixed income program returned 9.3 percent on an annualized basis. However, the total program has lagged behind its benchmark across the period by as much as 23 basis points. While the passive Fixed Income portfolio has met or exceeded its benchmark in the one-, three-, and five-year periods ending September 30, 2002, the active portion of the portfolio has failed to meet its benchmark during this same period. For example, the active program lagged behind the Lehman Brothers Aggregate Index by 164 basis points over the last year and 49 basis points over the last three years. Since the active portfolio is over-weighted in corporate bonds and spreads in the corporate sector are widening due to such factors as rapidly changing credit risk, lack of liquidity in the market, and accounting fraud or corporate scandals, performance in the active portfolio has lagged relative to its benchmark. The program is now 50 percent passive and all sectors except corporate credit are managed internally.

The High Yield portfolio, an alternative asset class, was intended as a lower risk substitute for equities and with the objective of getting a return of at least 8 percent over the ten-year life of the portfolio, net of defaults. For the one-year period ending September 30, 2002, the return for high yield bonds was 1.9 percent. However, the portfolio has suffered declines recently, with fiscal

year-to-date returns of -2.7 percent. During this same period, the Russell 3000 returned -17.2 percent. Since the inception of the high yield portfolio in June 2001, the annualized return (time-weighted) on this portfolio is -1.6 percent, compared to -2.3 percent for the custom benchmark, -6.9 for the Lehman High Yield index, and -25.8 percent for the Russell 3000. Accordingly, the portfolio has generally been performing as intended. The decision to target upper-tier, high yield bonds and to use a custom benchmark has benefited the fund.

The Board Approves Inclusion of a New Asset Class: Hedge Funds

The IAC has recommended and the Board approved the inclusion of a hedge fund program in the alternative investment category with a target implementation date of March 2003. Adding hedge funds to the portfolio is intended to achieve better risk-adjusted returns, because hedge fund managers generally have the ability to capitalize on opportunities that are unavailable to traditional long-only managers. Well-managed portfolios of hedge funds have shown a historically low correlation to other asset classes, such as fixed income and equity. In other words, hedge funds could provide additional diversification for the total VRS fund. In addition, hedge funds are relatively liquid compared to other alternative investments, such as private equity and real estate. Further, hedge funds have outperformed mutual funds and the U.S. equity market since 2000. However, hedge fund managers receive performance incentive-based compensation. As a result, fees for hedge funds are higher than some other asset classes, but these fees and the hedge fund compensation structure are designed to attract talented investment management to the sector. The VRS investment staff is in the process of identifying top-tier managers, an essential component of a successful hedge fund program. The Board will make an initial allocation of up to \$500 million to the hedge fund program with three initial strategies: long-short equity market neutral; long-short hedged equity; and distressed. To date, a benchmark for the program has not been determined.

Asset Liability Analysis

As a defined benefit plan, payments are an obligation of the Commonwealth, regardless of investment performance and returns. VRS builds its investment portfolio to generate maximum returns (thereby lowering the cost of the fund to the taxpayers), while controlling short-term volatility in asset values and the contribution rate. With this in mind, the investment department at VRS is beginning an asset-liability analysis with the fund's actuary, Watson Wyatt. The objective of the study is to examine expected risk and return characteristics of various asset combinations within a framework that measures volatility in contribution rates and funded status. Through this analysis, VRS will assess the risk target for the fund.

Asset allocation is a key factor impacting the long-term investment performance at VRS. A clear statement of the fund's asset allocation philosophy and process helps to ensure consistent decision making in this critical area. An asset-liability analytical framework is used to test the potential risk and return outcomes of various asset mixes. This type of analysis allows VRS to examine the impact of various portfolio structures on contribution rates. For example, in the analysis performed in 2000, equity/debt mixes of 70/30, 60/40, and 50/50 were tested. To improve these baseline portfolios consisting of domestic stocks and bonds, other asset classes are introduced to either increase the expected return while holding risk at the targeted level, or lower risk without giving up expected return. (VRS staff are planning to have completed the analysis and obtained the results by February 2003.)

Board Appoints new Chair and Members to the Investment Advisory Committee

Raymond D. Smoot Jr., PhD, Vice President for Administration and Treasurer for Virginia Tech since September 1999, was named chairman of the Investment Advisory Committee (IAC) by the board of trustees. Dr. Smoot succeeds Stuart A. Sachs. Joseph Grills, former CIO of IBM

Retirement Funds, was appointed by the Board to serve as Vice Chair of the Investment Advisory Committee. In addition, the Board named two new members to the IAC: Alice Handy, University of Virginia Treasurer and President of the University of Virginia Investment Management Company, and Dr. Deborah Allen Hewitt, president of Rutledge Research and associate professor of economics at The School of Business at the College of William and Mary.

VRS Board of Trustees Established a Corporate Governance Task Force

In response to concerns about various scandals in the market, including financial misstatements by firms, accounting fraud, CEO compensation, and other corporate governance issues, the VRS Board of Trustees established a Corporate Governance Task Force to review current VRS practices designed to protect assets and to examine methods of gaining greater accountability from publicly traded companies. The task force will examine the role of a public pension fund as a shareholder, and will compile academic research and best practices employed by peer public pension funds. The task force will also assess the impact of several remedies proposed by Congress and the stock exchanges. The task force will issue a corporate governance policy statement and recommendation to the VRS Board of Trustees at the February 2003 meeting.

A governing principle for the Task Force is that any corporate governance policy must be considered in light of its impact on the investments of the fund and implemented only if considered to enhance investment performance and the economic interests of the plan beneficiaries. Specific topics to be covered at the Task Force meetings include: proxy voting policies, securities litigation, the value of shareholder activist organizations (e.g., Council of Institutional Investors), corporate governance policies from other selected plans, and legislative and regulatory developments.

W. Mark Crain, Ph.D., a member of the VRS Board of Trustees and an economics professor at George Mason University, chairs the Task Force. The other members of the Task Force are Paul W. Timmreck, VRS Board member and Senior Vice President of Virginia Commonwealth University; Steven A. Markel, an insurance executive; Norwood Jackson, an accountant and former state auditor; Ruffin King, a lawyer and retired investment manager; and Owen B. Pickett, a Virginia Beach attorney who represented Virginia Beach and Norfolk in Congress for 14 years.



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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