

**Joint Legislative Audit and Review Commission
of the Virginia General Assembly**



**VRS Oversight:
Semi-Annual Investment Report
December 2003**

**JLARC Staff Briefing
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VRS Oversight Act

- **Section 30-78 *et seq.* of the *Code of Virginia* requires JLARC to oversee and evaluate VRS on a continuing basis.**

- **Areas for review and evaluation include:**
 - **Structure, governance, administration, and management**
 - **Biennial status report required**

 - **Actuarial policy and actuarial soundness**

 - **Investment practices, policies, and performance**
 - **Semi-annual investment report required.**

Semi-Annual Investment Report

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- The market value of the fund's assets as of September 30, 2003, was \$35.7 billion. ³
 - VRS' investment returns have improved since the last report, but fell short in the three- and five-year periods of the current actuarial assumed investment return of 8 percent.

One-Year Return	Three-Year Return	Five-Year Return	Ten-Year Return
18.6%	-3.2%	5.0%	8.8%

Semi-Annual Investment Report

(continued)

- Improving conditions in the public equity market positively influenced the fund's overall investment performance.
- U.S. and non-U.S. equities reported positive returns for the fiscal year-to-date, and the one-, and five-year periods ending September 30, 2003.
- During the one-, three-, and five-year periods ending September 30, 2003, the non-U.S. equity program outperformed the U.S. equity program and served as an important diversifier for the public equity program and the fund.
- The fixed income, private equity, and real estate programs offered necessary fund diversification, and provided positive returns for the one-year period ending September 30, 2003:
 - Fixed income: 6.2 percent
 - Private equity: 0.4 percent
 - Real estate: 12.7 percent

Semi-Annual Investment Report

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- **The fixed income and real estate programs have produced positive returns for one-, three-, and five-year periods ending September 30, 2003.**
- **VRS is in the process of restructuring the real estate program and is conducting a real estate advisor search.**
- **Recent private equity performance has not been as robust as in earlier periods; however, the annualized internal rate of return since inception for the private equity program is 23.8 percent.**

Hedge Fund Update

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- In November 2002, the Investment Advisory Committee recommended and the Board approved the inclusion of a hedge fund program in the alternative investment category with an initial allocation of up to \$500 million. In June 2003, the Board raised the targeted allocation to the hedge fund program to three percent of fund assets (approximately \$1.1 billion).
- The purpose of creating the separate allocation to the hedge fund program is to:
 - further diversify the portfolio; and
 - avoid potential large losses from significant negative movements in the public equity and fixed income markets.
- As of November 2003, \$500 million of the hedge fund investments have been made. The remaining approximately \$500 million is expected to be invested by the end of the first quarter of calendar year 2004.

Risk Management and Public Equity Program Changes

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- VRS has recently initiated a project to enhance its total fund risk management capabilities to further develop the ability to examine risk at any level within the fund using multiple types of risk measures.
- For example, the public equity program adopted a global risk budget by which the program will no longer consider U.S. and non-U.S. equities separately. The new approach will concentrate on the total equity program.
- The global risk budget allows staff to take 200 basis points of projected tracking error in the total public equity program over time.
 - Tracking error may vary from 0 basis points to a maximum of 400 basis points.
 - When opportunities to add value are greater, the maximum risk budget might be used.
 - When fewer opportunities are available, then the portfolio will be managed closer to the benchmark.

Rebalancing Policy Update

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- **The VRS Board recently amended the rebalancing policy.**

- **The new policy does not require the Chief Investment Officer (CIO) to rebalance the fund back to strategic targets as long as each asset class remains within the following ranges:**
 - **Domestic equity** **40 to 50%**
 - **Non-U.S. equity** **14 to 20%**
 - **Fixed income** **20 to 25%**
 - **Private equity** **5 to 8%**
 - **Hedge funds** **1.5 to 5%**