STUDY OF COMMONWEALTH INVESTMENT POLICIES

AUGUST 2010

APA
Auditor of Public Accounts
COMMONWEALTH OF VIRGINIA

AUDIT SUMMARY

Generally, we found that the agencies and institutions of higher education had sound investment policies that complied with best practices. Our comparison of investment policies of those agencies and institutions having investments to determine if they followed best practices is found in Appendix A. This shows the details of our review for state agencies and institutions of higher education.

The underlying need for an adequate investment policy is to serve as a contractual agreement between the entity and its internal and external investment managers. Because of this, entities need to ensure that the investment policies are current, reviewed at least annually, and meet best practice standards. Appropriate current investment policies can help ensure there is no question as to what investment transactions and activities meet the entity's objectives and policies.

Equally important, entities must ensure that investment managers comply with policies in place by enacting adequate policies to monitor investment activity. Completion and adherence to these recommendations will serve as a means to protect the entities and the Commonwealth from risks associated with investment activity.

We found the areas of monitoring, follow-up, and periodic review of investment policies for certain institutions of higher education required strengthening. This improvement is especially important where the institutions of higher education use an outside investment manager.

1. Certain institutions of higher education should update their investment policies to include best practice standards and periodically review their policies for possible improvements;

2. Investment policies should include the best practices standards in sufficient detail to allow external and internal investment managers to easily understand and follow the best practices; and

3. Senior management of institutions of higher education should annually complete a formal review of investment policies, to ensure that policies are in compliance with the entity's investment objectives, identified risks, economic factors, and other factors that may affect investments.

- T A B L E O F C O N T E N T S –

Summary of Review and Findings

We compared investment policies of agencies and institutions having investments to determine if they followed best practices. This report discusses what constitutes best practices for investment policies and our overall findings. Appendix A shows the details of our review for state agencies and institutions of higher education. Appendix B is a copy of the survey questionnaire.

Generally, we found that the agencies and institutions had sound investment policies that complied with best practices. The underlying need for an adequate investment policy is to serve as a contractual agreement between the entity and its internal and external investment managers. Because of this, entities need to ensure that the investment policies are current, reviewed at least annually, and meet best practice standards. Appropriate current investment policies can help ensure there is no question as to what investment transactions and activities meet the entity's objectives and policies.

Equally important, entities must ensure that investment managers comply with policies in place by enacting adequate policies to monitor investment activity. Completion and adherence to these recommendations will serve as a means to protect the entities and the Commonwealth from risks associated with investment activity.

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1. Certain institutions of higher education should update their investment policies to include best practice standards and periodically review their policies for possible improvements;

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3. Senior management of institutions of higher education should annually complete a formal review of investment policies, to ensure that policies are in compliance with the entity's investment objectives, identified risks, economic factors, and other factors that may affect investments.

Investment Policy

The financial markets are complex and react quickly to news and changes in the economy. The recent economic conditions have created unprecedented volatility and uncertainty in financial markets. In such a volatile environment, agencies and institutions should have a plan in place to guide investment decisions during all economic cycles. When the safety of public funds is at stake, the importance of having a formal investment policy to protect the value of those funds is increased. The public entrusts government officials to manage public funds with discretion and to keep the best interests of the citizens and other beneficiaries in mind. An investment policy is a key component of ensuring prudent investment of the Commonwealth's funds.

An investment policy statement ultimately functions as a plan to achieve an entity's financial and organizational objectives within a range of acceptable risk, while ensuring compliance with applicable laws and regulations. The investment policy also serves as a guide to ensure that all responsible parties are accountable for their actions and allows an entity to compare actual investment decisions and performance to expected results.

With the wide range of investment options available and varying degrees of risk associated with each option, clearly defined investment policies serve to help protect the institution from significant losses and ensure compliance with regulatory requirements. An investment policy also provides guidance during difficult economic cycles, and prevents impulsive reactions to short-term events.

This report does not encompass all items potentially required for an investment policy, but rather the minimum items that are normally included. Other items may require consideration to address an entity's unique operating environment and investment strategy.

Funds Held for Investment

Most State agencies only have short term operating funds held and invested by Treasury. State agencies and institutions holding funds for investment include the Virginia Retirement System, Virginia College Savings Plan and various universities. Those agencies and institutions with funds for investment have a variety of reasons and purposes for having these funds and also have numerous external and internal restrictions over the use of these funds.

While the Treasury has guidelines for investment of state operating funds in the general account, each individual agency and institution is responsible for developing and monitoring their own investment policy for funds within its purview. Institutions of higher education have endowment funds for purposes such as scholarships and to supplement funding for various projects and programs. Many of these funds are comprised of donations that have restrictions on the use of funds, based on the wishes of the donor. Universities may transfer the responsibility for administration and investment of endowment funds to a foundation that is a component unit of the university. For purposes of our review, we did not include funds that are solely the responsibility of a foundation.

On the other hand, universities may use an affiliated foundation much like an external investment manager to invest university operating or endowment funds. In these arrangements, the university retains ultimate responsibility for these funds. These endowment funds were included in the scope of our review.

Investment Objectives

Each state agency or institution holding funds has a specific reason for having these funds and must make sure that they have a plan to meet the objectives for the purpose that they are holding the funds. The investment policy represents the formal plan to meet these requirements; therefore an entity should ultimately consider those needs when formulating its investment policy and objectives.

Investment objectives do not exist in a vacuum; they influence the investment strategy and other considerations in the investment policy. Typically overall investment objectives are safety, liquidity, and investment return.

Safety

Safety refers to preservation of the principal of funds held by the agency or institution. An entity seeks to achieve this objective by managing the risks that affect the value of investments. There are a wide variety of investment risks and each entity must decide which risks are most significant in relation to the nature of their individual investments. The most common types of risk include: interest rate, credit, and currency. Other types of risk include: counterparty, market, operational, re-investment, and legislative risk that, depending on the size and complexity of the entity's portfolio, may represent significant risk to the entity. However, we will focus only on the most common types of risk in this report.

Interest rate risk is the risk that investment values will change due to changes in interest rates. This risk relates primarily to investment in bonds, and has an inverse effect. That is as interest rates increase, bond prices decrease, and vice versa. An increase in interest rates makes other investments with higher returns more desirable, thus reducing the value of a bond paying a lower rate. An entity can manage interest rate risk by investing in bonds with various maturities. The Code of Virginia includes maturity limitations for investments by public entities.

Credit risk is the risk of loss due to a borrower's failure to meet an obligation. Rating agencies, such as Moody's and Standard & Poor's, evaluate the credit quality of bond issuers and publish ratings to aid investors in analyzing this risk. The Code of Virginia includes credit rating limitations for investments by public entities in the *Investment of Public Funds Act*.

Currency risk refers to the risk that an investment's value will adversely change as the result of changes in the values of different foreign currencies. For example, if a U.S. investor holds shares of a stock denominated in the Euro currency, a decrease in the value of the Euro versus the Dollar would reduce the value of the investment if sold. The only state agency directly exposed to foreign currency risk as of fiscal year 2009 was the Virginia Retirement System.

Liquidity

Liquidity refers to the ability to convert a financial instrument into cash. Liquidity is a significant factor for entities to manage their operational financial objectives. Certain investment instruments may have restrictions that reduce their liquidity, such as redemption requirements or a limited market. An entity must structure its investment strategy to meet its liquidity requirements by choosing investments with durations that meet their operational needs. Operating funds generally have higher liquidity requirements since current obligations require specific cash flows. Endowment funds would generally have lower liquidity requirements and, therefore, the investment horizon may be longer.

Yield

Yield refers to an investment's return, including appreciation, dividends, and other investment revenue. Typically an entity considers yield in relation to allowable risk levels and liquidity requirements. Investment managers seek to maximize the return on investment within the defined risk parameters. Entities with a longer investment timeframe, such as endowment funds, may seek a higher return on their funds, since they can accept lower liquidity in the short term.

Statutory Requirements

Several statutory requirements apply to investments by public entities and some apply to private entities as well. These provisions set forth the Commonwealth's policy that both public and private fiduciaries must follow in holding, administering and managing funds held for others.

Section 2.2-4500 et seq. of the Code of Virginia known as the *Investment of Public Funds Act*, includes specific requirements for investment of funds by public entities. Public entities include state agencies and institutions, state and local authorities and local governments and their political subdivisions. The *Investment of Public Funds Act* specifically addresses legally allowed investment types, issuer, maturity, and rating requirements and describes the standards of care for investment of public funds, collateral and safekeeping arrangements, and guidelines for other investment contracts. Many public officials investing funds state that the *Investment of Public Funds Act* provides a safe harbor for their investment of funds, since it states that complying with listed investment holds the public official harmless if a loss of value occurs.

The *Uniform Prudent Management of Institutional Funds Act* (*UPMIFA*) in the Code of Virginia establishes the basic requirement for holding funds for others whether by a private or public body. The larger state institutions of higher education for their endowment funds follow the requirements of the *UPMIFA*.

UPMIFA provides guidance for the prudent investment and use of endowment funds, and addresses modification of donor restrictions. Both public and private entities typically supplement the *UPMIFA* with more restrictive and detailed policies and procedures.

The statutory requirement for the Virginia Retirement System exists with the enabling legislation of the Board of Trustees. Since institutions have the responsibility to develop their own investment strategies, they should consider applicable statutory requirements in their investment strategy and ensure that investment guidelines are in compliance with the Code of Virginia.

External Investment Management

A fundamental decision of any entity is whether to manage investments using internal resources or by contracting with external parties. The governing body for each entity makes this decision based on availability and expertise of internal resources in relation to the investment scope and objectives. While these agreements transfer day-to-day investment management duties to another party, the ultimate responsibility for the funds still resides with the entity. As such, the entity should clearly communicate their investment objectives, their investment policy requirements, and required deliverables to any external investment managers. Institutions should also have a policy in place for hiring and monitoring external investment managers, including due diligence procedures for evaluating their professional competency, their ability to achieve the entity's objectives, and ensuring their compliance with the entity's investment policy.

Investment Policy Best Practices

The organization of an investment policy can vary among different entities; however, each policy should contain certain items to ensure that an entity manages its investments appropriately. An entity should consider the following items when developing an investment policy.

Purpose/Scope Statement

An investment policy should clearly identify the funds to which the policy applies. This is generally included in a purpose or scope statement. This statement should identify the general purpose of the investments, the funds to which the policy applies, and general information about the entity. The scope statement ensures that all parties involved are clear as to which funds the policy covers.

Investment Objectives

As discussed earlier in this report, an institution’s investment objectives provide the framework for the overall investment strategy. The nature of invested funds and the intended use of those funds also drive the investment objectives. An investment policy should clearly define these objectives.

Responsibility of Parties Involved

The investment process involves numerous parties with varying levels of responsibility and authority. It is common for the individual or group of individuals ultimately responsible for investment management to delegate that responsibility to other parties, such as another department or external investment managers. The investment policy should describe the responsibility of each party involved, and the authority to delegate responsibilities to other parties. This section may also mention the responsibilities of other external parties, such as the custodian, auditors, or legal counsel.

Standards of Care

Investment managers are required to comply with professional standards of prudence, due care, and ethics when investing and managing assets for beneficiaries. The actions of a reasonable individual under similar circumstances and capabilities define the concepts of prudence and due care. The Code of Virginia includes the standards of care and prudent investment guidelines for trustees and management of institutional funds. An institution’s code of ethics for investment management should be included in the investment policy. Considerations for each of these items in the investment policy hold investment managers and other responsible parties accountable for their actions.

Spending Policy

An important aspect of an investment strategy is the timing of fund expenditures. A spending policy seeks to balance the overall investment objectives, including liquidity and return requirements. Required expenditures affect the allowable maturity dates of investments, so that cash is available when needed. The investment policy should address spending requirements or reference the institution’s spending policy.

Use of External Investment Managers

Many institutions rely on external investment managers for investment management due to the expertise that these firms provide, or because of a lack of internal resources. The investment policy should address the use of third-party managers, including the due diligence and hiring approval requirements. This section may also include other items, such as performance benchmarks, and diversification, compliance, and reporting requirements.

Risk Considerations

There are numerous types of risks involved in investment management, as discussed earlier in this report. Risk considerations are generally included in an entity's overall investment objectives and directly impact return objectives. That is; as risk levels increase, the anticipated return also increases. By identifying the specific risks applicable to an entity's funds, they can develop strategies to effectively manage those risks to achieve the investment objectives. In addition to the specific risk types, the entity should identify risks associated with its different investment time horizons; short-term, intermediate, and long-term. The investment policy should describe each risk applicable to the entity's funds, with the related approach for managing those risks.

Statutory Requirements

Public entities must comply with certain laws and regulations related to the investment of public funds. The investment policy should reference the specific statutes and regulations applicable to an entity's investments, so that all parties are aware of these requirements.

Diversification

In order to achieve the institution's investment objectives it is necessary to invest funds in varying investment types, such as stocks, bonds, etc. Asset diversification serves several purposes, such as, to comply with the Code of Virginia, individual asset limitations, reduce investment risks by diversifying holdings, manage liquidity needs, and maximize investment returns within an acceptable level of risk.

An allocation policy generally uses percentage terms, such as 70 percent in bonds and 30 percent in stocks. When there are significant changes in the economy that affects the risk of the entity's investments, it may be necessary to adjust the asset allocation policy to realign with the investment objectives. In addition to the asset allocation requirements, an entity should also specify a re-balance policy that specifies the allowable variance from the asset allocation percentage before the investment manager must buy or sell investments.

Entities should also diversify investments at the issuer level, meaning that they can only hold a certain amount of securities issued by a single organization. For certain securities such as stocks these limits are lower compared to investments such as U.S. Treasury obligations.

Authorized Investments

By clearly defining allowable investments, an entity can monitor investment manager compliance and ensure that investments are in line with investment objectives, appropriate risk exposures, and regulatory requirements. Unless an institution has specific statutory requirements for its investments, they must follow either the *Investment of Public Funds Act* or *UPMIFA*.

The *Investment of Public Funds Act* includes the allowable investment types for the Commonwealth, public officers, municipalities, and political subdivisions. An institution may place further restrictions based on their individual investment strategy. The investment policy should clearly define the allowed and unallowed investments, including investment types, credit quality, maturity, collateral, and capitalization requirements. Credit quality requirements would consist of the applicable rating agency such as Moody's, or Standard & Poor's, and the required rating. The specific requirements for credit quality, investment maturities, and issuer limitations are included in the *Investment of Public Funds Act*.

UPMIFA provides broader investment authority than the *Investment of Public Funds Act* and does not include specific authorized investments or limitations. Entities following *UPMIFA* must develop appropriate investment guidelines in relation to their specific investment objectives and risks.

The investment policy may also include specific information for unallowed investments and transaction types. Typically prohibited transactions would include derivatives, leverage, and speculative trades. Restrictions are generally due to regulatory requirements or investments that do not fit the entity's risk allowance. By clearly defining unallowed investments or transaction types, investment managers are aware of those restrictions and the entity's reduces its exposure to unauthorized risk.

Performance Benchmarks

A benchmark is a standard against which the performance of a security, fund, or investment manager is measured. Benchmarks are a performance and risk management tool, allowing an entity to compare investment performance with similar investment strategies. An institution should select benchmarks that correlate with their investment strategy and provide an accurate gauge of performance. By clearly identifying benchmarks and allowable variances in the investment policy, parties are aware of performance measurement expectations.

Reporting Requirements

An entity should specify reporting requirements for parties involved in the investment process. The extent of reporting depends on the nature and magnitude of investments. Generally, investment managers should provide reports to the entity's governing body at each of their meetings. Reports should provide adequate information to allow the governing body to verify compliance with the investment policy guidelines.

Policy Review Requirements

Economic, organizational, and legislative changes have an effect on the validity of the investment policy statement. An entity should periodically review the investment policy, to ensure that it reflects the current investment environment and changes to the entity's funding needs and investment objectives.

Policy Approval

The entity should formally approve the investment policy statement, in conjunction with the periodic review. A Board resolution will generally serve as formal approval and adoption of the policy. The investment policy should include the specific requirements for adoption, including the timing and responsible parties. Regardless of whether there are changes to the policy, the entity should maintain documentation of policy approval.

Investment Policy Monitoring

An investment policy is only as effective as the monitoring process to ensure adherence to the policy guidelines and investment objectives. An entity's monitoring process should include several levels of analysis. At a minimum, an entity must monitor actual investment results in comparison to the specific guidelines in the policy. This analysis should cover areas such as allowable and unallowable investments, diversification, and comparison of performance with benchmarks. The monitoring policy should also include a process for responding to non-compliance issues. Potential responses range from selling securities to withholding fees or terminating an investment manager.

Entities using external investment managers should have a formal monitoring process for those managers. In addition to verifying compliance with specific policy guidelines, the entity should engage in on-going due diligence analysis of external managers. On-going due diligence consists of periodic reviews of the manager's organizational structure and ability to achieve the entity's investment objectives. Due diligence methods may vary such as holding periodic meetings with the manager, requiring the manager to provide an update on investment performance at Board meetings, or by providing a questionnaire with specific information and document requests to facilitate the due diligence process. The entity should also obtain other external reports or reviews issued for the external manager, such as internal control analyses or audits by third-parties. Another form of compliance verification is requiring external managers to formally certify policy compliance on at least an annual basis. These monitoring procedures provide the entity some assurance that the external manager is providing the level of expected service and investing funds as required.

Each agency and institution with investment funds will have unique needs and should develop specific investment strategies to meet those needs. The methods used to manage and monitor investments can have a significant impact on the financial situation of an individual institution and the Commonwealth as a whole.

Investment funds held by state entities vary in type including operating funds, endowments, lottery proceeds, retirement contributions, member contributions, and other discretionary or restricted funds. Each type of funds requires a different investment approach due to the various risk, time, and regulatory considerations.

Commensurate with the need to complete the monitoring process is the need to maintain updated investment policies that are always in agreement with the entity's strategic goals and objectives. Senior management of the entity should give additional consideration to adjusting investment policies to address any potential risks associated with changing economic and investment environments. Management should update investment policies at least annually or as deemed necessary, based on changing economic conditions or changes in operations.

Review of Investment Policies

The governing body of each state entity is ultimately responsible for the prudent management of its investments not held by the State Treasurer. As such, each entity has developed an investment strategy and policy to meet its individual organizational needs. We found that the format and contents of these investment policies vary by institution to address the wide range of organizational goals and their related investment objectives.

Our review included state entities with significant investment activity including the Virginia Retirement System, Treasury, Virginia College Savings Plan, Virginia Lottery, and institutions of higher education with investments not managed by Treasury. Refer below to a schedule of investment balances as of June 30, 2009.

We compared the investment policies for those state entities included in the scope of our review to items generally considered best practices for an investment policy, identified in this report. Our comparison focused on whether these items were specifically included or referenced in the entity's investment policy. Refer to Appendix A for a chart with the results of our comparison.

Each entity reviewed had an investment policy; however, most of the policies are lacking some of the items generally considered a best practice. Certain entities have other policies in place that address the deficiencies we noted; however, their investment policy does not always reference those policies. By including all relevant information or a reference to that information in the investment policy, all associated parties would be aware of that information and its relevance to the policy. Also, we observed that some policies included a brief mention of certain items, but did not include specific details. For example, some policies mentioned risk, but not the specific types of risk, how these risks relate to their investments, and the entity's approach to address those risks.

Investments Not with the Treasurer
As of June 30, 2009

Agency Name	Amount
Virginia Retirement System	$ 45,046,551,000
Department of Treasury (General Account – external)	1,226,846,962
Virginia College Savings Plan	2,186,876,413
Virginia Lottery	293,164,180

Investments with the Treasurer
As of June 30, 2009

Agency Name	Amount
Department of Treasury (General Account – primary liquidity)	3,588,172,390
Department of Treasury (Local Government Investment Pool)	4,304,500,000

Virginia Retirement System

The Virginia Retirement System (VRS) has the largest and most complex investment program in the Commonwealth with an investment balance of approximately $45 billion as of fiscal year 2009. VRS administers a defined benefit plan, a group life insurance plan, a deferred compensation plan, and a cash match plan for Virginia's public sector employees, as well as an optional retirement plan for selected employees and the Virginia Sickness and Disability Program for state employees.

VRS pools funds for investment to provide resources to manage their programs. The primary source of funding is individual member and agency contributions. The nature of VRS' investment authority comes from the Code of Virginia and provides more flexibility as to the types of allowable investments and management discretion compared to other state institutions. The Board of Trustees and the Chief Investment Officer have the authority to invest funds with the skill, due care, and diligence of a person with similar knowledge and abilities.

The VRS investment department has divisions for their different investment types including public equity, fixed income, private equity, real estate, and credit strategies. VRS uses a mix of internal and external investment management to achieve its investment objectives. Due to the nature of the VRS' investments, their investment policy structure is different than other state institutions.

Investment policies are in place for the plan as a whole, the individual investment divisions, and individual internal and external investment managers. Each policy addresses issues related to the specific concerns and risk at each of these levels. Investment objectives and allowable strategies also affect the asset allocation policy and risk budget that the Board of Trustees approves. The Investment Advisory Committee provides investment strategy recommendations to the Board.

VRS' investment policy addresses all of the components of the best practice model. In many cases, the investment policy includes greater detail than most other entities.

Virginia College Savings Plan

The Virginia College Savings Plan (Plan) administers two primary programs: the Virginia Prepaid Education Program (VPEP) and the Virginia Education Savings Trust (VEST). Funds for these programs come directly from plan participants and the Plan invests these funds pursuant to the Code of Virginia. The Plan's Board is ultimately responsible for investments. The Plan uses external investment managers, who must formally acknowledge their fiduciary duties and intention to comply with the investment policy. The Plan invests in equity, fixed income, and real estate to meet its funding obligations. Due to the nature of the Plan's investments, they have exposure to a variety of investment risks including credit quality and interest rate.

The Plan's general investment policy addresses all of the items in the best practice model with the exception of identification of specific risks related to investments, which exists within each individual investment managers' contractual agreement. In the future, as the Plan matures, management will need to improve their objectives for liquidity of investments as the Plan has more experience with maturity of the VPEP contracts.

Virginia Lottery

The Virginia State Lottery Department (Lottery) administers the state lottery program which provides funding for lottery game services and other public uses. The lottery programs require specific funding flows to pay prizes as they are due. Lottery invests in U.S. Treasury STRIPS to provide prize funding and participates in the securities lending program through Treasury to meet program and operating needs. Lottery's investment risk is unique since they primarily purchase U.S. Treasury STRIPS and hold these securities until maturity to pay long-term prizes. This reduces their exposure to interest rate and credit risk. The Lottery's investment policy addresses all of the items in the best practice model that are applicable to them.

Department of Treasury

The Department of Treasury (Treasury) manages state operating funds in the General Account and the Local Government Investment Pool (LGIP), under the authority of the Treasury Board.

The General Account holds all funds not restricted by outside sources. This would include the Commonwealth's General Fund, highway maintenance, and other cash that the Commonwealth uses in its normal course of business. To manage the Commonwealth's operating cash needs; the General Account has two portfolios; the Primary Liquidity portfolio and the Extended Duration and Credit portfolio. These portfolios are structured to provide funds when needed while providing a risk-adjusted return on investment. Treasury manages the General Account using a mix of internal investment management by Treasury staff and external investment managers.

Section 2.2-4600 of the Code of Virginia et.seq. established the Local Government Investment Pool (LGIP), and provides an investment option for local governments and state agencies and institutions that offers professional investment management with low fees and high liquidity. In turn, Treasury invests those funds using an internal investment manager. Treasury has developed investment policies for both the General Account and the LGIP.

We believe that Treasury's investment policy is a model that other institutions can use when developing or modifying their investment policy. At the same time, institutions should always consider the nature of their individual programs, risks, and related investments that may differ from those at Treasury.

Higher Education Institutions

State-supported universities have similar investment objectives due to the nature of their funds; however, each university has adopted a unique investment strategy and policy structure. For most universities, endowment funds represent the majority of investments not held by the State Treasurer. As mentioned earlier, many universities have transferred the responsibility for administration and investment of endowment funds to a related foundation, while some universities administer these funds internally. Also, some universities may allow a foundation to manage its investments, while the university maintains ultimate responsibility for those funds. When a university uses a foundation as an external investment manager, it is important that the university provide guidance, oversight, and monitor compliance with investment guidelines.

Other than endowment funds, the majority of funds invested by universities consist of operating, auxiliary, specific program, and agency funds. Auxiliary funds represent funds from activities such as student meal plans and housing. Agency funds generally consist of funds that are the property of another entity such as funds held for student organizations. Our review focused on the universities with funds invested outside of those with Treasury. The schedule below includes the primary university and foundation balances for investments not with the State Treasurer.

Higher Education Institutions and Foundations Investments Not with the Treasurer
As of June 30, 2009

Agency Name	Entity	Foundation
Virginia Commonwealth University	$ 33,150,613	$ 417,471,665
University of Virginia	157,135,037	4,286,080,009
The College of William and Mary	69,220,252	352,307,439
Virginia Tech	62,816,000	591,380,000
Old Dominion University	17,060,446	131,207,852
Virginia State University	14,581,994	5,680,233
Virginia Military Institute	10,652,167	232,934,291
James Madison University	509,289	57,110,647

During our review, we found that most universities do not have a formal policy for monitoring, follow-up, and periodic review of investment policies. While some institutions mention reporting or compliance requirements in the overall investment policy, the institution should have a formal policy with specific details for the monitoring process. The monitoring policy should include specific responsibilities, reporting requirements, and the applicable timeframes for reviews. This policy may be included as part of the overall investment policy or in a separate document. If included in a separate document, the investment policy should reference those procedures.

The following recommendations apply to certain institutions of higher education noted in Appendix A.

1. Certain institutions of higher education should update their investment policies to include best practice standards and periodically review their policies for possible improvements;

2. Investment policies should include the best practices standards in sufficient detail to allow an external or an internal investment manager to easily understand and follow the best practices; and

3. Senior management at institutions of higher education should annually complete a formal review of investment policies, to ensure that policies are in compliance with the entity's investment objectives, identified risks, economic factors, and other factors that may affect investments.

Overall Conclusion

Generally, we found that the agencies and institutions of higher education had sound investment policies that complied with best practices. Our comparison of investment policies of agencies and institutions having investments to determine if they followed best practices is found in Appendix A, which shows the details of our review for state agencies and institutions of higher education.

Commonwealth of Virginia

Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218

Walter J. Kucharski, Auditor

August 31, 2010

The Honorable Robert F. McDonnell
Governor of Virginia

The Honorable Charles J. Colgan
Chairman, Joint Legislative Audit
and Review Commission

We have reviewed the investment policies used by the agencies of the Commonwealth and are pleased to submit our report entitled **Study of Commonwealth Investment Policies**. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Audit Objectives

Our audit's primary objective studied the various investment policies used by Commonwealth Agencies and Institutions to identify policies that did not comply with best practices.

Audit Scope and Methodology

We gained an understanding of the various investment policies followed by Commonwealth Agencies and Institutions. Our study developed a set of best practices for investment policies and criteria for those policies. Our review included all the agencies and institutions listed below.

Department of Treasury General Account and Local Government Investment Pool
Virginia College Savings Plan
Virginia Retirement System
Virginia State Lottery Department

The College of William and Mary in Virginia	Virginia Commonwealth University
James Madison University	Virginia Military Institute
Old Dominion University	Virginia Polytechnic Institute and State University
University of Virginia	Virginia State University

We conducted surveys and interviews, performed analysis, and reviewed policies in order to draw our conclusions and develop our recommendations.

Conclusions

Generally, we found that the agencies and institutions had sound investment policies that complied with best practices. We found the areas of monitoring, follow-up, and periodic review of investment policies for certain institutions of higher education required strengthening. This improvement is especially important where the institutions of higher education use an outside investment manager.

1. Certain institutions of higher education should update their investment policies to include best practice standards and periodically review their policies for possible improvements;

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Exit Conference and Report Distribution

We discussed this report with the management of each agency and institution listed above between September 8 and 16, 2010. Individual agencies and institutions had the opportunity to provide responses to this report, and those who chose to, are included in the section titled "Agency and Institution Responses."

This report is intended for the information and use of the Governor and General Assembly, management, and the citizens of the Commonwealth of Virginia and is a public record.

AUDITOR OF PUBLIC ACCOUNTS

AWP/clj

COMMONWEALTH of VIRGINIA

VIRGINIA COLLEGE SAVINGS PLAN
9001 Arboretum Parkway, Richmond, VA 23236

Mary G. Morris
Chief Executive Officer

September 20, 2010

Mr. Walter J. Kucharski
Auditor of Public Accounts
P. O. Box 1295
Richmond, VA 23218

Dear Mr. Kucharski:

The Virginia College Savings Plan appreciates the time and attention you and your staff have dedicated to benchmarking the investment policies of the Virginia Prepaid Education Plan (VPEP) and the Virginia Education Savings Trust (VEST).

We agree that formal investment policies are a key component to ensuring prudent investment of funds entrusted to the Plan. The comment regarding liquidity of investments in the VPEP portfolio, particularly as the Program matures, is shared by management, the Investment Advisory Committee and the Board. Maintaining sufficient liquidity is one of the primary investment objectives stated in the VPEP Investment Policies and Guidelines. Liquidity of the VPEP portfolio is always a key focus and was in 2009 when the Plan undertook an asset liability study using the services of both our actuary and investment consultant. Outcomes of the study included a major revision of the VPEP and VEST investment policies and guidelines as well as a significant shift in the asset allocation strategy of the VPEP portfolio. We have taken steps in the last year to continue to improve our ability to monitor our short and long-term liquidity position in VPEP and manage our investments accordingly.

We believe the current policies and guidelines and asset allocation strategy serve the current needs of the Plan's programs, annual work plans include regular in-depth reviews to ensure continued informed decisions about the appropriate investment management of the portfolios, including liquidity needs as VPEP matures.

Thank you for the opportunity to review and respond to your review of investment policies.

Sincerely,

Mary G. Morris

pc: Sherri Wyatt, CCO
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Virginia
Retirement
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Charles W. Grant, CFA
Chief Investment Officer

September 14, 2010

Mr. Walter J. Kucharski
Auditor of Public Accounts
P.O. Box 1295
Richmond, VA 23218

Dear Mr. Kucharski:

The Virginia Retirement System is in agreement with the findings of your report entitled *Study of Commonwealth Investment Policies*.

I appreciate the work your team has done in this important area.

Sincerely,

C. Grant

Charles W. Grant, CFA
Chief Investment Officer

An Independent Agency of the Commonwealth of Virginia

Does the Investment Policy include:	Treasury Gen Acct.	Treasury LGIP	VCSP VEST	VCSP VPEP	VRS	Lottery
Investment policy scope?	✓	✓	✓	✓	✓	✓
Overall investment objectives?	✓	✓	✓	✓	✓	✓
Distinguish the responsibilities of all investment parties?	✓	✓	✓	✓	✓	✓
Use of external managers?	✓	n/a	✓	✓	✓	n/a
Standards of care for investment managers?	✓	✓	✓	✓	✓	✓
Address specific risks related to its investments, including allowable risk exposures?	✓	✓	✓	✓	✓	x
Liquidity requirements and/or limitations?	✓	✓	n/a	✓	n/a	✓
Spending policy?	x	n/a	n/a	x	n/a	n/a
Asset allocation and/or diversification policy?	✓	✓	✓	✓	✓	n/a
Allowable investments?	✓	✓	✓	✓	✓	✓
Prohibited investments?	✓	✓	✓	✓	✓	n/a
Prohibited transactions	✓	✓	✓	✓	✓	n/a
Individual issuer limits?	✓	✓	✓	✓	✓	n/a
Specific laws/regulations?	✓	✓	✓	✓	✓	IC
Reporting requirements?	✓	✓	✓	✓	✓	✓
Performance benchmarks for individual managers, asset classes, and/or in total?	✓	✓	✓	✓	✓	n/a
Performance review and evaluation requirements?	✓	✓	✓	✓	✓	x
Formal approval of the policy by responsible parties?	✓	✓	✓	✓	✓	✓
Formal policy for monitoring the investment policy	✓	IC	✓	✓	✓	IC
Procedures for addressing occurrences of non-compliance with the policy, and processes for resolution?	✓	x	✓	✓	IC	x
Does the policy state how often the policy is reviewed?	✓	x	✓	✓	✓	✓

Legend:	
✓	Adequate
x	Not included
IC	Included but incomplete
n/a	Not applicable

Does the Investment Policy include:	Higher Education									
	VCU	UVA		CWM		VT	ODU	VSU	VMI	JMU
		Short-term	Long-term	Cash Mgmt	Endowment					
Investment policy scope?	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Overall investment objectives?	✓	✓	✓	✓	✓	✓	✓	✓	✓	x
Distinguish the responsibilities of all investment parties?	✓	✓	✓	✓	✓	IC	✓	✓	✓	✓
Use of external managers?	✓	✓	✓	✓	✓	✓	n/a	✓	✓	x
Standards of care for investment managers?	IC	✓	✓	IC	✓	✓	x	✓	✓	x
Address specific risks related to its investments, including allowable risk exposures?	IC	✓	✓	x	✓	✓	IC	✓	IC	x
Liquidity requirements and/or limitations?	✓	✓	IC	IC	✓	✓	✓	✓	IC	x
Spending policy?	✓	✓	✓	✓	✓	✓	✓	✓	✓	x
Asset allocation and/or diversification policy?	✓	✓	✓	✓	✓	✓	✓	✓	✓	x
Allowable investments?	✓	✓	✓	✓	✓	✓	✓	✓	✓	IC
Prohibited investments?	IC	IC	IC	✓	✓	✓	x	x	✓	IC
Prohibited transactions?	x	x	IC	✓	✓	✓	x	x	✓	x
Individual issuer limits?	✓	✓	✓	✓	✓	✓	✓	x	✓	x
Specific laws/regulations?	✓	✓	✓	IC	✓	✓	✓	✓	x	x
Reporting requirements?	✓	✓	✓	x	✓	IC	x	✓	✓	x
Performance benchmarks for individual managers, asset classes, and/or in total?	✓	✓	✓	x	✓	✓	✓	✓	✓	x
Performance review and evaluation requirements?	✓	✓	✓	x	✓	✓	x	IC	✓	x
Formal approval of the policy by responsible parties?	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Formal policy for monitoring the investment policy	✓	✓	✓	x	✓	IC	x	IC	✓	x
Procedures for addressing occurrences of non-compliance with the policy, and processes for resolution?	✓	✓	✓	x	✓	✓	x	✓	IC	x
Does the policy state how often the policy is reviewed?	✓	✓	✓	✓	✓	✓	x	✓	✓	x

Legend:	
✓	Adequate
x	Not included
IC	Included but incomplete
n/a	Not applicable

Abbreviations:	
VCU	Virginia Commonwealth University
UVA	University of Virginia
CWM	The College of William and Mary
VT	Virginia Polytechnic Institute and State University
ODU	Old Dominion University
VSU	Virginia State University
VMI	Virginia Military Institute
JMU	James Madison University

Project Summary: *The Statewide review of investment policies is being conducted to determine the nature of investment policies in use for State agencies/institutions for Investments NOT with the Treasurer, and how these policies are monitored. Please complete the following questionnaire/procedures to determine the nature of the agency/institution's investments and investment policy. The questionnaire groups questions by category. The General and Nature of Investments sections provide general information related to the agency/institution's structure, the nature of money that's invested, types of investment managers used, etc. The Investment Policies/Guidelines section includes questions related to the specific items that are included in the investment policy. These questions were developed based on investment policy best practices and all items may not be applicable depending on the nature of the entity and its investments. The Description/Clarification column provides additional guidance for each question and examples to guide you in completing the questionnaire.*

Prepared by:	
Agency name/#:	
Agency contact (name/title):	
Contact E-mail:	
Contact Phone #:	

BEFORE completing the questionnaire, obtain the following documents. (NOTE: AUDITORS MAY ALREADY HAVE SOME OF THESE DOCUMENTS FROM TESTWORK COMPLETED ELSEWHERE.)

1) Investment policies for:
- **Overall entity**
- **Funds invested internally**
- **Specific external managers**
- **Foundation(s)**

2) Investment policy monitoring policies and procedures (may be included in the investment policy)

3) Board resolutions or other documents describing the institution's responsibility for investments.

PLEASE INCLUDE COPIES OF THESE DOCUMENTS IN THE CAF FILE FOR THE APPLICABLE AGENCY/INSTITUTION.

Review the investment policy and other supporting documents to answer the following questions and determine whether certain items are included in the agency/institution's investment policy. If the agency does not have a formal investment policy, complete the following questions to determine if the entity has any of the following policies or other consideration in place.

GENERAL			
Question		**Description/Clarification**	**Response**
1	Who is ultimately responsible for investment of funds (Board, Management, Committee, etc.)?	This is generally not who actually manages investments, but rather the person/group with legal responsibility for investment of funds. This information may be included in the Code of Virginia or entity bylaws.	
2a	What are the sources and uses of the funds that are invested, (including State funds vs. Non-state)?	Where does the money originally come from and how is it ultimately used (ie: state funds, endowments, gifts, etc.)?	
2b	Is this documented in the investment policy?		
3	Does the agency/institution manage investments internally?	If an entity manages funds internally, they are performing the actual buying/selling of investments.	
4	Does the agency/institution use external investment managers?	Many agencies will use outside investment managers instead of managing funds themselves, or use internal and external management strategies.	
5a	Are the agency/institution's funds managed by a foundation?	Some entities will place their funds with a foundation associated with the entity to manage their investments. This is similar to using external managers and generally the foundation is audited by a third-party.	
5b	If so, what level of control does the entity exert over the foundation?	Does the entity tell the foundation what to invest in, what not to invest in, etc?	
6a	Are investments of the agency/institution "pooled" with investments of another entity (such as an endowment)?	When funds are invested with an external manager or foundation, the funds may be pooled with those of another entity, either related or unrelated, such as an endowment. If funds are pooled it is important for there to be a formal method to allocate returns and account for the money of each entity.	
6b	If so, what is the nature of all entities for which funds are pooled and is there a policy for allocating gains/losses?		
7	What was the balance of internally managed funds at the end of the most recent fiscal year?		
8	What was the balance of externally managed funds at the end of the most recent fiscal year?		

NATURE OF INVESTMENTS			
Question		**Description/Clarification**	**Response**
9a	What are the agency/institution's investment time horizon(s) (short-term, intermediate, long-term)?	There can be multiple investment time horizons. The agency should have different policy considerations for each time horizon.	
9b	Are these documented in the investment policy?		
10a	Does the agency/institution invest in derivatives (forwards, futures, options, swaps)?	Due to the nature of these investments from a risk perspective and the complex nature of these investments, specific considerations will normally be included in the investment policy statement to address their use.	
10b	If so, what is the nature of those derivatives?	Generally, what types of derivatives does the agency invest in, such as forwards, futures, options, swaps?	
11a	Does the agency have a securities lending program *(*other than with Treasury*)*?	This only relates to an entity that administers its own securities lending program or participates in a securities lending program outside of the Department of Treasury.	
11b	If so, is there a specific policy considerations related to the securities lending program?	The agency should have separate guidelines related to the administration of a securities lending program. These may be included in the overall investment policy.	

INVESTMENT POLICIES/GUIDELINES			
Question		**Description/Clarification**	**Response**
Review the agency/institution's investment policy and determine if the following items are included. Respond Y/N and included any additional information as necessary.			
12	Investment policy scope?	What does the policy apply to? Which funds? Name of the entity or organization?	
13	Goals of the organization?	General background information about the organization, including its purpose.	
14	Overall investment objectives?	Safety, Liquidity, and Yield considerations. These are generally listed in order of priority. Safety is focused on preserving the principal balance. Liquidity refers to the ability to convert investments to cash. Yield refers to the expected return on investment.	
15	Spending policy?	How funds are allowed to be spent and the timing? This is usually set by the governing body.	
16	Distinguish the responsibilities of all investment parties (Board of Directors, Investment Managers, Staff, etc)?	A formal statement of who is responsible for investment management and any delegation of that authority to other parties, such as external managers. When authority is delegated, the governing body would still remain ultimately responsible.	
17	Use of external managers?	Considerations for external managers, such as authorization to use external managers, reporting requirements, performance objectives, compliance requirements, diversification, etc.	
18	Pooling of Funds?	If applicable, this would describe the nature of funds that are pooled, the justification for pooling funds, and the basis for allocation. Funds generally would be allocated based on participation percentage.	
19	Standards of care for investment managers (ie: prudence, ethics, conflicts of interest, etc)?	A formal statement describing the standards of professionalism and fiduciary duties the governing body and invested managers are expected to follow. This statement may also limit the liability of certain parties from losses.	
20	Audit requirements for the accounts of the agency/institution and/or any other external parties?	The required frequency of audits and the professional competency of auditors (ie: must be audited by a CPA, etc.)	
21	Address specific risks related to its investments, including allowable risk exposures?	The levels of risk that the entity will take on, including Interest Rate, Credit, Default risk, and any other risks.	

22	Liquidity requirements and/or limitations?	Investment liquidity refers to the ease that investments can be converted to cash. Agencies need to structure their investment strategies to meet spending requirements and a liquidity policy ensures that funds are available when needed.	
23	Limitations or requirements on the amount of cash held in the portfolio?	Some entities may limit the amount of cash that can be held in the portfolio, because cash does not earn a return. Excess amounts of cash results in lost potential earnings on those funds.	
24	Asset allocation and/or diversification policy for specific investment types and managers, including rebalance ranges?	Asset allocation is a very important aspect of an investment policy. For entities with the ability to invest in a wide range of securities, this policy would limit the allowable amount of each type (ie: bonds, stocks, real estate, mutual funds, etc). A rebalance range establishes the percent that the investment percents can change before they are required to be adjusted.	
25	Allowable investments?	Specifically states what investments are allowed to be used (ie: stocks, bonds, real estate, hedge funds, etc).	
26	Prohibited investments?	Specifically states investments that are not allowed.	
27	Prohibited transactions	Refers to types of transactions that are not allowed (ie: short sells, use of leverage, derivatives, etc).	
28	Individual issuer limits?	Limits the amount of investments that are allowed in a specific security or issuer (ie: can't have more than five percent in any one stock).	
29	Specific laws/regulations that the entity is required to adhere to?	Reference to laws and regulations that govern the investment of funds. For agencies this would include any appropriation act or Code of Virginia requirements, in addition to another other internal or external requirements.	
30	Performance benchmarks for individual managers, asset classes, and/or in total (short-term, intermediate, long-term)?	Benchmarks provide a measurement base for investment performance, considering a similar investment strategy. Benchmarks can be at a variety of levels and time-frames depending on the entity's investment objectives.	
31	Performance review and evaluation requirements?	The policy should include requirements for performance reviews and evaluations, such as the Board reviewing investment performance in comparison to the investment policy requirements on a quarterly basis.	
32	Formal approval of the policy by responsible parties?	The policy should be signed/authorized by the parties.	
33	When was the investment policy last updated? (Please include the specific date.)	The date that the investment policy was most recently reviewed, updated, and/or revised.	

EXTERNAL MANAGERS (Complete the following section if the agency/institution uses external investment manager(s))			
Question		**Description/Clarification**	**Response**
34a	Does the agency/institution provide specific guidelines and investment requirements for external investment managers?	Generally the overall investment policy will mention the use of external managers, however there will be a separate more detailed policy for each external manager. This policy would have specific requirements for the manager such as allowed/prohibited investments, reporting requirements, etc.	
34b	If so, are these requirements formalized in the manager's contract or another binding form?		
35	Does the external manager policy include specific performance criteria or objectives?	This may be in the form of a specific performance benchmark that the manager is compared to or other specific objectives for the manager. For example, some institutions may require that the manager only invest in high-quality bonds or money market mutual funds.	
36	What is the agency/institution's process for ensuring that external investment managers are in compliance with applicable investment polices?	The agency should have a formal policy for ensuring that each external investment manager is in compliance with its investment guidelines on at least an annual basis.	
37	How often are external managers required to report on investment performance and/or policy compliance?	Generally investment managers will report investment performance on at least a quarterly basis.	
38	Are external managers required to formally certify policy compliance on at least an annual basis?	This would include the investment manager signing a formal statement saying that they were in compliance with all applicable investment policies/guidelines during a certain period. This should be done at least annually.	

FOUNDATIONS (Complete the following section if the agency/institution's funds are invested by a foundation)			
Some entities may allow a related foundation to invest their funds, much like using an external investment manager. For Universities, these funds may be combined with those of an endowment or other funds. The investment objectives may be different for varying funds invested by the foundation, so it's important for the entity to provide specific investment guidelines to the foundation, clearly identifying the responsible parties, and how the funds are to be managed.			
Question		**Description/Clarification**	**Response**
39a	Does the agency/institution provide specific guidelines and investment requirements to the foundation?	If funds are managed by a foundation it is important for the entity ultimately responsible for those funds to provide specific investment policies to the foundation.	
39b	If so, are these requirements formalized in the foundation's contract or another binding form?	Since the entity is ultimately responsible for its funds, the specific investment objectives, requirements, and limitations should be formalized in an investment policy or contract between the entity and the foundation.	
40	Does the foundation policy include specific performance criteria or objectives?	Depending on the nature and magnitude of the entity's investment objectives, specific performance criteria and/or objectives should be included in the investment policy such as a performance benchmark.	
41	What is the agency/institution's process for ensuring that foundations are in compliance with applicable investment polices?	The agency should have a formal policy for ensuring that the foundation is in compliance with its investment guidelines on at least an annual basis.	
42	How often are foundations required to report on investment performance and/or policy compliance?	Generally investment managers will report investment performance on at least a quarterly basis.	
43	Are foundations required to formally certify policy compliance on at least an annual basis?	This would include the investment manager signing a formal statement saying that they were in compliance with all applicable investment policies/guidelines during a certain period. This should be done at least annually.	

INVESTMENT POLICY MONITORING			
Question		**Description/Clarification**	**Response**
44	Does the agency/institution have a formal policy for monitoring the investment policy *(if so, please include a copy)*?	The entity should have a formal method of ensuring that the overall investment policy is followed and that individual investment managers are in compliance with their policies. For many agencies this involves establishing reports of performance, holdings, etc., and can be compared to the specific investment guidelines from the policy. These may be presented to the Board or governing body at its meetings.	
45	If there is an occurrence of non-compliance with the policy, what is the process for resolution?	The entity should have a formal process for responding to investment policy non-compliance issues. Depending on the specific policy item that is out of compliance and the severity, this could involve buying or selling investments to rebalance the account, consulting the investment manager, or taking negative action against a manager.	
46	Do investment managers use pre-trade compliance systems (internal & external)?	Some investment managers may have pre-trade compliance systems that verify an investment or transaction is allowed before it is bought or sold. This is a preventative measure that can decrease the risk of non-compliance.	
47	How often does the Board/management formally review the investment policy for reasonableness?	The Governing body or its designee should formally review the investment policy at least annually to ensure that the policy is current in relation to the entities objectives and changes in the economic or legislative environment.	