

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



**VRS Oversight:
Semi-Annual Investment Report
July 2004**

**JLARC Staff Briefing
Trish Bishop
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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**

Recent Fund Performance

- **Market value of the fund's assets as of March 31, 2004, was \$40.1 billion**
- **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
31.1%	4.9%	4.8%	10.3%

Recent Fund Performance

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- **The public equity program continues to be VRS' largest asset class, comprising 65.8 percent of the portfolio**

- **Improving conditions in the public equity market positively influenced the fund's overall investment performance:**
 - **Returns of 23.5 percent and 44.7 percent for the fiscal-year-to-date and one-year periods ending March 31, 2004, were particularly strong and exceeded established benchmarks**

- **The fixed income, private equity, and real estate programs offered necessary fund diversification, and provided positive returns for the one-year period ending March 31, 2004:**
 - **Fixed income: 6.2 percent**
 - **Private equity: 22.1 percent**
 - **Real estate: 19.4 percent**

Recent Fund Performance

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- **As noted in the December 2003 report, VRS is in the process of restructuring the real estate program and hiring a real estate professional to develop and manage the new real estate portfolio**
- **Recent private equity performance has improved since the last report and the annualized internal rate of return since inception for the private equity program is 23.8 percent**

Hedge Fund Update

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- **The purpose of creating the separate allocation to the hedge fund program is to:**
 - **Further diversify the portfolio**
 - **Avoid potential large losses from significant negative movements in the public equity and fixed income markets**

- **As of June 1, 2004, total appreciated value of the hedge fund program was \$1.157 billion (3 percent of the VRS portfolio)**

- **Through May 2004, the program has returned 8.6 percent for the fiscal-year-to-date versus 7.3 percent for its benchmark**

New Asset Allocation and Board Policy

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- The VRS Board of Trustees approved new strategic targets for the enhanced VRS portfolio at its May 2004 meeting
- Targeted risk level of the enhanced portfolio remained the same as the profile developed during the 2003 asset liability study
 - The risk profile has been defined as the risk associated with a baseline portfolio comprised of 70 percent equity, 25 percent fixed income, and 5 percent real estate
 - Today, this baseline portfolio implies a volatility of 12 percent
- Based upon this 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

New Asset Allocation and Board Policy

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- **After the analysis was conducted, a new enhanced portfolio was developed**
- **The 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**
- **The new enhanced portfolio's expected return is greater than and the associated risk is lower than that of the baseline portfolio**

Comparison of VRS Baseline, Current, and New Enhanced Portfolios

Asset Class	Baseline Portfolio	Current Portfolio	New Enhanced Portfolio
Fixed Income	25.00%	22.00%	20.00%
Dom. Equity	70.00%	48%	38.75%
Non-U.S. Equity		17.85%	20.00%
High-Yield		0.00%	3.00%
Private Equity		5.10%	7.00%
Real Estate	5.00%	3.80%	6.00%
Hedge Funds		3.00%	5.00%
Cash		0.25%	0.25%
Expected Return	6.60%	7.00%	7.20%
Expected Risk	12.00%	11.60%	11.20%

Reallocation Process

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- **In order to allocate resources in accordance with the new enhanced portfolio, staff recently made a number of investments and trades:**
 - **Reduced fixed income by 2 percent**
 - **Increased non-U.S. equity to 20 percent**
 - **In July, VRS plans to reduce passive domestic equity to fund an \$810 million investment in high yield**

- **Additional allocations to private equity, real estate, and hedge funds will be made on an opportunistic basis**

Rebalancing Policy Update

- The VRS Board recently amended the rebalancing policy to reflect the changes in the new asset allocation policy
- The new policy does not require the CIO to rebalance the fund to strategic targets as long as each asset class remains within the following ranges:

	<u>Previous</u>	<u>New</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%