



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

**Semi-Annual Investment Report
July 2004**

The market value of the VRS pension fund was \$40.1 billion as of March 31, 2004. The return for the fiscal year-to-date is 17.8 percent and 31.1 percent for the one-year period ending March 31, 2004. The fund's performance was generally in line with established benchmarks for the one-, three-, five-, and ten-year periods ending March 31, 2004. However, during the three- and five-year periods ending March 31, 2004, the VRS investment return fell short of the actuarially assumed investment rate of return of eight percent.

The public equity program continues to be VRS' largest asset class, comprising 65.8 percent of the portfolio or \$26.4 billion. The public equity program reported positive returns for the fiscal-year-to-date, one-, three-, and five-year periods ending March 31, 2004. The fiscal-year-to-date and one-year periods ending March 31, 2004, were particularly strong and exceeded established benchmarks, with returns of 23.5 percent and 44.7 percent respectively.

Profile: Virginia Retirement System Investments (as of March 2004)

Market Value of Assets: \$40.1 billion

Number of External Managers:
Public Equity – 23 Fixed Income - 7

Number of External Investment Accounts:
Public Equity – 32 Fixed Income - 7

Number of VRS Investment Department Staff: 34 authorized positions (3 vacant)

FY 2003 Investment Expenses: \$94.8 million (27.4 basis points)

FY 2004 Investment Expenses (July-May): \$84.9 million (21.6 basis points)

FY 2003 Investment Department Operating Expenses: \$6.3 million (1.8 basis points)

FY 2004 Investment Department Operating Expenses (July-May): \$5.8 million (1.5 basis points)

Total Return on Investments			
10 years	5 years	3 years	1 year
10.3%	4.8%	4.9%	31.1%
Performance/Intermediate Benchmark			
9.8%	3.7%	4.9%	31.4%
Time periods ending 3/31/2004			

Investment Policy Indicators (as of March 31, 2004)

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	65.8%	65.8%	73.1%	26.9%	77.0%	23.0%
Fixed Income	22.0%	21.8%	97.3%	2.7%	65.4%	34.6%
Hedge Funds	3.0%	2.6%	81.0%	19.0%	100%	0%
Private Equity	5.1%	5.1%	82.3%	17.7%	100%	0%
Real Estate	3.8%	3.8%	97.0%	3.0%	100%	0%

Table 1				
VRS Investment Performance for Period Ending March 31, 2004				
Program/ Performance Objective	Fiscal Year to Date	1 Year	3 Years	5 Years
<i>Total Fund</i>	17.8%	31.1%	4.9%	4.8%
VRS Performance Benchmark – Intermediate	18.2%	31.4%	4.9%	3.7%
VRS Performance Benchmark- Long Term	14.5%	28.2%	4.1%	2.7%
<i>Total Public Equity</i>	23.5%	44.7%	3.5%	1.3%
Public Equity Custom Benchmark	23.1%	44.3%	3.3%	1.1%
<i>Total Fixed Income</i>	3.3%	6.2%	7.5%	7.4%
Lehman Total VRS Custom	2.8%	5.3%	7.4%	7.3%
<i>Total Private Equity</i>	21.7%	22.1%	-2.6%	17.4%
Private Equity Custom Benchmark	36.9%	33.6%	-0.5%	2.9%
<i>Total Real Estate</i>	13.4%	19.4%	11.9%	11.7%
Real Estate Custom Benchmark	13.5%	18.9%	10.2%	11.2%
<i>Total Hedge Funds</i>	9.4%	n/a	n/a	n/a
Custom Hedge Funds Benchmark	6.8%	n/a	n/a	n/a
Source: JLARC staff analysis of VRS data.				

The fixed income program exceeded its benchmark and generated positive returns (3.3 percent, 6.2 percent, 7.5 percent, and 7.4 percent respectively) for the fiscal year-to-date-, one-, three-, and five-year periods ending March 31, 2004. The program also exceeded its benchmark in all of these periods.

The private equity program did not meet its benchmark for the fiscal-year-to-date, as well as the one-, and three-year periods ending March 31, 2004. However, the program substantially exceeded its benchmark (17.4% versus 2.9%) for the five-year period ending March 31, 2004.

The VRS real estate program outperformed its benchmark for the one-, three-, and five-year periods ending March 31, 2004. However, the program lagged behind its benchmark for the fiscal-year-to-date period ending March 31, 2004. Of note, the current real estate market is particularly challenging due to a large flow of capital into the real estate market at a time when fundamentals are somewhat weak. VRS has guarded against paying too much for real estate in this environment. As reported in the previous Semi-Annual Investment Report, VRS has been in the process of reorganizing its real estate program and hiring a top-tier experienced real estate professional to manage the real estate portfolio. The hiring of the new real estate manager is well-timed, because the new manager can be involved in developing the program and restructuring the portfolio.

Over the course of the first quarter of calendar year 2004, the VRS hedge fund program increased in size by more than \$250 million to \$1.03 billion. This was due mostly to new investments. The hedge fund program outperformed its benchmark for the fiscal-year-to-date period ending March 31, 2004. Since the inception of the program on July 1, 2003, and running through March 31, 2004, the hedge fund program returned 9.4 percent versus 6.8 percent for the custom benchmark. A more detailed discussion of the hedge fund program follows.

Hedge Fund Update

As of June 1, 2004, the total appreciated value of the hedge fund program was \$1.157 billion, representing 3 percent of the VRS portfolio.

The hedge fund program includes three portfolios of hedge fund managers. Ivy Asset Management Corporation and The Rock Creek Group serve as advisors to two portfolios, and VRS directly manages a third portfolio of managers. Currently, the dollar size of the three portfolios is \$504 million, \$468 million, and \$185 million respectively.

The current allocation among styles across the total hedge fund program is approximately one-half equity long/short (52%), one-third event driven (31%), with the remainder allocated to equity market neutral (13%), and a single multi-strategy manager (4%).

Through May 2004, the program has returned 8.6 percent for the fiscal year-to-date versus 7.3 percent for its benchmark. Over the same time period, the public equity market returned 22.0 percent, fixed income 0.4 percent, private equity 22.0 percent, and real estate 10.2 percent.

New Asset Allocation and Board Policy

The Board of Trustees approved new strategic targets for the enhanced VRS portfolio at its May 2004 meeting. The targeted risk level (volatility) of the enhanced portfolio remained the same as the profile developed in conjunction with the VRS actuary during the course of the asset/liability study conducted in 2003. The risk profile is the necessary starting point for asset allocation, and incorporates both assets and liabilities. Further, the risk profile analyzes asset volatility and the volatility of contribution rates and VRS' funded status. This risk profile has been defined as the risk associated with a baseline portfolio comprised of 70 percent equity, 25 percent fixed income, and five percent real estate. Today, this baseline portfolio implies a volatility of 12 percent. Based upon this targeted risk profile, the Board conducted an analysis of several enhanced portfolios to determine if they could achieve a better risk-adjusted return than that offered by the baseline portfolio.

After taking both current investment policy and practical constraints into consideration and conducting an analysis on a variety of different asset combinations, a new enhanced portfolio was developed as shown in Table 2. Effectively, this new enhanced portfolio decreases VRS' exposure to domestic equity and fixed income in favor of increased exposure to non-U.S. equity, high yield, private equity, real estate, and hedge funds. Table 2 also lists the percentage and dollar figure change from the "current" to the new enhanced portfolio.

Table 2					
Comparison of VRS Baseline, Current, and New Enhanced Portfolios (as of May 2004)					
Asset Class	Baseline Portfolio	Current Portfolio	New Enhanced Portfolio	% Change	\$ Change
Fixed Income	25.00%	22.00%	20.00%	-2.00%	-\$ 800 mm
Dom. Equity	70.00%	48.00%	38.75%	-9.25%	-\$3,700 mm
Non-U.S. Equity		17.85%	20.00%	+2.15%	+\$ 860 mm
High Yield		0.00%	3.00%	+3.00%	+\$1,200 mm
Private Equity		5.10%	7.00%	+1.90%	+\$ 760 mm
Real Estate	5.00%	3.80%	6.00%	+2.20%	+\$ 880 mm
Hedge Funds		3.00%	5.00%	+2.00%	+\$ 800 mm
Cash		0.25%	0.25%		
Expected Return	6.60%	7.00%	7.20%		
Expected Risk (standard deviation)	12.00%	11.60%	11.20%		

Source: Virginia Retirement System

Reallocation Process

In order to allocate resources in accordance with the new enhanced portfolio recommended by the Investment Advisory Committee and approved by the Board of Trustees, the staff made a number of investments and trades. During June of 2004, for example, VRS reduced its exposure to fixed income by 2 percent (down to 20 percent) and used the proceeds and excess cash to increase the non-U.S. equity exposure to 20%. In the beginning of July 2004, VRS plans to invest \$810 million in the high yield program (approximately 2 percent) and will reduce its passive domestic equity exposure by a like amount. By the end of September 2004, VRS plans to invest approximately an additional \$140 million in the high yield program, and the remaining cash needed to reach a 3 percent allocation to high yield should be invested within six to twelve months. The additional funds needed for the high yield managers will most likely be funded out of domestic equity.

Additional allocations to private equity, real estate, and hedge funds will be done on an opportunistic basis and will most likely be funded out of domestic equity. The timing and the funding of the alternative investments is highly dependent upon available opportunities and the drawdown schedules of the fund managers.

New Rebalancing Policy Ranges

According to VRS policy, the Board of Trustees establishes the long-term asset allocation for the total fund and certain minimum and maximum constraints for individual asset classes. The Board relies on the Chief Investment Officer (CIO), and the recommenda-

tion of the Investment Advisory Committee to determine allocations within ranges further to initiate rebalancing of the fund.

After the Board of Trustees voted to institute a new asset allocation policy, it again amended the rebalancing policy to reflect the program ranges set forth in the new asset allocation policy. At its May 20, 2004, meeting, the Board revised the rebalancing policy to permit the CIO to not rebalance the fund back to strategic targets as long as each asset class remains within the following ranges:

<u>Program</u>	<u>Previous Range</u>	<u>New Range</u>
Domestic Equity	40 to 50%	33 to 50%
Non-U.S. Equity	14 to 20%	16 to 24%
Fixed Income	20 to 25%	18 to 22%
Private Equity	5 to 8%	4 to 10%
Real Estate	4 to 8%	3 to 9%
Hedge Funds	1.5 to 5%	2 to 8%
High Yield	n/a	0 to 4%
TIPS	n/a	0 to 4%

On a quarterly basis, the VRS staff will continue to report to the IAC the current allocations of every asset class, in market value terms and as a percentage of the total fund, and the deviation of every asset class relative to policy guidelines, in market value terms.

New Members Appointed to the Board of Trustees and the Investment Advisory Committee

In late February 2004, the Governor appointed Judith Ewell, Ph.D., to the Virginia Retirement System’s Board of Trustees to serve a five-year term. Dr. Ewell is the Newton Family Professor of History at the College of William and Mary and is the higher education representative on the Board. In addition, the Joint Rules Committee appointed Edwin T. Burton, Ph.D., to the Board to serve a five-year term. Dr. Burton is a Professor of Economics at the University of Virginia and was appointed to serve on the Board as an investment professional. Dr. Burton previously served as a member and chairman of the Board of Trustees of the Virginia Retirement System. Further, in early 2004, the Board of Trustees of the Virginia Retirement System appointed two new members to the Investment Advisory Committee: Mr. Kenneth G. Lay, Deputy Treasurer and Director, Banking, Capital Markets and Financial Engineering Department, The World Bank; and Mr. Donald W. Lindsey, Chief Investment Officer, the George Washington University.

JLARC Reports on the Virginia Retirement System

The Virginia Retirement System's Investment in the RF&P Corporation, December 1993
Review of the Virginia Retirement System, January 1994
Review of the State's Group Life Insurance Program for Public Employees, January 1994
The VRS Investment Program, March 1995
The VRS Disability Retirement Program, March 1995
The 1991 Early Retirement Incentive Program, May 1995
Semi-Annual VRS Investment Report No. 4, September 1995
Semi-Annual VRS Investment Report No. 5, May 1996
Biennial Status Report on the Virginia Retirement System, May 1996
Legislator's Guide to the Virginia Retirement System, First Edition, May 1996
Review of VRS Fiduciary Responsibility and Liability, January 1997
Semi-Annual VRS Investment Report No. 8, May 1997
Semi-Annual VRS Investment Report No. 9, December 1997
Semi-Annual VRS Investment Report No. 10, July 1998
Semi-Annual VRS Investment Report No. 11, December 1998
Legislator's Guide to the Virginia Retirement System, Second Edition, May 1999
Semi-Annual VRS Investment Report No. 12, July 1999
VRS Biennial Status and Semi-Annual Investment Report No. 13, December 1999
Semi-Annual VRS Investment Report No. 14, July 2000
Semi-Annual VRS Investment Report No. 15, December 2000
Semi-Annual VRS Investment Report No. 16, July 2001
Semi-Annual VRS Investment Report No. 17, December 2001
Semi-Annual VRS Investment Report No. 18, July 2002
Semi-Annual VRS Investment Report No. 19, December 2002
Semi-Annual VRS Investment Report No. 20, July 2003
Semi-Annual VRS Investment Report No. 21, December 2003
Semi-Annual VRS Investment Report No. 22, July 2004

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