



**JOINT LEGISLATIVE AUDIT
& REVIEW COMMISSION**
OF THE VIRGINIA GENERAL ASSEMBLY

Semi-Annual Investment Report July 2003

The market value of the VRS pension fund was \$31.3 billion as of March 31, 2003. The return for the fiscal year-to-date is -7.9 percent, and -13.0 percent for the one-year period ending March 31, 2003. While the fund's performance exceeded established benchmarks for the fiscal year-to-date, one-, three-, five- and ten-year periods ending March 31, 2003, the VRS' investment return during these periods continued to fall short of the actuarially assumed investment rate of return of eight percent.

The public equity program continues to be VRS' largest asset class, comprising 59 percent of the portfolio. The U.S. equity market produced negative returns for the one-, three-, and five-year periods ending March 31, 2003. The U.S. equity market's negative return in the first quarter of 2003 can largely be attributed to concerns about the timing and magnitude of the current economic recovery and uncertainties related to the conflict with Iraq. In addition, leading indicators and consumer confidence declined significantly during this period. Further, annualized GDP was approximately 1.6 percent, and the economy lost jobs. Amid these

Profile: Virginia Retirement System Investments (as of May 2003)

Market Value of Assets: \$31.3 billion

Number of External Managers:
Public Equity – 19 Fixed Income - 6

Number of External Investment Accounts:
Public Equity – 24 Fixed Income - 6

Number of VRS Investment Department Staff: 33 authorized positions (3 vacant)

FY 2003 Investment Expenses: \$86.4 million (25.3 basis points) as of May 2003

FY 2003 Investment Department Operating Expenses: \$5.5 million (1.6 basis points) as of May 2003

Total Return on Investments			
10 years	5 years	3 years	1 year
7.8%	0.6%	-7.4%	-13.0%
Performance/Intermediate Benchmark			
7.3%	0.1%	-8.2%	-13.5%
Time periods ending 3/31/2003			

Investment Policy Indicators (as of March 31, 2003)

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	60.0%	59.0%	75.5%	24.5%	84.6%	15.4%
Fixed Income	25.0%	25.5%	96.7%	3.3%	62.9%	37.1%
High Yield Bonds	2.6%	2.6%	96.3%	3.7%	100.0%	0.0%
Private Equity	6.7%	6.7%	84.6%	15.4%	100.0%	0.0%
Real Estate	5.5%	5.5%	97.0%	3.0%	90.8%	9.2%

Table 1				
VRS Investment Performance for Periods Ending March 31, 2003				
<i>Program/ Performance Objective</i>	<i>Fiscal Year to Date</i>	<i>Prior 1 Year</i>	<i>Prior 3 Years</i>	<i>Prior 5 Years</i>
<i>Total Fund</i>	-7.9%	-13.0%	-7.4%	0.6%
VRS Performance Benchmark – Intermediate	-8.4%	-13.5%	-8.2%	0.1%
VRS Performance Benchmark- Long Term	-7.1%	-14.7%	-8.4%	0.0%
<i>Total U.S. Equity</i>	-13.5%	-24.6%	-15.0%	-4.3%
Russell 3000	-13.3%	-24.7%	-15.8%	-3.7%
<i>Total Non-U.S. Equity</i>	-19.5%	-20.9%	-19.3%	-6.9%
Salomon BMI Global ex U.S.	-19.2%	-20.9%	-17.8%	-6.7%
<i>Total Fixed Income</i>	7.4%	11.2%	9.7%	7.4%
Lehman VRS Custom	7.7%	11.7%	9.8%	7.5%
<i>Total Private Equity</i>	-11.3%	-12.9%	-4.8%	16.1%
Russell 3000 plus 250 Basis Points	-20.3%	-19.0%	-11.2%	1.8%
<i>Total Real Estate</i>	2.0%	4.6%	10.1%	7.9%
Blend of NCREIF and REIT Indexes	-0.1%	1.8%	9.0%	9.4%
<i>Total High Yield</i>	8.1%	4.6%	n/a	n/a
VRS Custom High Yield	9.7%	2.9%	n/a	n/a
<i>Source: JLARC staff analysis of VRS data.</i>				

uncertain economic conditions, the U.S. equity program exceeded its benchmarks for the one- and three-year periods ending March 31, 2003. While continuing to deliver negative returns, the non-U.S. equity program outperformed its benchmark, or basis for comparison, for the first quarter of 2003. VRS' exposure to emerging markets has added value to the active portion of the non-U.S. program.

The private equity program exceeded its benchmark for the one-, three-, and five-year periods ending March 31, 2003. While the Private Equity program continued to provide negative returns for the first quarter of 2003, the fiscal year-to-date, and the one- and the three-year periods ending March 31, 2003, the program continued to outperform the public equity program. Going forward, the private equity market in 2003 will likely continue to be hampered by the significant amount of capital previously raised but not yet spent.

Some analysts now see the real estate investment market more closely tied to the broader capital markets than at any other point in the last ten years. The risk of this interconnection between real estate and the capital markets is generally greatest when the interest rates rise as the economy begins to recover and corporate earnings improve. At this point of intersection, investors will withdraw from real estate in favor of the stock market. The speed at which this occurs could greatly impact this potential problem for real estate investors. In addition, commercial vacancy rates continue to be high, relative to the last three years, and in many cases are approaching the levels experienced during the recession of 1991, which produced all-time high vacancy rates for most property types. The program has outperformed its benchmark for the fiscal year-to-date as well as the quarter, one-, and three-year periods, ending March 31, 2003. However, the program lagged behind its benchmark by 153 basis points for the five-year period ending March 31, 2003.

Bond market returns remained favorable in the first quarter of 2003 and the fixed income portfolio turned in another strong performance. The fixed income program produced positive returns for the fiscal year-to-date, one-, three-, and five-year periods ending March 31, 2003. Fixed income and real estate were the only programs that provided positive returns across all of these periods.

The high yield program produced a 4.6 percent return for the one-year period ending March 31, 2003, and a fiscal year-to-date return of 8.1 percent. VRS' high yield portfolio consists of "upper tier" high yield bonds. Recently, the yield for these bonds has declined to about seven percent compared to the original purchase yield of 10.25 percent. As a result, by the end of May 2003, VRS was no longer holding a position in high yield bonds. However, since the July 1, 2001, inception of the program, high yield bonds have returned 6.54 percent over the total life of the investment. Further, using the Russell 3000 as a benchmark, the high yield program realized gains of \$145 million over the life of the investment.

Hedge Fund Update

During November 2002 the Board of Trustees of the Virginia Retirement System approved an allocation of \$500 million to establish a hedge fund program. VRS has been studying these types of investments for several years and has had significant experience with similar strategies in their domestic equity and private equity portfolios for the past ten years. The purpose of creating this separate allocation is to further diversify the portfolio in an effort to avoid potential large losses from significant negative movements in the public equity and fixed income markets.

Subsequent to the November 2002 approval, an extensive search was initiated to identify two fund-of-funds organizations to serve as advisors to VRS as it creates a customized hedge fund portfolio. One of those organizations, Ivy Asset Management based in Garden City, New York, is under contract. A second group has been identified, and it is currently expected that a contract will be executed by early July 2003. These advisors will play a critical initial role in the program, assisting VRS in selecting managers and establishing appropriate monitoring and risk management systems.

Both the advisors and VRS staff will perform extensive due diligence on each manager selected, with emphasis placed on ensuring proper diversification of manager strategies within the program. Those strategies fall within three categories of hedge funds: equity long/short, equity market neutral, and distressed/event driven. VRS expects that about one-half of the \$500 million total will be invested by July 2, 2003. The goal is to have the remainder of the \$500 million invested by September 30, 2003.

In June 2003, the Board of Trustees raised the targeted Virginia Retirement System allocation to the hedge fund program to three percent of fund assets. This represents approximately \$1 billion based on the current fund size, or an additional \$500 million beyond the amount originally approved in November. The additional funds will be invested by the end of FY 2004.

Corporate Governance Task Force

The Corporate Governance Task Force issued a Corporate Governance Practices Report dated February 18, 2003, and proposed a VRS Corporate Governance Policy to the Board of Trustees. The Board adopted the Policy at its February 20, 2003, meeting. The guiding principle for VRS corporate governance is fiduciary responsibility, that is, only taking actions that are in the best interest of the plan's participants and beneficiaries.

The policy statement outlined three broad categories of activity:

- *Proxy Voting* – VRS will review all proxy issues and vote them in the best interest of the participants and beneficiaries of the fund. Investment managers will submit an annual report to VRS summarizing their votes. The Board should review a report on proxy voting annually.
- *VRS as Long-Term Investor* – VRS should act like an owner in companies in which it invests by encouraging long-term value creation at these firms. The Task Force encouraged VRS to consider membership in appropriate organizations as a cost-effective means of achieving this goal. As a result, VRS became a member of the Council of Institutional Investors (CII) in March. The Task Force concluded that CII is the most effective organization for providing VRS with a voice for reaching and promoting positive change at poorly governed corporations. This organization should also be a useful vehicle for lobbying regulatory agencies, such as the SEC, as well as federal and state lawmakers.
- *Securities Litigation* – VRS should consider litigation and evaluate litigation strategy as a risk management tool to recover losses related to illegal conduct, fraud, or willful wrongdoing. The Office of the Attorney General should assist VRS in determining whether litigation should be pursued. The Office of the Attorney General is currently pursuing a search for a securities litigation firm to help monitor and identify potential securities litigation cases.

Asset Liability Study Update

Gabriel, Roeder and Smith, the VRS actuary, completed an asset/liability analysis and presented its results to the Board of Trustees and Investment Advisory Committee at the May 2003 meeting. One aspect of the study was an analysis of the risk profile for the investment fund. VRS defines its risk not only in terms of asset volatility, but also is focused on the volatility of the funded status and the required contribution rates. Given current expectations for asset returns over the coming ten years, the report indicated that, on average, raising or lowering the exposure to equities by ten percent had very little impact on the risk measures. It was noted, however, that extreme markets, such as those experienced over the past three years, are possible and can have a significant impact on the fund's risk vis-à-vis funded status and contribution rates.

After examining these results, the Board of Trustees voted to maintain a risk profile defined as 70 percent equity, 25 percent fixed income and five percent real estate. Using this profile, the staff presented a recommendation that the Board revise its asset allocation policy. After discussion, the Board adopted a policy that includes an

increase in non-U.S. equity from 15 percent to 17 percent, a decrease in fixed income from 25 percent to 22 percent, an increase in the hedge fund program to three percent, and an increase in private equity investments from six percent to seven percent. These changes will result in a lower domestic equity exposure as funding is accomplished in the private markets.



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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