

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



**VRS Oversight:
Semi-Annual Investment Report
July 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

- **The market value of the fund's assets as of March 31, 2003, was \$31.3 billion.**
- **VRS' investment returns of -13.0, -7.4, and 0.6 percent for the one- three-, and five-year periods, respectively, fell short of the current actuarial assumed investment return of 8 percent.**
- **At 7.8 percent, the total fund's investment return for the 10-year period ending March 31, 2003, slightly outperformed its benchmark (7.3 percent), but fell short of the current actuarial assumed rate of return.**

Semi-Annual Investment Report

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- **Conditions in the public equity market continued to negatively impact the fund's overall investment performance.**
- **U.S. and non-U.S. equities reported negative returns for the fiscal year-to-date, and the one-, three-, and five-year periods ending March 31, 2003, and failed to meet benchmarks for several time periods.**
- **The fixed income, real estate, and high yield programs offered necessary fund diversification, and provided positive returns for the one-year period ending March 31, 2003:**
 - **Fixed income: 11.2 percent**
 - **Real estate: 4.6 percent**
 - **High yield: 4.6 percent**

Semi-Annual Investment Report

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- **Since the July 1, 2001, inception of the program, high yield bonds have returned 6.54 percent over the total life of the investment. Using the Russell 3000 as a benchmark, the high yield program has realized gains of \$145 million.**

- **The fixed income and real estate programs have produced positive returns for fiscal-year-to-date, one-, three-, and five-year periods ending March 31, 2003.**

- **Returns for the private equity program have not been as robust as those reported in 1999 and 2000:**
 - **Despite recent negative returns, the program continues to provide enhanced returns relative to the public equity program.**

 - **In 2003 the private equity program will likely continue to be hampered by the significant amount of capital raised, but not yet spent.**

Hedge Fund Update

- In November 2002, the Investment Advisory Committee recommended and the Board approved the inclusion of a hedge fund program in the alternative investment category.
- In November 2002, the Board approved 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 billion or an addition \$500 million).
- An extensive search was conducted to identify two fund-of-funds organizations to serve as advisors to VRS.
- \$500 million will be invested by early July 2003, and the remaining \$500 million by the end of FY 2004.

Asset-Liability Analysis

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- **The VRS actuary completed an asset/liability analysis and presented the results to the Board and Investment Advisory Committee at the May 2003 meeting.**

- **An asset-liability analysis assists VRS in developing its asset allocation plan, a key factor impacting the long-term investment performance at VRS.**

- **Study objectives included:**
 - **Testing the potential risk and return outcomes of various asset combinations**
 - **Assessing the impact of various portfolio structures on contribution rates**
 - **Measuring volatility in contribution rates and funded status.**

Asset-Liability Analysis

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- **The Board voted to maintain a risk profile defined as 70 percent equity, 25 percent fixed income, and 5 percent real estate.**

- **Using this risk profile, the Board adopted an asset allocation policy that:**
 - **Increases non-U.S. equity from 15 to 17 percent**
 - **Decreases fixed income from 25 to 22 percent**
 - **Increases the hedge fund program to 3 percent**
 - **Increases private equity from 6 to 7 percent.**

- **These changes to the investment policy will essentially lower the fund's domestic equity exposure.**

Corporate Governance

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- In response to concerns about financial misstatements by firms, accounting fraud, and other corporate governance issues, the VRS Board established a corporate governance task force.
- In February 2003, the task force issued its final report and proposed a corporate governance policy, which the VRS Board adopted at its February 20, 2003 meeting.
- The policy statement outlined three broad categories of activity:
 - Proxy voting
 - VRS as long-term investor
 - Securities litigation.
- The guiding principle for VRS corporate governance is fiduciary responsibility, or only taking actions that are in the best interest of the plan's participants and beneficiaries.