



Comprehensive Annual Financial Report

FOR THE YEAR ENDED JUNE 30, 2004



AN INDEPENDENT AGENCY OF THE COMMONWEALTH OF VIRGINIA

Fiscal Year 2004
Financial and Statistical Highlights – All Pension Trust Funds

(Dollars in Thousands)

| | 2004 | 2003 | % Change |
|---|---------------|---------------|----------|
| For the Year | | | |
| Contributions | \$ 1,185,155 | \$ 1,041,835 | 13.8% |
| Investment Income (Net of investment expenses) | \$ 5,937,777 | \$ 969,638 | 512.4% |
| Retirement Benefits | \$ 1,760,992 | \$ 1,597,735 | 10.2% |
| Refunds | \$ 84,966 | \$ 72,150 | 17.8% |
| Administrative Expenses (Net of misc. income) | \$ 18,645 | \$ 16,670 | 11.8% |
| Increase in Net Assets Held in Trust for Pension Benefits | \$ 5,258,329 | \$ 324,918 | 1,518.4% |
| Retirement Benefits as a percentage of contributions | 148.6% | 153.4% | |
| Retirement Benefits as a percentage of contributions and investment income | 24.7% | 79.4% | |
| At Fiscal Year End | | | |
| Net Assets Held in Trust for Pension Benefits - VRS | \$ 37,784,408 | \$ 32,726,882 | 15.5% |
| Net Assets Held in Trust for Pension Benefits - SPORS | \$ 485,743 | \$ 423,814 | 14.6% |
| Net Assets Held in Trust for Pension Benefits - VaLORS | \$ 497,771 | \$ 394,779 | 26.1% |
| Net Assets Held in Trust for Pension Benefits - JRS | \$ 271,154 | \$ 235,272 | 15.3% |
| Investment Performance | | | |
| One-Year Return on Investments | 17.90% | 2.50% | |
| Three-Year Return on Investments | 3.80% | -4.20% | |
| Five-Year Return on Investments | 3.70% | 2.60% | |
| Participating Employers | | | |
| Counties/Cities/Towns | 243 | 241 | |
| Special Authorities | 176 | 172 | |
| School Boards | 145 | 145 | |
| State Agencies | 234 | 240 | |
| Total Employers | <u>798</u> | <u>798</u> | 0.0% |
| Membership/Retirees | | | |
| Active Members | 317,203 | 311,811 | 1.7% |
| Retired Members | 113,717 | 108,758 | 4.6% |

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FOR THE YEAR ENDED JUNE 30, 2004



AN INDEPENDENT AGENCY OF THE COMMONWEALTH OF VIRGINIA

This report was prepared by VRS Finance and Administrative Staff, except for the Investment Section, which was prepared by the VRS Investment Department.

ABOUT THE THEME:

In its day-to-day operations, VRS embraces a set of core values: customer service, productivity and quality management, teamwork, adapting to change and open communication. Embracing these core values, VRS promotes an environment where employees look beyond their own jobs and, in a spirit of teamwork and cooperation, pull together to help the agency achieve outstanding results and to set new standards of excellence.

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Certificate of Achievement for Excellence in Financial Reporting

Presented to

Virginia Retirement System

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2003

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



President

Executive Director



Public Pension Coordinating Council
Public Pension Standards
2003 Award

Presented to

Virginia Retirement System

In recognition of meeting professional standards for
plan design and administration
set forth in the Public Pension Standards.

Presented by the Public Pension Coordinating Council, a confederation of

National Association of State Retirement Administrators (NASRA)
National Conference on Public Employee Retirement Systems (NCPERS)
National Council on Teacher Retirement (NCTR)

A handwritten signature in black ink, reading 'Alan H. Winkle'. The signature is written in a cursive, flowing style.

Alan H. Winkle
Program Administrator



INTRODUCTORY SECTION

Production and Quality Management

WORKING AT A HIGH LEVEL OF
PRODUCTIVITY AND QUALITY
NOT ONLY TO DO ONE'S OWN JOB
BETTER BUT TO HELP OTHERS
DO THEIR JOBS BETTER.

Chairman's Letter



Alfonso I. Samper, Chairman
W. Forrest Matthews, Jr., Director
Nancy C. Everett, Chief Investment Officer

P.O. Box 2500, Richmond, Virginia 23218-2500
1200 East Main Street, Richmond, Virginia 23219
Telephone: (804) 649-8059 TDD: (804) 344-3190

November 5, 2004

The Honorable Mark R. Warner
Governor of Virginia
Members of the General Assembly

I am pleased to announce that the Virginia Retirement System (VRS) fund earned 17.9 percent for fiscal year 2004. This extraordinary return reflected the improving capital markets and the strengthening economy during the year. VRS assets totaled just over \$40 billion at year-end.

Each of the fund's five asset classes had a positive return during the fiscal year. The private equity program led the way with the highest return at 27.8 percent followed by public equity at 24.1 percent.

I am pleased to relate such positive information about the portfolio and believe that the success of the entire agency would not be possible without the VRS staff. In every aspect, from administering benefits to serving our members, retirees and beneficiaries, the contributions of VRS employees have enabled the agency to excel in its mission and goals.

In closing, I would like to express my gratitude to the VRS Board of Trustees for their guidance and commitment, and to the VRS staff for their dedication and hard work. Also, I wish to thank you for your continued support and leadership.

A handwritten signature in cursive script that reads 'Alfonso I. Samper'.

Alfonso I. Samper
Chairman
Virginia Retirement System

VRS Board of Trustees

Nine members serve on the VRS Board of Trustees. The appointment of board members is shared between the executive and legislative branches of the state government. Five, including the chairman, are appointed by the governor, and four are appointed by the Joint Rules Committee of the General Assembly. All nine members are confirmed by the General Assembly.

Of the nine board members, four must be investment experts; one must be experienced in employee benefit plans; one must be a local government employee; one must be an employee of a state-supported institution of higher education; one must be a state employee and one must be a public school teacher. The public employee members of the board may be either active or retired.



Alfonso I. Samper
Wachovia Securities



John M. Albertine, Ph.D.
Albertine Enterprises



Edwin T. Burton III, Ph.D
University of Virginia



Robert C. Carlson
Carlson Wealth Advisors, LLC



J. Douglas Conway, Jr.
County of Henrico
Division of Fire



Judith Ewell, Ph.D
Retired,
College of William and Mary



Vernard W. Henley
Retired,
Consolidated Bank

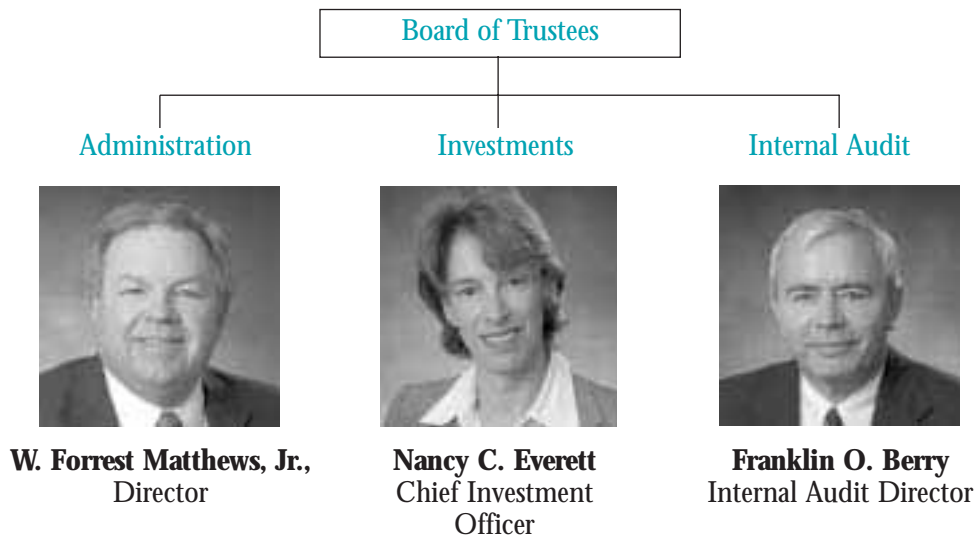


Paul W. Timmreck
Virginia
Commonwealth
University



Raymond B. Wallace, Jr.
Retired,
Henrico County
Public Schools

VRS Organization



VRS Investment Advisory Committee



(left to right):

Stuart A. Sachs
Retired, Sovran Capital Management

Alice W. Handy
Investure

Joseph W. Montgomery
Wachovia Securities

Raymond D. Smoot, Jr., Ph.D.
Virginia Tech Foundation, Inc.
Chairman

Donald W. Lindsey
George Washington University

Joe Grills
Retired, IBM Retirement Funds

Not Pictured:
Deborah Allen-Hewitt, Ph.D.
Rutledge Research

Kenneth G. Lay
The World Bank

Katrina F. Sherrerd, Ph.D.
Association for
Investment Management
and Research

VRS Administration Executive Team



Back row (left to right)

W. Forrest Matthews, Jr.
Director

Wallace G. Harris
Senior Deputy Director

J. Timothy Bass
Chief Technology Officer

Deborah P. Burgess
Lead Engineer-Desktop/Telephony

Virginia L. Bomar
Chief Customer Programs Officer

Deardrian B. Scott
Chief Customer Support Officer

Rose Mary Smith
Director of Product and
Data Quality

Barry C. Faison
Chief Financial Officer

Front row (left to right)

Jeanne L. Chenault
Public Relations Director

LaShaunda B. King
Executive Assistant

Donna M. Blatecky
Deputy Director for
Customer Relationships

Marion W. Price
IT Manager

Donna M. Shumate
Chief Human Resource Officer

Linda F. Walker
IS Auditor/Manager

Kathryn A. Quiriconi
Controller

Not Pictured:

Franklin O. Berry
Internal Audit Director

VRS Investment Executive Team



Back row (left to right)
Brian J. Wade
Investment Funds Manager

Charles W. Grant
Investment Managing Director

R. Ruffin King
Investment Funds Manager

Kenneth C. Howell
Investment Funds Manager

John T. Grier
Investment Funds Manager

Front row (left to right)
Field H. Griffith
Investment Funds Manager

Nancy C. Everett
Chief Investment Officer

Steven C. Henderson
Investment Funds Manager

Larry D. Kicher
Chief Operations Officer

Stephen R. McClelland
Investment Funds Manager

Professional Consultants

Actuary:
W. Michael Carter
Gabriel, Roeder, Smith & Company

Auditor:
Walter J. Kucharski
Auditor of Public Accounts
Commonwealth of Virginia

Life Insurance Carrier:
Joseph K. W. Chang
Minnesota Life Insurance Company

Master Custodian:
Mellon Trust

Legal Counsel:
Stephanie L. Hamlett
Brian J. Goodman
Office of the Attorney General
Commonwealth of Virginia

Virginia Sickness and Disability
Program:
Melissa D. Lamm
UnumProvident Corporation

Letter of Transmittal



W. Forrest Matthews, Jr.,
Director

Date: November 22, 2004

To: Members of the Board and Trustees

We are pleased to submit to you the Comprehensive Annual Financial Report (CAFR) of the Virginia Retirement System (System) for the fiscal year ended June 30, 2004.

The System administers benefits and services for more than 521,000 members, retirees and beneficiaries covered under VRS, the State Police Officers' Retirement System (SPORS), the Virginia Law Officers' Retirement System (VaLORS), Special Benefits for Local Law Enforcement Officials and Firefighters (LEOS/FIRE) and the Judicial Retirement System (JRS). Benefits include the traditional defined benefit plan; defined contribution plans; the Basic Group Life Insurance Program and the Optional Group Life Insurance Program for members and retirees; the Retiree Health Insurance Credit Program; and the Virginia Sickness and Disability Program (VSDP) for state employees, which includes minimum employer-paid long-term care coverage. Nearly 800 state agencies, school

VRS Milestones

- 1908** – Retired Teachers Fund created.
- 1942** – VRS and JRS created.
- 1944** – Political subdivisions allowed to join VRS.
- 1950** – SPORS created.
- 1960** – Group life insurance established.
- 1970** – COLA established.
- 1989** – Health insurance credit for state retirees established.
- 1992** – Health insurance credit for retired teachers and political subdivision retirees established.
- 1995** – Optional group life insurance program established.
- 1999** – Virginia Sickness & Disability Program (VSDP) for state employees established. VaLORS created.
- 2002** – Long-term care benefit added to VSDP.

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boards, political subdivisions and special authorities participate in VRS on behalf of their employees.

VRS' Comprehensive Annual Report for FY 2004 has been prepared in accordance with Section 51.1-1003 of the *Code of Virginia* (1950), as amended, and Section 4-9.00 of Chapter 1042 of the 2003 Virginia Acts of Assembly requiring every retirement system to publish an annual report. The report has been mailed to the Governor and the members of his Cabinet, the members of the Virginia General Assembly, VRS' participating employers and other interested parties. It also is available on the VRS Web site at www.varetire.org.

The report consists of the following sections:

- **Introductory Section:** letter from the Chairman of the VRS Board of Trustees; letter of transmittal; the identification of the organization.
- **Financial Section:** the opinion of the Auditor of Public Accounts; Management's Discussion and Analysis; the financial statements; required supplementary data; additional financial information.
- **Investment Section:** letter from the Chief Investment Officer; review of investment activity and performance for the fiscal year.
- **Actuarial Section:** certification letter of the independent consultant actuary, Gabriel, Roeder, Smith & Company; summary of the results of the most recent actuarial valuations; plan summary.
- **Statistical Section:** tables of significant data pertaining to the system; list of participating employers; information on other programs.

Accounting System and Internal Control

The financial statements included in the CAFR for FY 2004 are the responsibility of the System's management and have been prepared in accordance with generally accepted accounting principles (GAAP) for governmental accounting and reporting under the Governmental Accounting Standards Board (GASB) and the Financial Accounting Standards Board (FASB).

The accrual basis of accounting is used in the preparation of the financial statements. Revenues are taken into account when they are earned and become measurable; expenses are recorded when the liabilities are incurred. Investments are reported at fair value, as determined by the System's master custodian. Capital assets are recorded at cost and depreciated over their estimated useful life. Contributions to the System are based on the principle of level cost funding and are developed using the entry age normal cost method with current service financed on a current basis and prior service amortized within a period of 30 years or less. In management's opinion, the financial statements fairly present the plan net assets of the System at June 30, 2004, and the changes in its plan net assets for the period then ended.

GASB Statement Number 34 requires the System to include additional information in the CAFR. This additional information is provided in the Management's Discussion and Analysis (MD&A) and includes a narrative introduction, overview and analysis of the System's financial activities for the current fiscal year and the two preceding years. The letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The System's MD&A can be found immediately following the report of the independent auditor in the Financial Section.

The System's management also is responsible for maintaining a system of adequate internal accounting controls designed to provide reasonable assurance that transactions are executed in accordance with management's general or specific authorization, and are recorded as necessary to maintain accountability for assets and to permit preparation of financial statements in accordance with generally accepted accounting principles. The internal control system includes the organization plan, the appropriate segregation of duties and responsibilities and sound practices in the performance of duties and personnel with capabilities commensurate with their responsibilities. There is an internal audit program that reports to the Audit Committee of the Board of Trustees, and the budget for the System's administrative expenses is approved by the Board and appropriated by the General Assembly of Virginia. In addition, the retirement funds held by the System are constitutionally established as independent trust funds dedicated to the exclusive benefit of its members, retirees and beneficiaries. In management's opinion, the internal controls in effect during the fiscal year ended June 30, 2004 adequately safeguard the System's assets and provide reasonable assurance regarding the proper recording of financial transactions.

Legislative Initiatives

The Virginia General Assembly enacted several bills during the 2004 session that affect benefits for Virginia's public employees and retirees:

Hazardous Duty

- *House Bill 334* removed the five-year hazardous-duty vesting requirement for members of SPORS, VaLORS and LEOS/FIRE who were in service on June 30 and July 1, 2002. Law enforcement officers with five or more years of creditable service are considered vested for hazardous duty regardless of whether the service was rendered under these plans.
- *Senate Bill 311* allows service rendered in hazardous-duty positions before October 1, 1999, which were not covered under SPORS or LEOS and for which there was no separate coverage under VaLORS, to be considered hazardous-duty service for purposes of determining eligibility for the supplement for members retiring under the provisions of these plans. It is retroactive for those who retired on or after October 1, 1999.

Basic Group Life Insurance

- *House Bill 199* provides retirees who have at least 20 years of creditable service and return to work in a covered position with life insurance coverage equal to either twice their annual salary or the amount for which they would have been eligible had they remained retired, whichever is greater. House Bill 199 also provides that active members with at least 20 years of creditable service will have their life insurance benefit based on their highest annual salary.

Defined Contribution Plans

- *House Bill 551* permits political subdivisions offering the deferred compensation program to collect the administrative fees that VRS charges from their employees participating in the plan.
- *House Bill 576* allows school boards to offer a new supplemental retirement benefit, called the Virginia Supplemental Retirement Plan (VSRP), to qualified employees who serve in under-achieving schools as "turnaround specialists" or members of the Middle School Teacher Corps. VSRP does not replace the defined benefit plan.

Virginia Sickness and Disability Program

- *Senate Bill 628* precludes short-term disability coverage for elective surgery during the first six months of the probationary period for new employees unless the employer approves it and the required leave of absence is coordinated between the employee and employer.

Virginia Retirement System

- *House Joint Resolution 34* establishes a joint subcommittee to conduct a study of the benefit structure and funding of retirement plans administered by VRS, including line-of-duty benefits for public safety officers.

VRS Service

The aging of the workforce will challenge public pension systems not only in terms of adequate funding of benefits but also in delivering appropriate and superior service to customers. As employers, public pension systems are facing the coming wave of baby-boom retirements among their own workforces, and VRS is no exception.

In FY 2004, the VRS retiree payroll was \$1,761,000,000, representing a 10.2 percent increase over FY 2003. This year, we received nearly 8,300 applications for retirement, an increase of 4 percent over the previous fiscal year. The total number of retirees receiving the health insurance credit was 66,039, a 6.2 percent increase.

The Customer Contact Center received 204,812 calls in FY 2004 compared to 180,976 calls in FY 2003, or a 13 percent increase. The Customer Contact Center also saw a 49 percent increase in e-mails and an 87 percent increase in walk-in sessions. In addition, approximately 5,600 customers attended Group Counseling Sessions and Retirement Education Seminars in FY 2004, compared to approximately 2,800 in FY 2003.

Overall, 30 percent of VRS' 317,000 active members are between the ages of 40 and 50 and 35 percent are age 50 or older. Between now and 2010, approximately 47,000 current VRS members will be eligible for an unreduced retirement benefit.

FY 2004 Accomplishments

The success of the agency will continue to depend on protecting the fund, not only through prudent fund management but also through a commitment to controlling costs. According to the Cost Effectiveness Measurement, Inc. annual benchmarking analysis, released in April 2004, VRS' benefits administration

operating costs are \$36 per active member and annuitant, well below the peer group average of \$65.

The agency's success also will continue to depend on employees' commitment to provide the highest level of service to members, employers, retirees and beneficiaries. Their accomplishments in FY 2004 are worthy of recognition.

Education and Communication

- Self-service capabilities on the VRS Web site (www.varetire.org) were enhanced in FY 2004. They included a new online tool for employers to process Purchase of Prior Service (PPS) Credit applications and an easy-to-use online tutorial for QuickAccess, replacing the manual. An actuarial cost estimator for PPS also was added for members and employers. Overall, visits to the VRS Web site increased from an estimated 466,000 in FY 2003 to more than 620,000 in FY 2004. Between January and June 2004, visits to the VRS homepage exceeded 280,000. During the same period last year, visits totaled nearly 129,000.
- One of the most significant accomplishments of FY 2004 was the success of the VRS "Cost of Waiting" campaign, launched in January 2004 as a targeted program of publications and Web site marketing to members and employers. The campaign sought to remind members with eligible prior service before July 1, 2001 that the deadline to purchase that service at the 5 percent rate was June 30, 2004. After that date, the cost to these members would be at the higher actuarial rate. Between February and April 2004, total visits to the PPS homepage on the Web site numbered 3,332, a 43 percent increase over FY-2003. Total downloads of PPS forms and applications were 40,445, representing a dramatic 228 percent increase. The agency received more than 22,700 PPS applications, more than twice the number for FY 2003. Notwithstanding this increase, applications were processed within 30 days of receipt, exceeding agency expectations.
- Several publications were introduced or revised in FY 2004, enhancing VRS' support of human resource officers who administer benefits for their employees. The agency introduced a new comprehensive Employer Manual for benefits administrators and payroll officers. Revisions to the VRS, SPORS and VSDP Handbooks for Members and two new publications, Applying for Service Retirement and Applying for Disability Retirement Booklets, were published and made available on the VRS Web site.

In addition, all VRS forms were updated with the most current policies and procedures.

- VRS launched an Identity Theft Prevention project in FY 2004, which included removing social security numbers from external communications to members and retirees and from the Member Benefit Profile. The project also focused on in-house training regarding identity theft.
- More than 160 representatives from 85 school divisions attended eight employer forums in FY 2004. The agency also conducted 21 site visits with employers. Marketing efforts resulted in nearly 20 employers joining VRS or increasing the benefits they offer their employees.

Benefits Administration and Service

- Incoming calls to the Customer Contact Center were handled 94.9 percent of the time without having to transfer the caller, exceeding agency expectations.
- The agency exceeded its standard for accurate and timely retirement application processing, with 99.8 percent of applications processed within 90 days of receipt at an average accuracy rate of 99 percent. The agency also implemented First In First Out (FIFO), which decreased the retirement application processing time from 90 days to an average of 60 days during the peak period of July.
- Participation in the Commonwealth of Virginia Deferred Compensation Plan increased 12.1 percent over last fiscal year to 38,296 participants. Participation in the Virginia Cash Match Plan increased 13.8 percent to 34,517 participants. The Virginia Defined Contribution Plan Web site also was introduced in FY 2004 along with investment education seminars for employers and regional education and enrollment meetings for members.
- A new third-party administrator for the Virginia Sickness and Disability Program (VSDP) came on board effective January 1, 2004. The contract provided for several new features, including 24-hour access to claims information for participants, enhanced employer reporting and enhanced return-to-work services. The number of VSDP participants in FY 2004 was 64,715, representing 75 percent of those who are eligible to participate. Last year, 62,280 employees were participating in VSDP, representing 73 percent of those eligible for VSDP.
- In FY 2004, 99.1 percent of employer payroll reports were processed within 30 days, exceeding agency expectations.

Internal Support and Administration

- During FY 2004, the agency launched a comprehensive examination of business processes, many of which are carried out by employees who have a large amount of undocumented institutional knowledge. Twenty-nine essential business processes were documented in FY 2004, which included 117 separate procedures and flowcharts.
- The agency also completed 149 Client Readiness (system improvement) projects, resulting in improvements in the accuracy of work, the efficiency of benefits processing and the quality of customer service.
- One of VRS' major accomplishments during the fiscal year was the establishment of the VRS University to provide in-house training and professional and personal development for supervisors and employees.
- VRS formalized and streamlined its legislative review process with the establishment of the Legislative Review and Implementation Team (LRIT). LRIT is a cross-functional team that identifies, develops, assesses and implements all legislation affecting VRS and its members, employers, retirees and beneficiaries.
- In the area of technology, VRS achieved 99.48 percent system availability in FY 2004. The agency also carried out major upgrades to e-mail and antivirus capabilities, computer operations, data processing, servers and the imaging and workflow system. In addition, the agency's Security Policy was updated and a security awareness program implemented. Procurements also were developed for the Knowledge Management System, the Data Warehouse and a new telephony solution, which will integrate with the agency's other systems and applications to provide a more effective environment in support of customer service.

Fiduciary Responsibility

The VRS Board of Trustees (the "Board") has full power to invest and reinvest the trust funds of the System. To fulfill its responsibility, the Board has adopted various investment policies and guidelines. The Board's investment objective for the VRS portfolio is to maximize long-term investment returns while targeting an acceptable level of risk. Primary risk measures are volatility in the plan's assets, funded status and contribution rates. As set forth in Section 11 of Article X of the Constitution of Virginia, the funds of the retirement system shall be deemed separate and independent trust funds, shall be segregated from all

other funds of the Commonwealth and shall be invested and administered solely in the interests of the members and beneficiaries thereof. The Board retains a professional investment staff, as well as outside managers, to advise and assist in the implementation of these policies and objectives.

The assets of the System are invested in a prudent manner that is intended to provide for the anticipated growth of VRS' pension liability. Section 51.1-124.30(C) of the Code of Virginia states that ". . . the Board shall invest the assets of the Retirement System with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims." Accordingly, the Board must sufficiently diversify the portfolio to minimize the risk of large losses unless, under the circumstances, it is clearly prudent not to do so.

**Achievement Award
from the Public Pension Coordinating Council**

VRS received the Achievement Award from the Public Pension Coordinating Council (PPCC). The award recognizes VRS for excellence in meeting professional standards for plan design and administration as set forth in the Public Pension Standards.

Developed by the PPCC to promote excellence among state and local public retirement systems, the Public Pension Standards are the benchmark for measuring defined benefit plans. The purpose of the award is to promote high professional standards for public employee retirement systems and to publicly commend the systems that adhere to the standards of excellence.

The PPCC is a coalition of the National Association of State Retirement Administrators (NASRA), the National Council on Teacher Retirement (NCTR) and the National Conference on Public Employee Retirement Systems (NCPERS).

**Certificate of Achievement for Excellence in
Financial Reporting**

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Virginia Retirement System for its comprehensive annual financial report (CAFR) for the fiscal year ended June 30, 2003. This was the 22nd consecutive year that VRS achieved this prestigious award. To be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized

comprehensive annual report. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe our current comprehensive annual financial report continues to conform to the Certificate of Achievement Program requirements, and we are submitting it to GFOA to determine its eligibility for another certificate.

Acknowledgements

The mission of the Virginia Retirement System calls upon us to provide the best service possible and to be responsible stewards of the funds in our care on behalf of VRS members, retirees and beneficiaries. This report provides complete and reliable information that supports management's decisions in carrying out that mission.

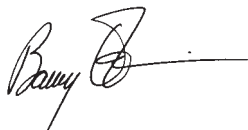
Responsible stewardship, however, is more than sound management. It also encompasses the outstanding commitment of VRS staff to excellence and the support of VRS' affiliated employers and partners as well as the guidance and dedication of the Board of Trustees. We would like to express our sincere thanks and appreciation to each of these exceptional individuals and representatives.

Finally, we wish to thank Governor Mark R. Warner and the members of the Virginia General Assembly for their continued commitment to the financial security of the employees and retirees of the Virginia Retirement System.

Respectfully submitted,



W. Forrest Matthews, Jr.
Director



Barry C. Faison
Chief Financial Officer



FINANCIAL SECTION

Adapting to Change

ACCEPTING THAT CHANGE HAPPENS
AND DOING EVERYTHING POSSIBLE TO
MAKE IT GO WELL.



Commonwealth of Virginia

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

Walter J. Kucharski, Auditor

October 26, 2004

The Honorable Mark R. Warner
Governor of Virginia

The Honorable Lacey E. Putney
Chairman, Joint Legislative Audit
and Review Commission

The Board of Trustees
Virginia Retirement System

INDEPENDENT AUDITOR'S REPORT ON FINANCIAL STATEMENTS

We have audited the accompanying basic financial statements of the Virginia Retirement System, which is an independent agency of the Commonwealth of Virginia, as of and for the years ending June 30, 2004 and 2003, as listed in the Table of Contents. These financial statements are the responsibility of the Virginia Retirement System's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the basic financial statements of the System are intended to present the financial position and the changes in financial position of only that portion of the aggregate remaining fund information of the Commonwealth of Virginia that is attributable to the transactions of the System. They do not purport to, and do not, present fairly the Commonwealth of Virginia's overall financial position as of June 30, 2004 and 2003, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the plan net assets of the Virginia Retirement System as of June 30, 2004 and 2003, and the changes in plan net assets for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis, funding progress, employer contributions, and actuarial methods and significant assumptions on pages 22 through 27 and 46 through 52 are not a required part of the basic financial statements, but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Virginia Retirement System's basic financial statements. The Introductory, Investment, Actuarial, and Statistical Sections as well as the supplementary information listed in the Financial Section of the Table of Contents are presented for the purpose of additional analysis and are not a required part of the basic financial statements. The supplementary information listed in the Financial Section of the Table of Contents has been subjected to the auditing procedures applied by us in the audit of the basic financial statements and, in our opinion based on our audit, is fairly stated in all material respects in relation to the basic financial statements taken as a whole. This Introductory, Investment, Actuarial, and Statistical Sections have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

In accordance with Government Auditing Standards, we have also issued our report dated October 26, 2004, on our consideration of the Virginia Retirement System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

AUDITOR OF PUBLIC ACCOUNTS

Management's Discussion and Analysis

This section presents management's discussion and analysis of the Virginia Retirement System's (the "System") financial statements and the significant events and conditions that affected the operations and performance of the System for the year ended June 30, 2004. It is presented as a narrative overview and analysis. We encourage readers to consider the information presented here in conjunction with additional information that we have furnished in our Letter of Transmittal.

The System is responsible for administering four defined benefit retirement plans—the Virginia Retirement System (VRS) for state employees, public school board employees, employees of participating political subdivisions, and other qualifying employees; the State Police Officers' Retirement System (SPORS) for state police officers; the Virginia Law Officers' Retirement System (VaLORS) for state law enforcement and correctional officers other than state police officers; and the Judicial Retirement System (JRS) for judges of courts of record or district courts of the state and other qualifying employees. All of these plans are defined as pension trust funds. The System also administers a Group Life Insurance Fund, a Retiree Health Insurance Credit Fund, and a Disability Insurance Trust Fund. All of these plans are defined as other employee benefit trust funds. The pension and other employee benefit trust funds are classified as fiduciary funds.

Financial Highlights

- The combined total net assets held in trust for benefits of the Pension Trust Funds increased by \$5,258.3 million, or 15.6% during the fiscal year ended June 30, 2004. The increase was due to significantly improved market returns; however, these were partially offset by the increased expense for benefit payments as a percentage of contributions.
- The System's rate of return on investments during the fiscal year ended June 30, 2004, was 17.9% compared with a return of 2.5% for the fiscal year ended June 30, 2003. The increase is due to greatly improved returns on equity investments.
- The VRS, SPORS, VaLORS, and JRS were actuarially funded at 96.4%, 82.6%, 53.6%, and 81.0% based on the actuarial valuation as of June 30, 2003. For the VRS and SPORS plans, this was a decline from their funded ratios of 101.8% and 85.4% based on the actuarial valuation as of June 30, 2002. For the VaLORS and JRS plans, there is a slight improvement from their June 30, 2002 funded ratios of 51.9% and 79.8%. All of the funded ratios continue to reflect the impact of the

significant investment losses recorded in FY 2001 and FY 2002 on the Actuarial Value of Assets.

Overview of the Financial Statements and Accompanying Information

1. **Fund Financial Statements.** The System presents the Statement of Plan Net Assets as of June 30, 2004 and 2003 and the Statement of Changes in Plan Net Assets for the years then ended. The statements were prepared on the accrual basis of accounting and are used to account for resources administered by the VRS for the benefit of the plan members and beneficiaries. These statements are as follows:
 - Statement of Plan Net Assets – Defined Benefit Pension Trust Funds, Other Employee Benefit Plans and Agency Fund. This statement reflects the balance of the resources available to pay benefits to members, including retirees and beneficiaries, at the end of the fiscal year.
 - Statement of Changes in Plan Net Assets—Defined Benefit Pension Trust Funds and Other Employee Benefit Plans. This reflects the changes in the resources available to pay benefits to members, including retirees and beneficiaries, during the fiscal year.
2. **Notes to Financial Statements.** The Notes to Financial Statements are an integral part of the financial statements and contain additional detailed information and schedules to provide a better understanding of the financial statements.
3. **Required Supplementary Information.** The required supplementary information consists of two schedules and related notes. The required supplementary schedules are as follows:
 - Required Supplemental Schedule of Funding Progress
 - Required Supplemental Schedule of Employer Contributions
 - Notes to Required Supplemental Schedules – Actuarial Methods and Significant Assumptions
4. **Statement of Changes in Assets and Liabilities Agency Fund – Optional Life Insurance Fund**

Virginia Retirement System's Net Assets

(Expressed in Millions)

| | 2004 | Increase (Decrease) | 2003 | Increase (Decrease) | 2002 |
|---|--------------------|------------------------|--------------------|------------------------|--------------------|
| Assets: | | | | | |
| Cash, Receivables and Capital Assets | \$ 2,507.9 | \$ 374.6 | \$ 2,133.3 | \$ 169.9 | \$ 1,963.4 |
| Investments | 40,266.8 | 4,700.0 | 35,566.8 | 492.9 | 35,073.9 |
| Security Lending Collateral | 3,134.8 | 691.4 | 2,443.4 | (322.6) | 2,766.0 |
| Total Assets | \$ 45,909.5 | \$ 5,766.0 | \$ 40,143.5 | \$ 340.2 | \$ 39,803.3 |
| Liabilities: | | | | | |
| Accounts Payable | \$ 241.7 | \$ 17.7 | \$ 224.0 | \$ (257.9) | \$ 481.9 |
| Investment Purchases Payable | 2,491.2 | (281.8) | 2,773.0 | 646.1 | 2,126.9 |
| Obligations Under Security Lending | 3,134.8 | 691.4 | 2,443.4 | (322.6) | 2,766.0 |
| Total Liabilities | \$ 5,867.7 | \$ 427.3 | \$ 5,440.4 | \$ 65.6 | \$ 5,374.8 |
| Total Net Assets | \$ 40,041.8 | \$ 5,338.7 | \$ 34,703.1 | \$ 274.6 | \$ 34,428.5 |

Virginia Retirement System's Change in Net Assets

(Expressed in Millions)

| | 2004 | Increase (Decrease) | 2003 | Increase (Decrease) | 2002 |
|--|-------------------|------------------------|-------------------|------------------------|---------------------|
| Additions: | | | | | |
| Member Contributions | \$ 87.7 | \$ (41.5) | \$ 129.2 | \$ (29.9) | \$ 159.1 |
| Member Contributions paid by Employer | 585.1 | 65.1 | 520.0 | 15.5 | 504.5 |
| Employer Contributions | 626.0 | 124.4 | 501.6 | (61.1) | 562.7 |
| Net Investment Income | 6,101.3 | 5,106.8 | 994.5 | 3,828.4 | (2,833.9) |
| Total Additions | \$ 7,400.1 | \$ 5,254.8 | \$ 2,145.3 | \$ 3,752.9 | \$ (1,607.6) |
| Deductions: | | | | | |
| Retirement Benefits | \$ 1,761.0 | \$ 163.3 | \$ 1,597.7 | \$ 159.9 | \$ 1,437.8 |
| Refunds of Member Contributions | 85.0 | 12.8 | 72.2 | (1.3) | 73.5 |
| Insurance Premiums and Claims | 106.0 | 1.7 | 104.3 | 8.7 | 95.6 |
| Retiree Health Insurance Reimbursements | 64.9 | 3.9 | 61.0 | 3.4 | 57.6 |
| Long Term Disability Benefits | 23.8 | 7.0 | 16.8 | 5.2 | 11.6 |
| Administrative and Other Expenses | 20.7 | 2.0 | 18.7 | (0.6) | 19.3 |
| Total Deductions | \$ 2,061.4 | \$ 190.7 | \$ 1,870.7 | \$ 175.3 | \$ 1,695.4 |
| Net Increase (Decrease) in Net Assets | \$ 5,338.7 | \$ 5,064.1 | \$ 274.6 | \$ 3,577.6 | \$ (3,303.0) |

5. Other Supplementary Schedules. Other schedules are included which provide more detailed information not provided in the basic financial statements. The other supplementary schedules are as follows:

- Schedule of Administrative Expenses
- Schedule of Investment Expenses
- Schedule of Professional and Consulting Services

Analysis of Financial Activities – Pension Plans

The System’s funding objective is to meet its long-term benefit obligations through investment income and contributions. Accordingly, the collection of contributions and the income from investment provide the reserves needed to finance the benefits provided under the plans.

Membership

As discussed earlier, the System administers retirement plans for a variety of employee groups. The distribution of the active membership as of June 30, 2004, 2003, and 2002 is presented below in Figure 1.

Figure 1.
Active Membership Distribution at June 30

| | 2004 | 2003 | 2002 |
|---------------------------------------|----------------|----------------|----------------|
| State Employees (VRS) | 76,911 | 76,161 | 78,655 |
| Teachers (VRS) | 135,130 | 132,656 | 129,795 |
| Political Subdivision Employees (VRS) | 93,436 | 91,340 | 89,588 |
| State Police Officers (SPORS) | 1,751 | 1,709 | 1,745 |
| Virginia Law Officers (VaLORS) | 9,573 | 9,538 | 10,025 |
| Judges (JRS) | 402 | 407 | 406 |
| Total | 317,203 | 311,811 | 310,214 |

Contributions and Investment Earnings

Pension trust fund revenue is used to finance the retirement benefits provided by the retirement plans. The primary sources of revenue for the retirement plans include contributions from both active members and employers, and investment income generated from the investment of plan assets. Total contributions and investment earnings for the fiscal year ended June 30, 2004 amounted to \$7,122.9 million. This was an increase of \$5,111.4 million compared with FY 2003. This is an improvement over the increase of \$3,719.9 million that was recorded in FY 2003. This information is presented below in Figure 2.

Member contributions, including those paid by employers, increased \$23.6 million, while employers’ contributions increased \$119.7 million for a total increase in contributions of \$143.3 million from the prior fiscal year. Investment income also provided an increase to plan net assets in FY 2004. Member contributions paid by members decreased by \$41.5 million. This was caused mostly by the conversion of a large school system from withholding their employees’ contributions on a pre-tax basis to having the school system pay the contributions on behalf of the employees. There was also continued activity among members purchasing previously refunded and other qualified service. Employer contributions increased due to the reinstatement of contributions for state employees in FY 2004. This is discussed further in Note 13 of the Notes to Financial Statements. During FY 2003 the System experienced growth in total member contributions of \$26.8 million and a decline in employer contributions of \$29.4 million. As in FY 2004, the member contributions paid by members were impacted by the number of members purchasing service. The decline in the employer contributions related to the suspension of contributions for state employees in FY 2003.

Figure 2.
Contributions and Investment Earnings for the Years Ended June 30

(Expressed in Millions)

| | 2004 | Increase (Decrease) | 2003 | Increase (Decrease) | 2002 |
|---------------------------------------|-------------------|---------------------|-------------------|---------------------|---------------------|
| Member Contributions | \$ 87.6 | \$ (41.5) | \$ 129.1 | \$ 11.3 | \$ 117.8 |
| Member Contributions Paid by Employer | 585.1 | 65.1 | 520.0 | 15.5 | 504.5 |
| Employer Contributions | 512.4 | 119.7 | 392.7 | (29.4) | 422.1 |
| Investment Income* | 5,937.8 | 4,968.1 | 969.7 | 3,722.5 | (2,752.8) |
| Total | \$ 7,122.9 | \$ 5,111.4 | \$ 2,011.5 | \$ 3,719.9 | \$ (1,708.4) |

* Net of investment expenses, including net securities lending income and miscellaneous income.

Investments

There was net investment income for FY 2004 of \$5,937.8 million. The net investment income increased \$4,968.1 million for FY 2004 (Figure 2). This compares to a net investment income increase of only \$3,722.5 million in FY 2003. Total pension trust fund investments increased to \$39,224.5 million at fair value at June 30, 2004. This was an increase of \$4,639.9 million over the fair value of \$34,584.6 million at June 30, 2003. The total pension trust fund assets also increased in FY 2003 by \$527.9, although not as much, from their fair value of \$34,056.7 at June 30, 2002.

The total return on pension trust fund investments for the fiscal year ended June 30, 2004 was a 17.9%. The annualized return was 3.8% over the past three years and 3.7% over the past five years. An explanation of investment policies and strategies and the portfolio's composition is included in the Investment Section of this CAFR. In addition, a review of investment activity and results for FY 2004 is provided in that section.

The System's investment portfolio consists of funds contributed by both employers and employees of Virginia's state agencies, teachers, state police and law enforcement officers, and many local governments. These contributions are combined in a commingled pool and invested to provide for the payment of current and future benefits to participants when they retire. Each plan owns an equity position in the pool and receives a proportionate share of the total investment income/loss from the pool.

Expenses – Deductions from Plan Net Assets

The primary expenses of the pension trust funds include annuity benefits for retirees and beneficiaries, refunds of contributions to former members, and expenses associated with the administration of the retirement plans. Expenses for FY 2004 totaled \$1,864.6 million, an increase of \$178.0 million, or 10.6%, over the 2003 period. The details are presented below in Figure 3.

The increase in benefit payments to \$1,761.0 million in FY 2004 was due to continued growth in the number of retirees and beneficiaries receiving benefits combined with a cost-of-living adjustment (COLA) of 1.6% on July 1, 2003. The number of retirees and beneficiaries receiving benefit payments increased to approximately 113,717 at June 30, 2004. This is an increase of 4.6% from the 108,758 at June 30, 2003. The increase in benefit payments for FY 2004 was \$163.3 million as compared to \$159.9 million for FY 2003.

Refunds of contributions to members who terminated their employment during FY 2004 amounted to \$85.0 million (15,328 refunds), compared with \$72.2 million (13,148 refunds) refunded during FY 2003 and \$73.5 million (12,902 refunds) refunded during FY 2002. There was an increase in the number of refunds during FY 2004 as well as an overall growth in the total value of those refunds.

Administration and other expenses for FY 2004 were \$18.6 million, compared with \$16.7 million for FY 2003 and \$17.8 million for FY 2002. The increase of \$1.9 million for FY 2004 is the result of an increase in administration expenses due mainly to an increase in staff salaries, related benefit costs (especially the resumption of the employer share of retirement), and other administrative costs.

Figure 3.
Primary Expenses for the Years Ended June 30

(Expressed in Millions)

| | 2004 | Increase (Decrease) | 2003 | Increase (Decrease) | 2002 |
|--------------------------|-------------------|------------------------|-------------------|------------------------|-------------------|
| Benefits | \$ 1,761.0 | \$ 163.3 | \$ 1,597.7 | \$ 159.9 | \$ 1,437.8 |
| Refunds | 85.0 | 12.8 | 72.2 | (1.3) | 73.5 |
| Administration and Other | 18.6 | 1.9 | 16.7 | (1.1) | 17.8 |
| Total | \$ 1,864.6 | \$ 178.0 | \$ 1,686.6 | \$ 157.5 | \$ 1,529.1 |

Retirement Reserves

Funds are derived from the excess of revenues over expenses and are accumulated by the pension plans to meet current and future obligations to retirees and beneficiaries. The higher the level of funding, the larger the accumulation of assets and the greater the investment income potential.

Since revenues exceeded expenses for FY 2004, there was a net increase of \$5,258.3 million in the retirement reserves held by the plans. This compares to an increase of \$324.9 million in the retirement reserves in FY 2003. As noted above, the increase for FY 2004 was primarily related to the significantly improved investment performance for the year. During the fiscal year, the amount of interest credited to member accounts was \$248.2 million. The amount of member balances transferred to employer reserves upon members' retirements was \$341.0 million. The member and employer balances in retirement reserves at June 30, 2004 are presented below in Figure 4.

Actuarial Valuations and Funding Progress

Actuarial valuations of VRS, SPORS, VaLORS, and JRS are performed at least every two years to determine funding requirements by the System's actuarial firm, Gabriel, Roeder, Smith & Company. The funding policy provides for periodic employer contributions at actuarially determined rates that will remain relatively level over time as a percentage of payroll and will accumulate sufficient assets to meet the costs of all basic benefits when due.

The latest valuations of the four pension plans performed as of June 30, 2003 by Gabriel, Roeder, Smith & Company, indicated that the ratio of assets accumulated by the plans to their total actuarial accrued liabilities for benefits were 96.4% for VRS, 82.6% for SPORS, 53.6% for VaLORS, and 81.0% for JRS. The valuations reflect full prefunding of the statutory cost-of-living adjustment (COLA) for retirees. Funding progress for the pension plans is presented in Required Supplemental Schedule of Funding Progress in the Financial Section. Additional information on the plans' funding progress is contained in the Actuarial Section of this CAFR.

Analysis of Financial Activities – Other Employee Plans

Group and Optional Life Insurance Program

The group life insurance program, enacted by the General Assembly on July 1, 1960, provides life insurance and accidental death and dismemberment coverage to the majority of members participating in the System-administered pension plans as well as other qualifying employees. Group life insurance premiums are paid by covered employees and/or employers to fund the program. Approximately 331,897 employees and 106,933 retirees were covered by the group life insurance program at the end of the fiscal year.

The optional life insurance program, enacted by the General Assembly of Virginia on November 1, 1995, provides life insurance and accidental death and dismemberment coverage to employees covered under the group life insurance program as a supplement to that program. Employees may also cover their spouses and children under this program. Optional life insurance premiums are paid by the covered employees. The System collected \$16.7 million in optional life premiums for approximately 51,613 employees during FY 2004. This is a decrease from the \$17.6 million collected from approximately 50,958 employee during FY 2003 and reflects the reductions in premiums for certain age groups during the year.

During FY 2004, the System remitted \$122.8 million to the insurance company for premiums and claims (\$106.0 million for the group life insurance program and \$16.8 million for the optional life insurance program). This is a slight increase over the total premiums and claims of \$121.9 million remitted for FY 2003 and reflects the growth in claims expense in the basic offset by the lower optional insurance premiums noted above. The difference between the amounts collected and paid by the System for the group life insurance program comes out of the reserve established to prefund death benefits for retirees. This reserve had net assets held in trust for benefits of \$778.5 million at June 30, 2004 and experienced investment income (including net securities lending

Figure 4.
Reserve Balances at June 30

(Expressed in Millions)

| | 2004 | Increase (Decrease) | 2003 | Increase (Decrease) | 2002 |
|-------------------|--------------------|------------------------|--------------------|------------------------|--------------------|
| Member Reserves | \$ 6,908.4 | \$ 505.1 | \$ 6,403.3 | \$ 470.6 | \$ 5,932.7 |
| Employer Reserves | 32,130.6 | 4,753.2 | 27,377.4 | (145.7) | 27,523.1 |
| Total | \$ 39,039.0 | \$ 5,258.3 | \$ 33,780.7 | \$ 324.9 | \$ 33,455.8 |

income) of \$133.7 million during the fiscal year. For FY 2003, this reserve had an investment income of \$18.3 million and ended the year with a reserve balance of \$751.7 million down from \$838.6 at June 30, 2002. For FY 2004, the growth is the result of investment income. As was the case in FY 2003, there was a lack of contributions as a result of the premium holiday declared by the General Assembly beginning in April 2002 and continuing through June 30, 2004.

Retiree Health Insurance Credit Program

The retiree health insurance credit program was established by the General Assembly of Virginia on January 1, 1990 and provides credits against health insurance premiums for eligible state retirees. Coverage under the program was extended to retired teachers and employees of participating political subdivisions on July 1, 1993. During FY 2004, the System collected \$78.4 million in retiree health insurance credit contributions from participating employers and provided reimbursements of \$64.9 million to 65,153 eligible retirees. During FY 2003, the System collected \$74.1 million in retiree health insurance credit contributions from participating employers and provided reimbursements of \$61.0 million to approximately 62,196 eligible retirees. The growth in contributions reflects general payroll increases since there were no rate changes during the year. The growth in retiree health insurance credits reflects the increase in the number of eligible retirees. The Retiree Health Insurance Credit Fund reserve had net assets held in trust for benefits of \$120.9 million at June 30, 2004 and experienced investment income (including net securities lending income) of \$15.6 million during the fiscal year. The reserve balances at June 30, 2003 and June 30, 2002 were \$92.2 million and \$76.2 million, respectively.

Virginia Sickness and Disability Program

The Disability Insurance Trust Fund, also known as the Virginia Sickness and Disability Program (VSDP) was established by the General Assembly of Virginia on January 1, 1999 and provides sick leave, family and personal leave and short-term and long-term disability benefits to eligible state employees. The System is responsible for the administration of the program and the payment of the long-term disability benefits. Sick leave and short-term disability benefits are paid to eligible employees directly by the employer. During FY 2004, the System collected \$35.2 million in VSDP contributions from participating employers and provided long-term disability benefits \$23.8 million to eligible employees. This is an increase over the \$34.8 million in contributions collected and \$16.8 million in benefits paid in FY 2003. Contribution growth reflects increases in the covered payroll. There were no contribution rate changes during the year. The increase in benefits reflects growth in the number of employees receiving long-term disability benefits, the amount of those benefits, and the operating costs of the program. The Disability Insurance Trust Fund reserve had net assets held in trust for benefits of \$103.3 million at June 30, 2004 and experienced investment income (including net securities lending income) of \$14.2 million during the fiscal year. The reserve balances at June 30, 2003 and June 30, 2002 were \$78.4 million and \$57.9 million, respectively.

Request for Information

This financial report is designed to provide a general overview of the Virginia Retirement System's finances for all of those with an interest in the System's finances. Questions concerning any of the information provided in this report or requests for additional information should be addressed to the Chief Financial Officer of the Virginia Retirement System, P.O. Box 2500, Richmond, VA 23218-2500.

FINANCIAL SECTION

Virginia Retirement System
Statement of Plan Net Assets –
Defined Benefit Pension Trust Funds,
Other Employee Benefit Trust Funds and Agency Fund

As of June 30, 2004 and 2003

| | Pension Trust Funds | | | | Total Pension Trust Funds |
|---|----------------------------------|---|---|----------------------------------|------------------------------------|
| | Virginia Retirement System | State Police Officers' Retirement System | Virginia Law Officers' Retirement System | Judicial Retirement System | |
| Assets: | | | | | |
| Cash (Note 5)..... | \$ 4,967 | \$ 23 | \$ 24 | \$ 13 | \$ 5,027 |
| Receivables: | | | | | |
| Contributions | 92,182 | 610 | 2,338 | 747 | 95,877 |
| Interest and dividends..... | 80,138 | 1,027 | 1,049 | 573 | 82,787 |
| Receivable for security transactions | 2,148,767 | 27,542 | 28,118 | 15,352 | 2,219,779 |
| Other receivables..... | 6,231 | 60 | 62 | 34 | 6,387 |
| Total receivables..... | 2,327,318 | 29,239 | 31,567 | 16,706 | 2,404,830 |
| Due from other funds..... | 5,885 | 2,305 | 2,329 | 1,831 | 12,350 |
| Investments: (Note 5) | | | | | |
| Bonds and mortgage securities | 6,757,560 | 86,617 | 88,428 | 48,281 | 6,980,886 |
| Stocks | 13,412,668 | 171,921 | 175,515 | 95,829 | 13,855,933 |
| Fixed income commingled funds | 1,155,781 | 14,815 | 15,124 | 8,258 | 1,193,978 |
| Index and pooled funds | 11,059,500 | 141,758 | 144,722 | 79,017 | 11,424,997 |
| Real estate..... | 1,029,870 | 13,201 | 13,477 | 7,358 | 1,063,906 |
| Private equity..... | 1,882,348 | 24,128 | 24,632 | 13,449 | 1,944,557 |
| Hedge Funds | 1,127,350 | 14,450 | 14,752 | 8,055 | 1,164,607 |
| Short-term investments..... | 1,544,556 | 19,797 | 20,211 | 11,034 | 1,595,598 |
| Total investments | 37,969,633 | 486,687 | 496,861 | 271,281 | 39,224,462 |
| Collateral on loaned securities | 2,955,932 | 37,888 | 38,681 | 21,119 | 3,053,620 |
| Property, plant, furniture and equipment (Note 6) | 6,089 | - | - | - | 6,089 |
| Total assets..... | 43,269,824 | 556,142 | 569,462 | 310,950 | 44,706,378 |
| Liabilities: | | | | | |
| Retirement benefits payable..... | 145,596 | 2,191 | 1,805 | 1,786 | 151,378 |
| Refunds payable..... | 5,560 | 19 | 268 | - | 5,847 |
| Accounts payable and accrued expenses | 15,714 | 184 | 188 | 103 | 16,189 |
| Compensated absences payable..... | 1,161 | - | - | - | 1,161 |
| Insurance premiums and claims payable | - | - | - | - | - |
| Payable for security transactions..... | 2,349,115 | 30,110 | 30,740 | 16,784 | 2,426,749 |
| Other payables..... | 1,045 | 7 | 7 | 4 | 1,063 |
| Obligations under security lending program | 2,955,932 | 37,888 | 38,681 | 21,119 | 3,053,620 |
| Due to other funds..... | 11,293 | - | 2 | - | 11,295 |
| Total liabilities | 5,485,416 | 70,399 | 71,691 | 39,796 | 5,667,302 |
| Net assets held in trust for benefits (Note 4) | | | | | |
| (See Required Supplemental Schedule of Funding Progress, page 46.) | \$37,784,408 | \$ 485,743 | \$ 497,771 | \$ 271,154 | \$39,039,076 |

The accompanying notes to financial statements are an integral part of this statement.

FINANCIAL SECTION

(Expressed in Thousands)

| Other Employee Benefit Trust Funds | | | | Agency Fund | Totals | |
|------------------------------------|---------------------------------|---------------------------------|--|------------------------------|---------------------|----------------------|
| Group Life Insurance | Retiree Health Insurance Credit | Disability Insurance Trust Fund | Total Other Employee Benefit Trust Funds | Optional Life Insurance Fund | 2004 | 2003 |
| \$ 40 | \$ 6 | \$ 5 | \$ 51 | \$ 1,604 | \$ 6,682 | \$ 50,609 |
| 1,214 | 5,141 | 1,488 | 7,843 | - | 103,720 | 110,936 |
| 1,734 | 247 | 219 | 2,200 | - | 84,987 | 101,737 |
| 46,485 | 6,629 | 5,875 | 58,989 | - | 2,278,768 | 1,836,743 |
| 102 | 34 | 1,268 | 1,404 | - | 7,791 | 4,542 |
| 49,535 | 12,051 | 8,850 | 70,436 | - | 2,475,266 | 2,053,958 |
| 360 | 5,264 | 12 | 5,636 | 1,815 | 19,801 | 22,509 |
| 146,188 | 20,849 | 18,477 | 185,514 | - | 7,166,400 | 8,313,309 |
| 290,160 | 41,381 | 36,675 | 368,216 | - | 14,224,149 | 8,657,200 |
| 25,003 | 3,566 | 3,160 | 31,729 | - | 1,225,707 | 104,739 |
| 239,253 | 34,121 | 30,240 | 303,614 | - | 11,728,611 | 12,890,439 |
| 22,280 | 3,177 | 2,816 | 28,273 | - | 1,092,179 | 1,098,165 |
| 40,721 | 5,808 | 5,147 | 51,676 | - | 1,996,233 | 2,177,483 |
| 24,388 | 3,478 | 3,083 | 30,949 | - | 1,195,556 | - |
| 33,415 | 4,766 | 4,223 | 42,404 | - | 1,638,002 | 2,325,445 |
| 821,408 | 117,146 | 103,821 | 1,042,375 | - | 40,266,837 | 35,566,780 |
| 63,947 | 9,120 | 8,082 | 81,149 | - | 3,134,769 | 2,443,399 |
| - | - | - | - | - | 6,089 | 6,270 |
| 935,290 | 143,587 | 120,770 | 1,199,647 | 3,419 | 45,909,444 | \$40,143,525 |
| - | - | - | - | - | 151,378 | 138,221 |
| 95 | 93 | 162 | 350 | - | 6,197 | 7,341 |
| 312 | 5,516 | 2,089 | 7,917 | - | 24,106 | 17,107 |
| - | - | - | - | - | 1,161 | 1,167 |
| 34,900 | - | - | 34,900 | 3,059 | 37,959 | 36,715 |
| 50,819 | 7,248 | 6,423 | 64,490 | - | 2,491,239 | 2,773,030 |
| 11 | 2 | 1 | 14 | - | 1,077 | 937 |
| 63,947 | 9,120 | 8,082 | 81,149 | - | 3,134,769 | 2,443,399 |
| 6,742 | 713 | 691 | 8,146 | 360 | 19,801 | 22,509 |
| 156,826 | 22,692 | 17,448 | 196,966 | 3,419 | 5,867,687 | 5,440,426 |
| \$ 778,464 | \$ 120,895 | \$ 103,322 | \$ 1,002,681 | \$ - | \$40,041,757 | \$ 34,703,099 |

Virginia Retirement System
Statement of Changes in Plan Net Assets -
Defined Benefit Pension Trust Funds and Other Employee Benefit Trust Funds

For the Years Ended June 30, 2004 and 2003

| | Pension Trust Funds | | | | Total Pension Trust Funds |
|--|----------------------------------|---|---|----------------------------------|------------------------------------|
| | Virginia Retirement System | State Police Officers' Retirement System | Virginia Law Officers' Retirement System | Judicial Retirement System | |
| Additions: | | | | | |
| Contributions: | | | | | |
| Members..... | \$ 85,769 | \$ 790 | \$ 880 | \$ 197 | \$ 87,636 |
| Member paid by employers..... | 564,020 | 4,037 | 14,703 | 2,371 | 585,131 |
| Employers..... | 446,084 | 10,405 | 40,709 | 15,190 | 512,388 |
| Total contributions..... | 1,095,873 | 15,232 | 56,292 | 17,758 | 1,185,155 |
| Investment income: | | | | | |
| Net appreciation/(depreciation) in fair value of investments..... | 5,305,412 | 68,242 | 65,189 | 37,773 | 5,476,616 |
| Interest, dividends and other investment income..... | 554,731 | 7,135 | 6,816 | 3,950 | 572,632 |
| Total investment income before investment expenses..... | 5,860,143 | 75,377 | 72,005 | 41,723 | 6,049,248 |
| Investment expenses..... | (119,070) | (1,531) | (1,463) | (849) | (122,913) |
| Net investment income..... | 5,741,073 | 73,846 | 70,542 | 40,874 | 5,926,335 |
| Security lending income: | | | | | |
| Gross income..... | 35,607 | 458 | 438 | 254 | 36,757 |
| Less: Borrower rebates and agent fees..... | (25,403) | (327) | (312) | (181) | (26,223) |
| Net security lending income..... | 10,204 | 131 | 126 | 73 | 10,534 |
| Miscellaneous revenue..... | 908 | - | - | - | 908 |
| Total additions..... | 6,848,058 | 89,209 | 126,960 | 58,705 | 7,122,932 |
| Deductions: | | | | | |
| Retirement benefits..... | 1,692,166 | 26,336 | 19,784 | 22,706 | 1,760,992 |
| Refunds of member contributions..... | 80,237 | 731 | 3,998 | - | 84,966 |
| Insurance premiums and claims..... | - | - | - | - | - |
| Retiree health insurance reimbursements..... | - | - | - | - | - |
| Long term disability benefits..... | - | - | - | - | - |
| Administrative expenses..... | 18,119 | 213 | 196 | 117 | 18,645 |
| Other expenses..... | - | - | - | - | - |
| Total operating expenses..... | 1,790,522 | 27,280 | 23,978 | 22,823 | 1,864,603 |
| Transfers..... | (10) | - | 10 | - | - |
| Net increase (decrease)..... | 5,057,526 | 61,929 | 102,992 | 35,882 | 5,258,329 |
| Net assets held in trust for benefits - Beginning of year..... | 32,726,882 | 423,814 | 394,779 | 235,272 | 33,780,747 |
| Net assets held in trust for benefits - End of year..... | \$37,784,408 | \$ 485,743 | \$ 497,771 | \$ 271,154 | \$39,039,076 |

The accompanying notes to financial statements are an integral part of this statement.

FINANCIAL SECTION

(Expressed in Thousands)

| Other Employee Benefit Trust Funds | | | Totals | | |
|------------------------------------|---------------------------------|---------------------------------|--|---------------------|---------------------|
| Group Life Insurance | Retiree Health Insurance Credit | Disability Insurance Trust Fund | Total Other Employee Benefit Trust Funds | 2004 | 2003 |
| \$ 12 | \$ - | \$ - | \$ 12 | \$ 87,648 | \$ 129,174 |
| - | - | - | - | 585,131 | 519,954 |
| 8 | 78,383 | 35,247 | 113,638 | 626,026 | 501,687 |
| 20 | 78,383 | 35,247 | 113,650 | 1,298,805 | 1,150,815 |
| 123,349 | 14,375 | 13,097 | 150,821 | 5,627,437 | 411,449 |
| 12,897 | 1,503 | 1,369 | 15,769 | 588,401 | 671,074 |
| 136,246 | 15,878 | 14,466 | 166,590 | 6,215,838 | 1,082,523 |
| (2,768) | (323) | (293) | (3,384) | (126,297) | (102,219) |
| 133,478 | 15,555 | 14,173 | 163,206 | 6,089,541 | 980,304 |
| 828 | 96 | 88 | 1,012 | 37,769 | 45,885 |
| (591) | (69) | (63) | (723) | (26,946) | (34,436) |
| 237 | 27 | 25 | 289 | 10,823 | 11,449 |
| - | - | - | - | 908 | 2,682 |
| 133,735 | 93,965 | 49,445 | 277,145 | 7,400,077 | 2,145,250 |
| - | - | - | - | 1,760,992 | 1,597,735 |
| - | - | - | - | 84,966 | 72,150 |
| 106,031 | - | - | 106,031 | 106,031 | 104,275 |
| - | 64,920 | - | 64,920 | 64,920 | 61,027 |
| - | - | 23,835 | 23,835 | 23,835 | 16,780 |
| 615 | 372 | 671 | 1,658 | 20,303 | 18,428 |
| 372 | - | - | 372 | 372 | 276 |
| 107,018 | 65,292 | 24,506 | 196,816 | 2,061,419 | 1,870,671 |
| - | - | - | - | - | - |
| 26,717 | 28,673 | 24,939 | 80,329 | 5,338,658 | 274,579 |
| 751,747 | 92,222 | 78,383 | 922,352 | 34,703,099 | 34,428,520 |
| \$ 778,464 | \$ 120,895 | \$ 103,322 | \$ 1,002,681 | \$40,041,757 | \$34,703,099 |

Notes to Financial Statements

June 30, 2004 and 2003

1. Summary of Significant Accounting Policies**A. The Financial Reporting Entity**

The Virginia Retirement System (the "System") is an independent agency of the Commonwealth of Virginia that administers defined benefit pension plans, other employee benefit plans, and other funds established by the Commonwealth. The System is included in the basic financial statements of the Commonwealth of Virginia. As required by generally accepted accounting principles (GAAP), these financial statements include all of the funds for which financial transactions are recorded in the System's accounting system and for which its Board of Trustees exercises administrative responsibility.

Defined Benefit Pension Plans:

Virginia Retirement System (VRS)
 State Police Officers' Retirement System (SPORS)
 Virginia Law Officers' Retirement System (VaLORS)
 Judicial Retirement System (JRS)

Other Employee Benefit Plans:

Group Life Insurance Fund
 Retiree Health Insurance Credit Fund
 Disability Insurance Trust Fund
 (also known as the Virginia Sickness and Disability Program [VSDP])

Agency Fund:

Optional Life Insurance Fund

Effective January 1, 1997, the Constitution of Virginia was amended to strengthen the independence of the Virginia Retirement System and to protect its funds by requiring that they be separate and independent trust funds segregated from all other funds of the Commonwealth and administered solely in the interest of the members and beneficiaries thereof.

B. Administration

The responsibility for general administration and operation of the defined benefit pension plans, other employee benefit plans, and other funds is vested in the Board of Trustees. The board consists of five members appointed by the Governor and four members appointed by the Joint Rules Committee, all subject to confirmation by the General Assembly of Virginia. A director is appointed by the Board of Trustees to serve as the chief administrative officer of

the retirement systems. A chief investment officer is employed by the board to direct, manage, and administer the investment of the System's funds. Full power to invest and reinvest the assets of the defined benefit pension plans, other employee benefit plans, and other funds is vested in the board. The Board of Trustees has appointed Mellon Trust as the custodian of designated assets of the System.

The Virginia Retirement System, the State Police Officers' Retirement System, the Virginia Law Officers' Retirement System, and the Judicial Retirement System are administered in accordance with Title 51.1, Chapters 1, 2, 2.1, 3, and 4 of the *Code of Virginia* (1950), as amended.

The Group Life Insurance Fund, the Retiree Health Insurance Credit Fund, and the Disability Insurance Trust Fund are administered in accordance with Title 51.1, Chapter 5; Title 51.1, Chapter 14; and Title 51.1, Chapter 11, respectively, of the *Code of Virginia* (1950), as amended.

The Optional Life Insurance Fund is administered in accordance with Section 51.1-512 and 51.1-512.1 of the *Code of Virginia* (1950), as amended.

Other programs of the Commonwealth of Virginia for which the Board of Trustees has oversight responsibility but has little administrative involvement and does not perform the investment function include the following: the Commonwealth's Deferred Compensation Plan (IRC Section 457) and its Cash Match Plan for state employees and employees of participating political subdivisions; Defined Contribution Plans for political appointees, employees of institutions of higher education, and certain employees of public school divisions and teaching hospitals; the Commonwealth Health Research Fund, which provides financial support for research efforts that may maximize human health benefits for citizens of the Commonwealth; and the Volunteer Firefighters' and Rescue Squad Worker's Service Award Fund, which provides service awards to eligible volunteer firefighters and rescue squad workers. Because the Board of Trustees has a limited administrative role for these programs (it neither owns the assets nor does it have custody of them) and their financial transactions are not recorded in the System's accounting system, these programs are not included in the System's financial statements.

C. Basis of Accounting

The accounts of the defined benefit pension plans and the other employee benefit plans, are accounted for and presented using the flow of economic resources measurement focus and the accrual basis of accounting. Under the accrual basis, revenues are recognized when earned and expenses are recognized when the liability is incurred, regardless of the timing of related cash flows. Employee and employer contributions are recognized as revenues in the period in which employee services are performed and investment income is recognized as earned by the plans. Benefits and refunds are recognized when due and payable in accordance with the terms of the plans.

The agency fund is accounted for using the accrual basis of accounting; however, because it is purely custodial, it does not recognize revenues and expenditures and does not have a fund balance. The agency fund accounts for assets received and disbursed by the System in its capacity as an agent for the Commonwealth of Virginia.

D. Investments**1. Investment Valuation**

Investments are reported at fair value as determined by the System's master custodian, Mellon Trust, from its Global Pricing System. This system assigns a price source, based on asset type and the vendor pricing products to which the master custodian subscribes, for every security held immediately following its acquisition. Prices supplied by these sources are monitored daily by the master custodian.

When a pricing source is unable to provide a price, quotes are sought from major investment brokers and market-making dealers, or internal calculations are applied if feasible. As a last resort, the master custodian will contact investment managers for a price. Commingled funds, partnerships, and real estate assets are priced by the master custodian from statements received from the funds, partnerships, or investment managers.

The pricing sources used by the master custodian provide daily prices for equity securities; corporate, government, and mortgage-backed fixed income securities; private placement securities; futures and options on futures; open-ended funds; and foreign exchange rates. Depending on the vendor, collateralized mortgage obligations (CMOs), adjustable rate mortgages

(ARMs), and asset-backed securities are priced either daily, weekly, or twice a month and at month end. Municipal fixed income securities and options on U.S. Treasury/GNMA securities are priced at month end.

2. Investment Transactions and Income

Security transactions and related gains and losses are recorded on a trade date basis. The cost of investments sold is the average cost of the aggregate holding of the specific investment sold. Dividend income is recorded on the ex-dividend date, and interest income is accrued as earned. Futures contracts are valued daily, with the resulting adjustments recorded as realized gains or losses arising from the daily settlement of variation margin. Gains and losses related to forward contracts and options are recognized at the time the contracts are settled. Investments in limited partnerships are accounted for on the equity method of accounting, and their earnings (losses) for the period are included in investment income using the equity method.

E. Property, Plant, Furniture, and Equipment

Capital assets are recorded at cost at the time of acquisition and are reported net of accumulated depreciation. The System capitalizes all property, plant, and equipment that have a cost or value greater than \$5,000. Depreciation is computed on the straight-line basis over the estimated useful life of the property, ranging from 5 to 40 years.

F. Accumulated Vacation, Sick Leave, and Disability Credits

Employees of the System participate in the Commonwealth's accumulated vacation program and in either its sick leave or the Virginia Sickness and Disability Program (VSDP), which is administered by the System. Unused vacation may be accumulated and is paid at the time of permanent separation from service up to the maximum calendar year limit. Unused sick leave may be accumulated. If the member is vested, unused sick leave is paid at the rate of 25% of the amount accumulated not to exceed \$5,000 at the time of permanent separation from service. Unused VSDP disability credits converted from unused sick leave are paid in the same manner as unused sick leave at the time of permanent separation. The accrued liability for unused vacation, sick leave, or disability credits reflected in the accompanying statements at June 30, 2004 and 2003 was computed using salary rates in effect at those times and represents vacation and sick leave earned

up to the allowable ceilings as well as unused, converted disability credits.

G. Administrative Expenses and Budget

The administrative expenses related to the System’s administration and trust fund management activities are approved by the Board of Trustees and included in a budget prepared in compliance with the Commonwealth’s biennial budgetary system (cash basis). Appropriations are controlled at the program level and lapse at the end of the fiscal year. Administrative expenses are funded exclusively from investment income. Expenses for goods and services received but not paid for prior to the System’s fiscal year-end are accrued for financial reporting purposes in accordance with generally accepted accounting principals (GAAP). A reconciliation of the difference between the GAAP basis and budgeted basis is presented in the Schedule of Administrative Expenses.

H. Investment Income Allocation

Income earned on investments is distributed monthly to the Virginia Retirement System, the State Police Officers’ Retirement System, the Virginia Law Officers’ Retirement System, the Judicial Retirement System, the Group Life Insurance Fund, the Retiree Health Insurance Credit Fund, and the Disability Insurance Trust Fund. Distribution of investment income is based on the respective equity of each trust fund in the common investment pool.

The retirement plans distribute their cumulative investment income, net of administrative expenses, in the following manner:

1. Investment income is distributed to each of the individual member accounts based on a rate of 4% applied to each member’s cumulative balance as of the close of the preceding fiscal year.
2. The remaining portion is allocated quarterly to the participating employer accounts based on the ratio of their member account and employer account balances to the total of all such balances.

2. Plan Description

A. Retirement Plans

The Virginia Retirement System (System) was established on March 1, 1952, as the administrator of the Virginia Retirement System (VRS), a qualified governmental retirement plan, that provides defined benefit coverage for state employees, public school board employees, employees of participating political subdivisions, and other qualifying employees. The

VRS is a mixed agent and cost-sharing, multiple-employer retirement plan. The plan’s accumulated assets may legally be used to pay all plan benefits provided to any of the plan members or beneficiaries.

The System also administers single-employer retirement plans for state police officers, who are covered under a separate State Police Officers’ Retirement System (SPORS) established on July 1, 1950; state law enforcement and correctional officers other than state police officers, who are covered under the Virginia Law Officers’ Retirement System (VaLORS) established on October 1, 1999; and judges of a court of record or a district court of the state and other qualifying employees, who are covered under the Judicial Retirement System (JRS) established on July 1, 1970.

At June 30, 2004 and 2003, the distribution of participating employers in the VRS was as follows:

| VRS Employers | | |
|------------------------|------------|------------|
| | 2004 | 2003 |
| Cities and Towns | 151 | 149 |
| Counties | 92 | 92 |
| School Boards* | 145 | 145 |
| Special Authorities | 176 | 172 |
| State Agencies | 234 | 240 |
| Total employers | 798 | 798 |

* Of the 145 school boards, 131 also provide coverage for their nonprofessional employees and are treated as political subdivisions by the System.

All full-time, salaried, permanent employees of participating employers must participate in VRS, SPORS, VaLORS, or JRS, with these exceptions: (1) certain full-time faculty and administrative staff of state colleges and universities and (2) eligible classified employees of the two state teaching hospitals. These employees have the option not to participate in the systems. Benefit provisions and all other requirements are established by Title 51.1 of the *Code of Virginia* (1950), as amended.

Benefits vest after five years of service. Employees are eligible for an unreduced retirement benefit at age 65 if they have five years of service (age 60 for participating law enforcement officers and firefighters) or at age 50 with at least 30 years of service if elected by the employer (age 50 with at least 25 years of service for participating law enforcement officers and firefighters). Employees

Membership Figures at June 30

| | 2004 | | | | TOTAL | 2003 |
|--|----------------|--------------|--------------|------------|----------------|----------------|
| | VRS | SPORS | VaLORS | JRS | | TOTAL |
| Retirees and beneficiaries receiving benefits | 111,484 | 866 | 979 | 388 | 113,717 | 108,758 |
| Terminated employees entitled to benefits but not yet receiving them | 27,538 | 67 | 254 | 13 | 27,872 | 26,783 |
| Total | 139,022 | 933 | 1,233 | 401 | 141,589 | 135,541 |
| Active plan participants: | | | | | | |
| Vested | 196,178 | 1,392 | 6,540 | 323 | 204,433 | 198,193 |
| Nonvested | 109,299 | 359 | 3,033 | 79 | 112,770 | 113,618 |
| Total | 305,477 | 1,751 | 9,573 | 402 | 317,203 | 311,811 |

The table above shows membership in VRS, SPORS, VaLORS, and JRS at at June 30, 2004 and 2003.

may retire with a reduced benefit at age 50 if they have at least 10 years of credited service or at age 55 (age 50 for participating law enforcement officers and firefighters) if they have at least five years of credited service.

Annual retirement benefits are payable monthly for life in an amount equal to 1.7 % of their average final salary (AFS) for each year of credited service. AFS is defined as the highest consecutive 36 months of salary. Benefits are actuarially reduced for members who retire prior to becoming eligible for full retirement benefits. Members of SPORS and VaLORS and participating law enforcement officers and firefighters may receive a monthly benefit supplement if they retire prior to age 65. Members of VaLORS hired before July 1, 2001 were allowed to make a one-time election to increase the multiplier from 1.7% to 2.0% instead of receiving the supplement. Members of VaLORS hired after June 30, 2001 have their benefit computed using the 2.0% multiplier and are not eligible for the supplement. Members of JRS receive weighted years of creditable service for each year of actual service under JRS. VRS, SPORS, VaLORS, and JRS also provide death and disability benefits. Cost-of-living increases, based on changes in the Consumer Price Index and limited to 5% per year, are granted in the second year of retirement and in every year thereafter.

Employees are required by Title 51.1 of the *Code of Virginia* (1950), as amended, to contribute 5% of their annual salary to the retirement plans. This 5% member contribution may be assumed by the employer. If an employee leaves covered employment, the accumulated contributions plus earned interest may be refunded to the employee. Each participating employer is required by state statute to contribute the

remaining amounts necessary to fund the retirement plans using the Entry Age Normal actuarial cost method adopted by the Board of Trustees. State statute may be amended only by the General Assembly of Virginia.

B. Group and Optional Life Insurance Programs

The Group Life Insurance Fund was established on July 1, 1960, for state employees, teachers, employees of political subdivisions participating in the VRS; state police officers; other state law enforcement and correctional officers; judges; and other qualifying employees. The program provides life insurance for natural death coverage equal to an employee's annual salary rounded to the next highest \$1,000, and then doubled. Accidental death coverage is double the natural death coverage. The program also provides coverage for accidental dismemberment and accidental blindness as well as an accelerated death benefit for terminal conditions. Approximately 331,897 employees and 106,933 retirees were covered under the program at June 30, 2004.

Employees who retire or terminate from service after age 50 with at least 10 years of service (including five years of continuous service) or at age 55 with at least five years of continuous service (age 50 for state police officers, other state law enforcement and correctional officers, and participating law enforcement officers and firefighters of political subdivisions), or who retire because of disability, are entitled to post-employment life insurance benefits. At retirement or termination, accidental benefits cease, and natural death coverage reduces at a rate equal to 25% on January 1 of the first full year following retirement or termination and each year thereafter, until it reaches 25% of its original value. These group life insurance benefit provisions and

requirements are established by Title 51.1 of the *Code of Virginia* (1950), as amended.

Participating employers and their covered employees are required by Title 51.1 of the *Code of Virginia* (1950), as amended, to contribute to the cost of group life insurance benefits. Retirees are not required to contribute, and employers may assume the employees' contributions.

Contribution requirements are determined on the aggregate actuarial cost method adopted by the Board of Trustees. Since 1960, when the group life insurance program was first established, a portion of the premium contributions collected during employees' active careers has been placed in an Advance Premium Deposit Reserve, which was established to prefund death benefits to members after retirement.

An Optional Group Life Insurance Fund was established on November 1, 1995 for all employees currently covered under the basic group life program as a supplement to that plan. Employees may also purchase optional life insurance on their spouses and children. The optional program provides natural death coverage for the employee equal to one, two, three, or four times annual salary rounded to the next highest \$1,000, up to a maximum of \$500,000. Spouse coverage is available up to one-half of the employee's optional insurance amount, and children can be insured for \$8,000, \$16,000, or \$24,000, depending on the option chosen by the employee. An additional accidental death and dismemberment benefit is payable for death or bodily injuries. Approximately 51,613 employees were covered under this program at June 30, 2004.

Optional group life insurance coverage ends for employees when they retire, or terminate their employment, or when their basic coverage ends. Employees who retire for disability may continue their optional coverage until age 65 provided they continue to pay the required insurance premiums. Spouse coverage terminates should a couple divorce or when the employee leaves employment. Children's coverage ends with the termination of the employee's coverage or when the child marries or turns 21 years of age (25 years of age for full-time college students).

Premiums for optional life insurance coverage are the responsibility of the covered employees and are deducted from their salaries by their employers as required by Title 51.1 of the *Code of Virginia* (1950), as amended. Premium requirements are based on the

age of the covered employee and are determined by the Board of Trustees.

C. Retiree Health Insurance Credit Program

The Retiree Health Insurance Credit Fund was established on January 1, 1990 and provides benefits for retired state employees, state police officers, other state law enforcement and correctional officers, and judges who have at least 15 years of creditable service under the retirement plans. The program provides a maximum credit reimbursement of \$120.00 against the monthly health insurance premiums of eligible retirees.

A similar program was established on July 1, 1993 to provide benefits for retired teachers and employees of participating local governments with at least 15 years of creditable service under the retirement plans. Retired teachers may receive a monthly credit ranging from a maximum of \$75.00 to \$105.00, and local government retirees may receive a maximum credit of \$45.00.

Benefit provisions and eligibility requirements are established by Title 51.1, Chapter 14 of the *Code of Virginia* (1950), as amended. The amount required to fund all credits is financed on a current disbursement basis by the employers based on contribution rates determined by the System's actuary. Approximately 65,153 retired employees were covered under this program at June 30, 2004.

D. Virginia Sickness and Disability Program

The Disability Insurance Trust Fund, also known as the Virginia Sickness and Disability Program (VSDP), was established on January 1, 1999 and provides benefits for all full-time, classified state employees hired on or after January 1, 1999. Classified state employees includes state police officers and other state law enforcement and correctional officers. Part-time, classified state employees who work at least 20 hours a week on a salaried basis and who accrue leave are also covered. Eligible state employees and state police officers of the Commonwealth employed prior to January 1, 1999 had the option during an open enrollment period to elect to participate in the VSDP or to remain under the Commonwealth's existing sick leave program and retain their eligibility for disability retirement benefits under VRS and SPORS. Eligible employees enrolled in VSDP are not eligible for disability retirement benefits under the VRS, SPORS, or VaLORS.

Teaching, administrative, and research faculty of Virginia institutions of higher education hired or appointed on or after January 1, 1999 who elected VRS as their retirement plan must make an irrevocable election to participate in the VSDP or in the institution's disability program. If there is no institution program, the faculty member is covered under the VSDP.

By providing sick leave, family and personal leave, and short-term and long-term disability benefits, the VSDP gives its members income protection from their very first day on the job. After a seven-calendar-day waiting period following the first incident of disability, full-time and eligible part-time classified employees receive short-term disability benefits from 60% to 100% of compensation, for a maximum of 125 work days, based on months of state service. After a 180-calendar-day waiting period (125 work days of short-term disability), full-time and eligible part-time classified employees receive long-term disability benefits equal to 60% of compensation until they return to work, until age 65 (age 60 for state police officers and other state law enforcement and correctional officers), or until death. Approximately 64,715 employees were covered under the program at June 30, 2004.

State agencies are required by Title 51.1 of the *Code of Virginia* (1950), as amended, to contribute to the cost of providing long-term disability benefits and of administering the program. Initial contribution requirements to fund the program were determined by the System's actuary using an estimate of the amount of liability for disability benefits that would transfer from VRS, SPORS, and VaLORS to VSDP for the anticipated participants in VSDP.

3. Contributions – Retirement Plans

The funding policy of the retirement plans provides for periodic employer contributions at actuarially determined rates, which will remain relatively level

over time as a percentage of payroll and will accumulate sufficient assets to meet the cost of all basic benefits when due. Contribution rates are developed using the entry age normal cost method for both normal cost and amortization of the unfunded actuarial accrued liability. Gains and losses are reflected in the unfunded actuarial accrued liability that is being amortized as a level percentage of payroll within 30 years or less.

The amount of contributions to be provided by employers for state employees, each participating political subdivision, the State Police Officers' Retirement System, the Virginia Law Officers' Retirement System, and the Judicial Retirement System for FY 2004 and FY 2003 was actuarially computed by Gabriel, Roeder, Smith & Company during their valuation as of June 30, 2001. In addition, a separate contribution requirement was computed for the teacher cost-sharing pool by the actuary for each year.

Contributions totaling \$1,185,155,000 and \$1,041,835,000 for the fiscal years ended June 30, 2004 and 2003, respectively, were made by employers and employees in accordance with statutory requirements. These contributions covered employers' normal costs and amortization of unfunded actuarial accrued liabilities.

Total employer contributions were \$512,388,000 for FY 2004. Included in total employer contributions were \$1,086,000 from school boards for payments toward the Early Retirement Program costs and \$13,145,000 from state agencies for payments toward Workforce Transition Act (WTA) costs. Included in the employee contributions of \$87,636,000 were \$83,378,000 paid for the purchase of previously refunded service and other qualifying service.

Employer contributions to the VRS cost-sharing pool for teachers represented 3.77% of covered payrolls.

Contributions for the Years Ending June 30

(Expressed in Thousands)

| | 2004 | | | | | 2003 |
|---|--------------------|------------------|------------------|------------------|--------------------|--------------------|
| | VRS | SPORS | VaLORS | JRS | TOTAL | TOTAL |
| Employer contributions | \$ 446,084 | \$ 10,405 | \$ 40,709 | \$ 15,190 | \$ 512,388 | \$ 392,732 |
| Employee contributions paid by employer | 564,020 | 4,037 | 14,703 | 2,371 | 585,131 | 519,954 |
| Employee contributions | 85,769 | 790 | 880 | 197 | 87,636 | 129,149 |
| Total contributions | \$1,095,873 | \$ 15,232 | \$ 56,292 | \$ 17,758 | \$1,185,155 | \$1,041,835 |

Additionally, the employer contributions to VRS by the state for state employees was 3.77% of covered payroll, and each political subdivision's contributions ranged from zero (0.00%) to 22.00% of covered payrolls. Employer contributions to SPORS by the state represented 12.79%, employer contributions to VaLORS by the state represented 13.95%, and employer contributions to JRS by the state represented 32.03% of covered payrolls. Employee contributions represented 5.00% of covered payrolls. Employer and employee contributions are required by Title 51.1 of the *Code of Virginia* (1950), as amended.

In addition to determining contribution requirements, the actuarial computations present an estimate of the discounted present value of the prospective accrued liability contributions that will have to be paid by employers in the future so that such contributions, together with the assets on hand, the normal contributions to be made in the future by employers and employees, and the income generated by investing the funds will be sufficient to provide all benefits to be paid to present members in the future as well as to annuitants and their designated beneficiaries. Historical trend information designed to provide information

about the System's progress in accumulating sufficient assets to pay benefits when due is presented in the Required Supplemental Schedule of Funding Progress.

4. Reserve Accounts

The reserve account balances available for benefits at June 30, 2004 and 2003 are presented in the table shown below. These funds are required by Titles 51.1 and 2.1 of the *Code of Virginia* (1950), as amended, to provide for the payment of current and future benefits.

Member and employer reserves are funded by member and employer contributions and investment income. Each member has an account that accumulates member contributions plus annual interest. Each employer has an account that accumulates employer contributions, transfers of investment income reduced by the administrative expenses incurred in operating the retirement plans, and transfers of member contributions and interest upon a member's retirement. Employer accounts are charged with benefit payments. The Advance Premium Deposit Reserve accumulates a portion of insurance premium contributions collected during an employee's active career and investment earnings thereon and is charged for death benefits paid

Reserve Balances Available for Benefits at June 30

(Expressed in Thousands)

| | 2004 | 2003 |
|---|----------------------|----------------------|
| Virginia Retirement System: | | |
| Member Reserve | \$ 6,675,417 | \$ 6,183,699 |
| Employer Reserve | 31,108,991 | 26,543,183 |
| Total VRS | 37,784,408 | 32,726,882 |
| State Police Officers' Retirement System: | | |
| Member Reserve | 62,070 | 59,681 |
| Employer Reserve | 423,673 | 364,133 |
| Total SPORS | 485,743 | 423,814 |
| Virginia Law Officers' Retirement System: | | |
| Member Reserve | 143,047 | 133,041 |
| Employer Reserve | 354,724 | 261,738 |
| Total VaLORS | 497,771 | 394,779 |
| Judicial Retirement System: | | |
| Member Reserve | 27,900 | 26,865 |
| Employer Reserve | 243,254 | 208,407 |
| Total JRS | 271,154 | 235,272 |
| Group Life Insurance: | | |
| Advance Premium Deposit Reserve | 778,464 | 751,747 |
| Retiree Health Insurance Credit Reserve | 120,895 | 92,222 |
| Virginia Sickness and Disability Program: | | |
| Disability Insurance Trust Fund | 103,322 | 78,383 |
| Total Pension and Other Employee Benefit Reserve | \$ 40,041,757 | \$ 34,703,099 |

and expenses incurred in operating the group life insurance program.

The Retiree Health Insurance Credit Reserve is funded by employer contributions and investment income. It is charged for credit reimbursements applied to the monthly health insurance premiums of eligible retired employees and for expenses incurred in operating the Retiree Health Insurance Credit Fund program.

The Disability Insurance Trust Fund is funded by employer contributions and investment income. It is charged for long-term disability benefits and for expenses incurred in operating the Virginia Sickness and Disability Program.

5. Deposits and Investments

A. Deposits

Deposits of the System that are maintained by the Treasurer of Virginia at June 30, 2004 and 2003 were entirely insured under the Virginia Security for Public Deposits Act, Section 2.2-4400 et seq. of the *Code of Virginia* (1950), as amended, which provides for an assessable multiple financial institution collateral pool. Deposits with the System's master custodian, Mellon Trust, were entirely insured by federal depository insurance coverage.

The carrying amounts of these deposits at June 30, 2004 and 2003 consisted of the following (in thousands):

| | 2004 | 2003 |
|-----------------------|-----------------|------------------|
| Deposits | Carrying Amount | Carrying Amount |
| Treasurer of Virginia | \$ 6,453 | \$ 48,257 |
| Master Custodian | 229 | 2,352 |
| Total Deposits | \$ 6,682 | \$ 50,609 |

B. Investments

1. Authorized Investments

The Board of Trustees of the System has full power to invest and reinvest the trust funds in accordance with Section 51.1-124.30 of the *Code of Virginia* (1950), as amended. This section requires the board to discharge its duties solely in the interest of the beneficiaries and to invest the assets with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. The board must

also diversify such instruments so as to minimize the risk of large losses unless, under the circumstances, it is clearly prudent not to do so. There is no concentration of investments in any one organization that represents 5% or more of plan net assets available for benefits.

Investment value and earnings of the investment pool are proportionally allocated among the System's trust funds on the basis on each fund's equity interest in the common investment pool. An Investment Summary is included in the Investment Section of this report. As of June 30, 2004 and 2003, the equity interests of each fund were as follows:

| | 2004 | 2003 |
|--|----------------|----------------|
| • Virginia Retirement System | 94.27% | 94.22% |
| • State Police Officers' Retirement System | 1.21% | 1.22% |
| • Virginia Law Officers' Retirement System | 1.24% | 1.13% |
| • Judicial Retirement System | 0.68% | 0.67% |
| • Group Life Insurance Fund | 2.04% | 2.27% |
| • Retiree Health Insurance Credit Fund | 0.30% | 0.27% |
| • Disability Insurance Trust Fund | 0.26% | 0.22% |
| Total | 100.00% | 100.00% |

2. Custodial Risk

Investments held by the System at June 30, 2004 have been categorized according to the level of credit risk associated with its custodial arrangements at fiscal year-end. Category 1 includes investments that are insured or registered or for which securities are held by the System or its agent in the System's name. Category 2 includes uninsured and unregistered investments for which securities are held by the counterparty's trust department or agent in the System's name. Category 3 includes uninsured and unregistered investments for which securities are held by the counterparty, or by its trust department or agent, but not in the System's name. Certain investments cannot be categorized because they are not evidenced by physical securities. Securities lent at year-end for cash collateral are presented as unclassified, while securities lent for non-cash collateral are classified according to their custodial arrangements for the related non-cash collateral securities. The cash collateral is invested in instruments, such as commercial paper, repurchase agreements, asset-backed securities, certificates of deposit, and floating rate notes, in an agent-managed separate account.

Summary of Categorized Investments at Fair Value

As of June 30, 2004

(Expressed in Thousands)

| | Category | | | Non-Categorized | Total Fair Value at June 30 2004 |
|---|----------------------|-------------|-------------------|----------------------|----------------------------------|
| | 1 | 2 | 3 | | |
| Long-Term Investments | | | | | |
| Bonds and Mortgage Securities: | | | | | |
| U.S. Government and agencies | \$ 3,335,363 | \$ - | \$ 85,929 | \$ - | \$ 3,421,292 |
| Corporate and other bonds | 1,429,713 | - | 6,241 | - | 1,435,954 |
| Common and preferred stocks | 13,214,040 | - | - | - | 13,214,040 |
| Equity index and pooled funds | - | - | - | 11,728,611 | 11,728,611 |
| Fixed income commingled funds | - | - | - | 1,225,707 | 1,225,707 |
| Real estate investments | - | - | - | 1,092,179 | 1,092,179 |
| Private equity | - | - | - | 1,996,233 | 1,996,233 |
| Hedge funds | - | - | - | 1,195,556 | 1,195,556 |
| Held by brokers-dealers under securities lending program: | | | | | |
| U.S. Government and agencies | 102,976 | - | 82,598 | 1,984,678 | 2,170,252 |
| Corporate and other bonds | - | - | - | 138,902 | 138,902 |
| Common and Preferred stocks | - | - | 38,843 | 971,266 | 1,010,109 |
| Total long-term investments | 18,082,092 | - | 213,611 | 20,333,132 | 38,628,835 |
| Short-Term Investments | | | | | |
| Investments held by Treasurer: | | | | | |
| Local Government Investment Pool | - | - | - | 262,700 | 262,700 |
| Investments held with Trustees: | | | | | |
| The Boston Company | - | - | - | 1,336,210 | 1,336,210 |
| Pooled Employee Trust Funds | - | - | - | 39,092 | 39,092 |
| Foreign currencies | - | - | - | - | - |
| Total short-term investments | - | - | - | 1,638,002 | 1,638,002 |
| Total Investments | \$ 18,082,092 | \$ - | \$ 213,611 | \$ 21,971,134 | \$ 40,266,837 |
| Securities Lending Separate Account | \$ - | \$ - | \$ - | \$ 3,134,769 | \$ 3,134,769 |

3. Securities Lending

Under authorization of the Board, the System lends its fixed income and equity securities to various broker-dealers on a temporary basis. This program is administered through an agreement with the System's custodial agent bank. All security loan agreements are collateralized by cash, securities, or irrevocable letter of credit issued by major banks, and have a market value equal to at least 102% of the market value for domestic securities and 105% for international securities. Securities received as collateral cannot be pledged or sold by the System unless the borrower defaults. Contracts require the lending agents to indemnify the System if the borrowers fail to return the securities lent and related distributions, and if the collateral is inadequate to replace the securities lent.

All security loans can be terminated on demand by either the System or the borrowers. The majority of loans are open loans—meaning the rebate is set daily, which results in a maturity of one or two days on average, although securities are often on loan for longer periods. The maturity of loans generally does not match the maturity of collateral investments, which averages 84 days. At year-end, the System has no credit risk exposure to borrowers because the amounts it owes the borrowers exceed the amounts the borrowers owe it. The market value of securities on loan at June 30, 2004 and 2003 was \$3,319,263,000 and \$2,638,297,000, respectively. The value of collateral (cash and non-cash) at June 30, 2004 and 2003 was \$3,364,650,000 and \$2,697,437,000 respectively.

Securities on loan are included with investments on the statement of net assets and are classified in the summary of custodial risk (see note 5B2 Custodial Risk). The invested cash collateral is included in the statement of net assets as an asset and corresponding liability. The invested cash collateral is also classified in the summary of custodial risk.

4. Accounts Receivable/Accounts Payable for Security Transactions

In addition to unsettled purchases and sales, accounts receivable and accounts payable for security transactions at June 30, 2004 and 2003, respectively, include (1) receivables for deposits with brokers for securities sold short of \$820,698,000 and \$785,703,000 and (2) payables for securities sold short and not covered with market values of \$796,912,000 and \$773,381,000, respectively.

5. Derivative Financial Instruments

Derivative instruments are financial contracts whose values depend on the values of one or more underlying assets, reference rates, or financial indexes. They include futures, forwards, options, and swap contracts. Some traditional securities, such as structured notes, can have derivative-like characteristics. In this case, the return may be linked to one or more indexes and asset-backed securities such as collateralized mortgage obligations (CMOs), which are sensitive to changes in interest rates and prepayments. Futures, forwards, options, and swaps are generally not recorded on the financial statements, whereas structured notes and asset-backed investments generally are recorded.

The System is a party, both directly and indirectly, to various derivative financial investments that may or may not appear on the financial statements and that are used in the normal course of business to enhance returns on investments and manage risk exposure to changes in value resulting from fluctuations in market conditions. These investments may involve, to varying degrees, elements of credit and market risk in excess of amounts recognized on the financial statements. Credit risk is the possibility that loss may occur from the failure of a counterparty to perform according to the terms of the contract. Market risk arises from adverse changes in market prices, interest rates, and foreign exchange rates that may result in a decrease in the market value of a financial investment or an increase in its funding cost, or both.

In addition to risk exposure from directly held derivative financial instruments, the System may have indirect exposure to risk through its ownership interests

in commingled investment funds that use, hold, or write derivative financial instruments. Indirect exposure may also arise from stock lending programs in which the commingled funds participate. Such programs usually reinvest a portion of their cash collateral holdings in derivative instruments. The System's pro rata share of the contractual or notional amounts of outstanding derivative transactions in commingled investment funds and their related security lending programs approximated \$412,888,000 at June 30, 2004 and \$276,828,000 at June 30, 2003.

6. Forward, Futures, and Option Contracts

Forward contracts are contracts to purchase or sell, and futures contracts are contracts to deliver or receive financial instruments, foreign currencies, or commodities at a specified future date and at a specified price or yield. Futures contracts are traded on organized exchanges (exchange traded) and require initial margin (collateral) in the form of cash or marketable securities. The net change in the futures contract value is settled daily, in cash, with the exchanges. Holders of futures contracts look to the exchange for performance under the contract and not to the entity holding the offsetting futures position. Accordingly, the amount at risk posed by nonperformance of counterparties to futures contracts is minimal. In contrast, forward contracts traded over the counter are generally negotiated between two counterparties. They are subject to credit risks resulting from nonperformance of one of the counterparties and to market risks resulting from adverse fluctuations in market prices, interest rates, and foreign exchange rates.

Options may be either exchange traded or negotiated directly between two counterparties over-the-counter. Options grant the holder the right, but not the obligation, to purchase or sell a financial instrument at a specified price and within a specified period of time from the "writer" of the option. As a purchaser of options, the System typically pays a premium at the outset. This premium is reflected as an asset on the financial statements. The System then retains the right but not the obligation to exercise the option and purchase the underlying financial instrument. Should the option not be exercised, it expires worthless and the premium is recorded as a loss. A writer of options assumes the obligation to deliver or receive the underlying financial instrument on exercise of the option. Certain option contracts may involve cash settlements based on specified indexes such as stock indexes. As a writer of options, the System receives a premium at the outset. This premium is reflected as a liability on the financial statements and bears the risk of an unfavorable change in the price of the financial instrument underlying the option.

Forward, futures, and options contracts provide the System with the opportunity to build passive benchmark positions, manage portfolio duration in relation to various benchmarks, adjust portfolio yield curve exposure and gain market exposure to various indexes in a more efficient way and at lower transaction costs. Credit risks depend on whether the contracts are exchange traded or exercised over-the-counter. Market risks arise from adverse changes in market prices, interest rates, and foreign exchange rates. At June 30, 2004, the System had purchased S&P, Russell Index, Treasury bonds and notes, and global indices futures and options with a notional value of \$3,684,005,000, and sold Treasury bonds and notes, and global indices futures and options with a notional value of \$570,095,000. At June 30, 2003, the notional values of the balances purchased and sold were \$3,634,769,000 and \$1,248,932,000, respectively. At June 30, 2004, the System had pledged as collateral U.S. Treasury and U.S. Government Agency securities with a total market value of \$92,170,000 as the margin requirement for futures contracts. At June 30, 2003, the market value of the pledged securities was \$147,183,000.

7. Foreign Exchange Contracts

Foreign exchange contracts include forward, futures, and options contracts. They involve either the exchange of specific amounts of two currencies or the delivery of a fixed amount of a currency at a future date and specified exchange rate. Forward and futures contracts settle three or more business days from the contract date. Forward contracts are negotiated over-the-counter between two counterparties, while futures contracts are exchange traded. Foreign currency options, which are either negotiated between two counterparties or are exchange traded, grant the buyer the right, but not the obligation, to purchase or sell at a specified price, a stated amount of an underlying currency at a future date. At June 30, 2004, the System had sold foreign currency contracts with a notional value of \$1,190,129,000 and had purchased foreign currency contracts with a notional value of \$1,127,966,000. At June 30, 2003, the notional values of the foreign currency contract sold and purchased were \$460,454,000 and \$462,032,000, respectively.

Foreign exchange contracts are used by the System to effect settlements and to protect the base currency (\$US) value of portfolio assets denominated in foreign currencies against fluctuations in the exchange rates of those currencies. The credit risk of currency contracts that are exchange traded lies with the clearinghouse of the exchange where the contracts are traded. The credit

risk of currency contracts traded over-the-counter lies with the counterparty, and exposure is usually equal to the unrealized profit on in-the-money contracts. The market risk in foreign currency contracts is related to adverse movements in currency exchange rates.

8. Asset-Backed Securities

Among the instruments with derivative-like characteristics that the System invests in and that appear on the financial statements are various asset-backed securities such as collateralized mortgage obligations (CMOs), principal-only strips (POs) and interest-only strips (IOs). These instruments are used primarily to enhance returns by taking advantage of opportunities available in this sector of the securities markets. CMO securities are bonds collateralized by mortgage-backed securities and issued in several tranches that represent a reallocation of the underlying mortgage-backed securities cash flows. Both PO and IO securities are created by splitting the asset-backed securities into principal-only and interest-only portions. At June 30, 2004, the System held CMO securities with a market value of \$217,916,000 and IO and PO securities with a market value of \$2,777,000. At June 30, 2003, the market value for CMO securities held was \$157,025,000 and the market value for IO and PO securities held was \$7,839,000.

The credit risks on the various asset-backed securities in which the System invests are usually very low. Many of the securities held by the System are issued by quasi-U.S. governmental agencies. Others are issued by organizations with AAA or AA credit ratings. The market risk of these securities depends on changes in interest rates and the level of the underlying prepayments (i.e., when the underlying principal and interest are repaid by the mortgagors).

9. Swap Agreements

Swaps are negotiated contracts between two counterparties for the exchange of payments at certain intervals over a predetermined time frame. The payments are based on a notional principal amount and calculated using either fixed or floating interest rates or total returns from certain instruments or indices. During FY 2004, the System entered into interest rate and total return swaps with a total notional value of \$126,500,000. For FY 2003, the total notional value was \$100,000,000. Swaps are used to manage risk and enhance returns. To reduce the risk of counterparty non-performance, the System generally requires collateral on any material gains from these transactions.

6. Property, Plant, Furniture, and Equipment

The summary of property, plant, furniture, and equipment at June 30, 2004 and 2003 is as follows (in thousands):

| | Balance June 30, 2003 | Increases | Decreases | Balance June 30, 2004 |
|---|--------------------------|-----------------|-------------|--------------------------|
| Nondepreciable capital assets: | | | | |
| Land | \$ 1,368 | \$ - | \$ - | \$ 1,368 |
| Total nondepreciable capital asset | 1,368 | - | - | 1,368 |
| Depreciable capital assets: | | | | |
| Building | 4,632 | - | - | 4,632 |
| Furniture and equipment | 3,783 | 178 | - | 3,961 |
| Total depreciable capital assets | 8,415 | 178 | - | 8,593 |
| Less accumulated depreciation: | | | | |
| Building | 579 | 116 | - | 695 |
| Furniture and equipment | 2,934 | 243 | - | 3,177 |
| Total accumulated depreciation | 3,513 | 359 | - | 3,872 |
| Total depreciable capital assets – Net | 4,902 | (181) | - | 4,721 |
| Total capital assets – Net | \$ 6,270 | \$ (181) | \$ - | \$ 6,089 |

Depreciation expense amounted to to \$359,000 and \$417,000 in 2004 and 2003, respectively.

7. Operating Leases

The System has commitments under various operating leases for equipment and office space for some staff. In general, the leases are for a three-year term. In most cases, the System expects that in the normal course of business, these leases will be replaced by similar leases. Total rental expense for the fiscal year ended June 30, 2004, was \$1,301,000. The System has, as of June 30, 2004, the following total future minimum rental payments due under the above leases (in thousands):

| Year | Amount |
|---|-----------------|
| 2005 | \$ 655 |
| 2006 | 299 |
| 2007 | 92 |
| Total future minimum rental payments | \$ 1,046 |

8. Defined Benefit Pension Plan

A. Contributions to Pension Plan:

All full-time, salaried, permanent employees of the System are employees of the Commonwealth and are included in the Commonwealth's participation in the Virginia Retirement System (VRS), a defined benefit pension plan administered by the System. The Commonwealth, not the System, has overall responsibility for contributions to this plan and other employee benefit plans.

B. Other Information:

Note 2A provides information regarding types of employees covered, benefit provisions, employee eligibility requirements (including eligibility requirements for vesting), and the authority under which benefit provisions and employer/employee obligations to contribute are established. Additional information on funding policy and contributions required and made can be found in Note 3. Information on the actuarial method and assumptions can be found in the "Notes to Required Supplemental Schedules."

Historical trend information showing the Commonwealth of Virginia's progress in accumulating sufficient assets to pay benefits when due is presented in the Commonwealth's Comprehensive Annual Financial Report for the fiscal year ended June 30, 2004.

9. Other Employee Benefit Programs

A. Life Insurance Benefits

The Commonwealth of Virginia participates in the System-administered group life insurance program, which provides postemployment life insurance benefits, in accordance with state statutes, to eligible retired and terminated employees. There were approximately 96,354 state employees and 42,316 retirees in the program during FY 2004. Information regarding eligibility requirements and benefit provisions as well as contribution requirements can be found in Note 2B.

Postemployment life insurance benefits are advance-funded based on biennial actuarial computations using the aggregate cost actuarial method. The significant actuarial assumptions used were the same as those used to prepare actuarial valuations of the System-administered pension plans at June 30, 2001, and the modified market value of plan assets was used for valuation purposes.

Separate measurements of assets and actuarial accrued liabilities are not made for individual employers participating in the program. The accrued liabilities for postemployment death benefits actuarially determined through an actuarial valuation performed as of June 30, 2003, were \$1,671.2 million. The actuarial value of the program's assets available for benefits on that date was \$902.1 million, leaving a present value of future contributions of \$769.1 million.

The System's contribution requirements for its employees for the fiscal years ended June 30, 2004 and 2003 were zero each year. In April 2002, the General Assembly suspended contributions for the Group Life insurance Program through June 30, 2004.

B. Retiree Health Insurance Credits

The Commonwealth of Virginia provides health insurance credit reimbursements, in accordance with state statutes, against the monthly health insurance premiums of its retirees who have at least 15 years of service. The monthly credit amounts to \$4.00 per year of service, not to exceed a maximum credit of \$120.00. All state agencies are required to contribute to the program at an actuarially determined percentage of their payroll. Contributions are being financed on a current disbursement basis. Approximately 29,046 state retirees were receiving health insurance credits at June 30, 2004. Note 2C contains information regarding eligibility requirements, benefit provisions, and contribution requirements.

For the fiscal year ended June 30, 2004, state agencies were required to contribute to the program at the statutory rate of 0.89% of covered payroll. The System's contribution requirements for its employees for the fiscal years ended June 30, 2004 and 2003 were \$102,000 and \$96,000, respectively.

C. Virginia Sickness and Disability Program

By providing sick leave, family and personal leave, and short-term and long-term disability benefits, the VSDP gives its members income protection from their very first day on the job. At June 30, 2004 approximately 64,715 participants were enrolled in the program.

For the fiscal year ended June 30, 2004, state agencies were required to contribute to the program at the actuarially estimated rate of 1.07% of payroll for state employees and 1.42% for state police officers and state law enforcement and correctional officers other than state police officers. The System's contribution requirements for its employees for the fiscal years ended June 30, 2004 and 2003 were \$124,000 and \$116,000, respectively.

10. Litigation

The System, its Board of Trustees, officers, and employees are defendants in claims and lawsuits that are either pending, in progress, or have been settled since June 30, 2004. It is not reasonably possible at the present time to estimate the ultimate outcome or the System's liability, if any, with respect to the various proceedings. However, on the basis of advice received from the Attorney General and outside counsel who have reviewed the status of these claims and lawsuits, it is the opinion of management that such liability, if any, would not have a material adverse effect on the System's financial condition.

11. Risk Management

In order to cover its exposures to various risks of loss, the System, an independent agency of the Commonwealth of Virginia, participates in the Commonwealth's self-insurance programs for state employee health care and risk management. The latter program includes property, general (tort) liability, medical malpractice, and automobile plans. The System's employees are covered by the Commonwealth's Worker's Compensation program administered by the Department of Human Resources. In addition, the System is self-insured for fiduciary liability and director's and officer's liability under a program administered by the Commonwealth's Division of Risk Management. There were no claims in excess of coverage and no reductions in coverage during FY 2004 and the three preceding fiscal years.

12. Commitments

The System extends investment commitments in the normal course of business. At June 30, 2004 and 2003, these commitments amounted to \$1,829,000,000 and \$1,746,000,000, respectively.

13. Statutory Contribution Adjustment

During its 2002 Session, the General Assembly made a number of adjustments to reduce funded employer contributions for the defined benefit retirement plans to levels below those recommended by the VRS actuary and approved by the Board of Trustees. Those changes affected FY 2003 and FY 2004. The changes made modified the contributions received for all state employee groups (state employees in the VRS plan as well as those in SPORS, VaLORS, and JRS) and teachers. The change did not impact the rates contributed by political subdivisions. For FY 2003 and FY 2004 the rates computed by the actuary were 3.60%, 3.60%, 12.11%, 13.22%, and 30.61% for

state employees, teachers, SPORS, VaLORS, and JRS, respectively. The VRS Board of Trustees approved a rate of 4.24% (the actuarial rate for FY 2002) for state employees and teachers in anticipation of future rate increases. The Board certified a rate of 25.00% for SPORS and VaLORS, and a rate of 45.00% for JRS. These rates reflect efforts by the Board to raise the funding ratios of these plans to a 90% funded level.

For FY 2004, the funded rate for teachers was reduced from 4.24% to 3.60%, plus 0.17% to offset the impact of early implementation of the rate in FY 2002. For FY 2004, the rate for state employees in the VRS plan was also 3.77%. FY 2004 rates for SPORS, VaLORS, and JRS were 12.79%, 13.95%, and 32.03%, respectively, or the rates recommended by the actuary, plus an amount to offset the impact of early implementation of the rate in FY 2002.

Required Supplemental Schedule of Funding Progress

(Dollars in Millions)

| Biennial Actuarial Valuation Date June 30 | Actuarial Value of Assets (a) | Actuarial Accrued Liability (AAL) - Entry Age (b) | Unfunded AAL (UAAL) (b-a) | Funded Ratio (a/b) | Covered Payroll (c) | UAAL as a Percentage of Covered Payroll (b-a)/(c) |
|--|-------------------------------|---|---------------------------|--------------------|---------------------|---|
| Virginia Retirement System (VRS) | | | | | | |
| 2003 | \$ 39,243 | \$ 40,698 | \$ 1,455 | 96.4% | \$ 10,885 | 13.4% |
| 2002 | 38,957 | 38,265 | (692) | 101.8% | 10,669 | (6.5%) |
| 2001 | 37,968 | 35,384 | (2,584) | 107.3% | 10,145 | (25.5%) |
| 2000 ** | 34,392 | 32,643 | (1,749) | 105.4% | 9,529 | (18.4%) |
| 1999 | 29,804 | 31,419 | 1,615 | 94.9% | 9,138 | 17.7% |
| 1998 * | 25,481 | 29,027 | 3,546 | 87.8% | 8,638 | 41.1% |
| 1996 ** | 19,032 | 23,842 | 4,810 | 79.8% | 7,769 | 61.9% |
| 1994 | 14,891 | 20,405 | 5,514 | 73.0% | 7,274 | 75.8% |
| State Police Officers' Retirement System (SPORS) | | | | | | |
| 2003 | \$ 509 | \$ 616 | \$ 107 | 82.6% | \$ 79 | 135.4% |
| 2002 | 508 | 595 | 87 | 85.4% | 81 | 107.4% |
| 2001 | 495 | 557 | 62 | 88.9% | 83 | 74.7% |
| 2000 ** | 441 | 513 | 72 | 86.0% | 81 | 88.9% |
| 1999 | 377 | 463 | 86 | 81.4% | 77 | 111.7% |
| 1998 * | 322 | 425 | 103 | 75.8% | 65 | 158.5% |
| 1996 ** | 243 | 371 | 128 | 65.5% | 60 | 213.3% |
| 1994 | 201 | 277 | 76 | 72.6% | 58 | 131.0% |
| Virginia Law Officers' Retirement System (VaLORS) | | | | | | |
| 2003 | \$ 458 | \$ 854 | \$ 396 | 53.6% | \$ 292 | 135.6% |
| 2002 | 418 | 806 | 388 | 51.9% | 306 | 126.8% |
| 2001 | 393 | 628 | 235 | 62.6% | 320 | 73.4% |
| 2000 *** | 307 | 680 | 373 | 45.1% | 315 | 118.4% |
| Judicial Retirement System (JRS) | | | | | | |
| 2003 | \$ 282 | \$ 348 | \$ 66 | 81.0% | \$ 48 | 137.5% |
| 2002 | 281 | 352 | 71 | 79.8% | 48 | 147.9% |
| 2001 | 277 | 342 | 65 | 81.0% | 47 | 138.3% |
| 2000 ** | 245 | 330 | 85 | 74.2% | 45 | 188.9% |
| 1999 | 210 | 302 | 92 | 69.5% | 42 | 219.0% |
| 1998 * | 180 | 274 | 94 | 65.7% | 39 | 241.0% |
| 1996 ** | 138 | 243 | 105 | 56.8% | 36 | 291.7% |
| 1994 | 115 | 199 | 84 | 57.8% | 33 | 254.5% |

* Change in benefit formula, unreduced early retirement age, and in the actuarial amortization method.

** Revised economic and demographic assumptions due to experience study.

*** The first actuarial valuation for the Virginia Law Officers' Retirement System, established on October 1, 1999, was performed as of June 30, 2000.

Required Supplemental Schedule of Employer Contributions

(Dollars in Thousands)

| Year Ended June 30 | Annual Required Contribution | Percentage Contributed | Statutory Required Contribution | Percentage Contributed |
|--|------------------------------------|---------------------------|---------------------------------------|---------------------------|
| Virginia Retirement System (VRS) | | | | |
| 2004 * | \$ 469,200 | 91.66% | \$ 430,064 | 100.00% |
| 2003 * | 450,766 | 67.61% | 304,784 | 100.00% |
| 2002 * | 459,613 | 79.68% | 366,239 | 100.00% |
| 2001 * | 630,458 | 99.99% | 630,370 | 100.00% |
| 2000 * | 785,376 | 93.24% | 732,273 | 100.00% |
| 1999 * | 738,051 | 85.64% | 632,084 | 100.00% |
| 1998 * | 757,164 | 71.06% | 538,016 | 100.00% |
| 1997 ** | 720,436 | 61.91% | 446,005 | 100.00% |
| State Police Officers' Retirement System (SPORS) | | | | |
| 2004 * | \$ 20,187 | 51.16% | \$ 10,328 | 100.00% |
| 2003 * | 19,866 | 44.20% | 8,781 | 100.00% |
| 2002 * | 20,190 | 50.00% | 10,095 | 100.00% |
| 2001 | 20,420 | 100.00% | 20,420 | 100.00% |
| 2000 * | 17,684 | 85.07% | 15,044 | 100.00% |
| 1999 * | 16,088 | 69.87% | 11,241 | 100.00% |
| 1998 * | 11,764 | 71.70% | 8,435 | 100.00% |
| 1997 ** | 11,099 | 64.69% | 7,180 | 100.00% |
| Virginia Law Officers' Retirement System (VaLORS) | | | | |
| 2004 * | \$ 72,752 | 55.80% | \$ 40,596 | 100.00% |
| 2003 * | 72,699 | 48.00% | 34,895 | 100.00% |
| 2002 * | 77,417 | 32.30% | 25,006 | 100.00% |
| 2001 | 51,072 | 100.00% | 51,072 | 100.00% |
| 2000 *** | 16,216 | 84.81% | 13,753 | 100.00% |
| Judicial Retirement System (JRS) | | | | |
| 2004 * | \$ 21,341 | 71.18% | \$ 15,190 | 100.00% |
| 2003 * | 21,110 | 64.44% | 13,604 | 100.00% |
| 2002 * | 21,282 | 50.00% | 10,641 | 100.00% |
| 2001 | 20,822 | 100.00% | 20,822 | 100.00% |
| 2000 * | 15,075 | 99.07% | 14,935 | 100.00% |
| 1999 * | 14,118 | 91.64% | 12,938 | 100.00% |
| 1998 * | 12,873 | 86.74% | 11,166 | 100.00% |
| 1997 ** | 12,378 | 83.43% | 10,327 | 100.00% |

* Contributions made by employers during the fiscal years ended June 30, 1998, 1999, 2000, 2001, 2002, 2003, and 2004 were not in all cases in accordance with the actuarially determined Annual Required Contribution (ARC), but they did meet the statutory requirements. Beginning with FY 1998, all employers were provided an option to elect an annual contribution that met the parameters of the ARC which includes full pre-funding of the automatic cost-of-living increases (COLAs) for retirees, or an annual contribution that would phase in the parameters over a five-year period ending with FY 2002.

** Contributions made by employers during the fiscal year ended June 30, 1997, were in accordance with statutory requirements that differ from the actuarially determined Annual Required Contributions (ARC) primarily because statutory required contributions funded cost-of-living increases (COLAs) for retirees on a current disbursement basis. Contribution information that meets the ARC parameters of GASB Statement No. 25 is unavailable for fiscal years prior to FY 1997.

*** The VaLORS program was effective on October 1, 1999.

**Notes to Required Supplemental Schedules
Actuarial Methods and Significant Assumptions**

The information presented in the required supplementary schedules was determined as part of the actuarial valuations at the dates indicated. Additional information as of the latest actuarial valuation follows:

| | |
|--|-----------------------|
| Valuation Date: | June 30, 2003 |
| Actuarial Cost Method: | Entry Age Normal |
| Amortization Method: | |
| State Employees | Level percent, closed |
| Political Subdivision Employees. | Level percent, open |
| Teachers. | Level percent, closed |
| State Police /VA Law Officers /Judges | Level percent, closed |
| Payroll Growth Rate | 3.00% |
| Remaining Amortization Period: | |
| State Employees | 23 Years |
| Political Subdivision Employees. | 0 to 30 Years |
| Teachers. | 23 Years |
| State Police /VA Law Officers /Judges | 23 Years |
| Asset Valuation Method: | Modified Market |
| Actuarial Assumptions: | |
| Investment Rate of Return * | 8.00% |
| Projected Salary Increases * | |
| State /Political Subdivision Employees | 4.25% to 6.30% |
| Teachers. | 4.00% to 7.00% |
| State Police /VA Law Officers | 4.50% to 5.75% |
| Judges | 5.00% |
| Cost-of-Living Adjustments | 3.00% |

* Includes inflation at 3.00%

Virginia Retirement System
 Statement of Changes in Assets and Liabilities - Agency Fund
 Optional Life Insurance Fund

For the Years Ended June 30, 2004 and 2003

(Expressed in Thousands)

| | Balance July 1, 2003 | Additions | Deductions | Balance June 30, 2004 |
|--|----------------------------|-------------------------|-------------------------|-----------------------------|
| Assets: | | | | |
| Cash | \$ 1,171 | \$ 20,747 | \$ 20,314 | \$ 1,604 |
| Due from other funds..... | 1,772 | 43 | - | 1,815 |
| Total assets..... | <u>\$ 2,943</u> | <u>\$ 20,790</u> | <u>\$ 20,314</u> | <u>\$ 3,419</u> |
| Liabilities: | | | | |
| Insurance premiums and claims payable..... | \$ 2,943 | \$ 116 | \$ - | \$ 3,059 |
| Due to other funds..... | - | 360 | - | 360 |
| Total liabilities..... | <u>\$ 2,943</u> | <u>\$ 476</u> | <u>\$ -</u> | <u>\$ 3,419</u> |

Schedule of Administrative Expenses
Years Ended June 30, 2004 and 2003

(Expressed in Thousands)

| | Totals | |
|--|------------------|------------------|
| | 2004 | 2003 |
| Personal Services: | | |
| Salaries and wages | \$ 12,440 | \$ 11,937 |
| Per diem services | 309 | 282 |
| WTA service costs | 66 | - |
| Retirement contributions | 1,068 | 604 |
| Social Security | 876 | 838 |
| Group life and medical insurance | 1,296 | 1,129 |
| Compensated absences | 131 | 134 |
| Total personal services | 16,186 | 14,924 |
| Professional Services: | | |
| Data processing | 4,853 | 4,071 |
| Actuarial and consulting | 596 | 699 |
| Legal | 1,081 | 623 |
| Medical | 196 | 255 |
| Management services | 263 | 43 |
| Public information services | 32 | 1 |
| Personnel development services | 13 | 48 |
| Total professional services | 7,034 | 5,740 |
| Communication Services: | | |
| Media | 15 | 18 |
| Printing | 755 | 684 |
| Postal and delivery | 394 | 522 |
| Telecommunications | 343 | 365 |
| Total communication services | 1,507 | 1,589 |
| Rentals: | | |
| Business equipment | 667 | 592 |
| Office space | 634 | 324 |
| Total rentals | 1,301 | 916 |
| Other Services and Charges: | | |
| Skilled and clerical services | 216 | 262 |
| Depreciation | 359 | 417 |
| Dues and memberships | 115 | 110 |
| Building expense | 472 | 490 |
| Equipment | 156 | 533 |
| Insurance | 27 | 28 |
| Repairs and maintenance | 29 | 26 |
| Supplies and materials | 159 | 116 |
| Travel and transportation | 623 | 625 |
| Miscellaneous | 110 | 116 |
| Total other services and charges | 2,266 | 2,723 |
| Total Administrative Expenses (GAAP basis) | 28,294 | 25,892 |
| Adjustments necessary to convert administrative expenses on the GAAP basis to the budgetary basis at year end (net) | (279) | (438) |
| Administrative Expenses (Budgetary basis) | \$ 28,015 | \$ 25,454 |
| Administrative Expenses Appropriated | \$ 30,930 | \$ 29,402 |
| Distribution of Administrative Expenses: | | |
| Total Administrative Expenses (GAAP Basis) | \$ 28,294 | \$ 25,892 |
| Less: In-house Investment Management | (7,991) | (7,464) |
| Net Administrative Expenses | \$ 20,303 | \$ 18,428 |

Schedule of Investment Expenses
for the Year Ended June 30, 2004

(Expressed in Thousands)

| | | |
|--|---------------|--------------------------------|
| Management fees: | | |
| Domestic managers | \$ 6,598 | |
| Non-U.S. equity managers | 16,527 | |
| Fixed income managers | 5,128 | |
| Real estate managers | 9,122 | |
| Private equity managers | 52,125 | |
| Hedge fund managers | <u>14,343</u> | \$103,843 |
| Performance fees | | <u>10,441</u> |
| Total management and performance fees | | <u>114,284</u> |
| Miscellaneous fees and expenses: | | |
| Custodial fees | \$ 3,357 | |
| Legal fees | 170 | |
| Other fees and expenses | <u>495</u> | 4,022 |
| In-House Investment Management: | | <u>7,991</u> |
| Total investment expenses | | <u><u>\$126,297</u></u> |

Schedule of Professional and Consulting Services
for the Year Ended June 30, 2004

(Expressed in Thousands)

| | | | |
|--|---|-----------|--------------|
| Actuarial, Legal and Oversight Services: | | | |
| Attorney General of Virginia | Legal Services | \$ | 176 |
| Joint Legislative Audit Review Commission | Oversight Responsibilities | | 98 |
| Troutman Sanders Mays & Valentine, LLP | Legal Services | | 157 |
| Kaufman & Canoles | Legal Services | | 51 |
| Gabriel, Roeder, Smith & Company | Actuarial Services | | 259 |
| Watson Wyatt Worldwide | Disability Plan Consulting | | 5 |
| Subtotal Actuarial, Legal, and Oversight Services | | \$ | 746 |
| Consulting Services: | | | |
| Bon Secours Memorial Regional Medical Center | Disability Medical Reviews | \$ | 84 |
| Samuel R. Brown, PC | Fact Finding Hearing Officer for Disability Cases | | 2 |
| Clear Management Human Resource Consultants | Organizational Consulting Services | | 7 |
| CorVel Corporation | Physician Referral for Disability Cases | | 104 |
| Cost Effectiveness Measurement Inc. | Cost Driver Benchmarking/Investment Cost Effectiveness Analysis | | 40 |
| Carlos Deupi, AIA | Architectural Consulting Services | | 34 |
| Genex/ROI | Disability Retirement Consulting Services | | 3 |
| Georgeson Shareholder Communications, Inc. | Member Location Consulting Services | | 11 |
| Katzen & Frye, PC | Fact Finding Hearing Officer for Disability Cases | | 11 |
| McCaul, Martin, Evans & Cook, PC | Fact Finding Hearing Officer for Disability Cases | | 4 |
| Medical Board | Medical Examiners | | 66 |
| Mellon Consultants, LLC | Investment Consulting Services | | 82 |
| Palmer & Cay Consulting Group | Consulting Services | | 115 |
| Pension Consulting Alliance Inc. | Real Estate Services | | 65 |
| Reed Smith, LLP | Professional Services | | 13 |
| Steven P. Peterson, Independent Contractor | Systems Analysis for Public Equity Investments | | 73 |
| Social Security Disability Consultants | Social Security Advocacy and Disability Tracking | | 523 |
| Smartfish | Recruitment Consulting Services | | 204 |
| Strategic Economic Decisions, Inc. | Economic Advisory Services | | 20 |
| Virginia Commonwealth University Grants | Strategic Planning Consulting Services | | 65 |
| Subtotal Consulting Services | | | 1,526 |
| Total | | \$ | 2,272 |

A photograph of two people sitting at a table, engaged in a conversation. The person on the left is looking towards the person on the right. The person on the right is wearing glasses and has their hands clasped. A laptop is open on the table in front of them. The entire image is overlaid with a semi-transparent teal color.

INVESTMENT SECTION

Open Communication

NOT ONLY COMMUNICATING REGULARLY –
COMMUNICATING BETTER IN ORDER TO
SOLVE PROBLEMS.

Chief Investment Officer's Letter



Nancy C. Everett, CFA
Chief Investment Officer

1200 East Main Street, P.O. Box 2500, Richmond, Virginia 23219
Telephone: (804) 649-8059 TDD: (804) 344-3190

October 18, 2004

Members of the Board of Trustees and Participant of the
Virginia Retirement System

The VRS investment fund posted a significantly above average return of 17.9% for the fiscal year. While much of the return was due to continuing improvement in both the domestic and international equity markets during the year, other asset classes such as real estate and hedge funds also had strong returns.

During the year, VRS continued to focus on its asset allocation policy. The Board completed its annual review of the policy, deliberating the appropriateness of its risk profile and adjusting capital market return expectations to reflect the current valuation framework. Based on results of this analysis, the fund will maintain a similar risk profile going forward but will continue to focus on diversifying its large equity exposure and slightly lowering its fixed income exposure in the face of rising interest rates.

There were relatively few changes in the management of the investment fund during the year. The new hedge fund program was gradually funded and now stands at 3% of the total portfolio. New tools are being developed in the area of risk management to allow the Board to better assess where it can add value for the risk it takes investing the portfolios. Additionally, VRS will complete a review of its Real Estate portfolio in the coming year.

This was another important year for VRS. The strong return will help to offset recent softness experienced in the markets. The asset allocation review has reaffirmed the objectives of the fund for the long-term with an eye toward current valuation issues and risks in the markets. The Board remains focused on other important issues, such as corporate governance, that can substantially impact the portfolio. All of these initiatives will serve to ensure the Board is continually working toward fulfilling its fiduciary responsibility to the participants and beneficiaries of the fund.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "N. Everett", is written over a light blue horizontal line.

Nancy C. Everett, CFA
Chief Investment Officer

Investment Account

The VRS investment account consists of funds contributed by both employers and employees of Virginia’s state agencies, teachers, state police, law enforcement and many local governments. These contributions are pooled and invested to provide for the payment of current and future benefits to these participants. The VRS Board of Trustees, as fiduciaries, has the responsibility to invest the account solely in the interest of the beneficiaries of the system.

Account Objectives

Each individual’s retirement benefit is based on a formula and takes into account years of service and salary. VRS utilizes an actuarial process to estimate what the aggregate of these benefit payments will look like into the future. This process includes certain assumptions about the long-term rate of return necessary to meet the liabilities along with other assumptions about the demographics of the workforce and the growth of salaries. One of the objectives of the account is to meet the long-term actuarial return assumption, currently 8%. Meeting this objective will help maintain the stability of the required contributions and the System’s funded status.

The Board of Trustees has also established intermediate-term objectives related to certain benchmark indices to measure the ongoing success of the investment program over 5 to 10 year periods. These serve as management tools to help judge the progress toward achieving long-term goals.

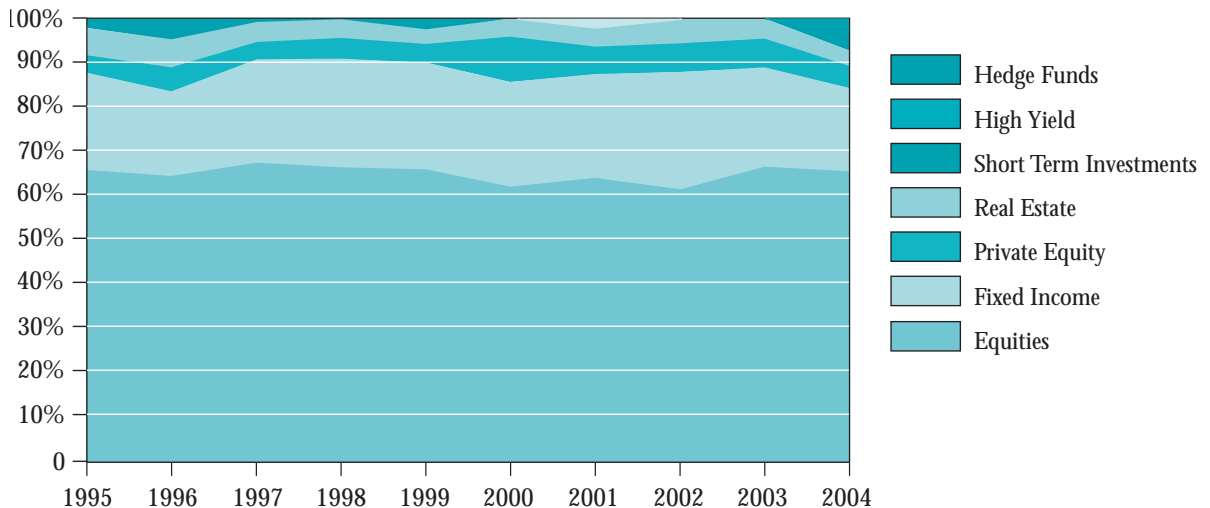
Investment Strategies

In order to achieve these objectives, The Board of Trustees has adopted various investment policies and guidelines and retains a professional investment staff, as well as outside managers, to advise and assist in the implementation of its policies. As established by the *Code of Virginia*, “the Board shall invest the assets of the Retirement System with the care, skill, prudence, and due diligence that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims.” The investment horizon of the fund’s portfolio reflects the long-term nature of VRS’ pension obligations.

Every year, the Board conducts an asset allocation study, incorporating an analysis of the long-term liabilities of the plan. The results of this study help the Board to determine its long-term risk tolerance and devise a strategic asset allocation strategy designed to maximize the expected return of the fund while controlling risk. Diversification among investments, which individually may be volatile in the short run, provides a framework for this asset allocation strategy. The most recent study was completed in June, 2004.

The chart below illustrates the long-term nature of the evolution of asset allocation.

Investment Comparison at Fair Market Value



Investment Results

Stock market returns were very strong during the year helping the fund achieve a positive return. Longer-term results are still impacted by the lower returns for the past several years. With the exception of fixed income, all asset classes posted strong returns for the year. Additionally, the fund's 10.3% annualized 10-year return remains well ahead of the 8% actuarial assumption.

Investment Performance Summary

Annualized Data for Period Ending June 30, 2004

| | 1 Year | 3 Years | 5 Years |
|--|--------|---------|---------|
| 1. Total Fund Time Weighted Returns | | | |
| VRS | 17.9 | 3.8 | 3.7 |
| Inflation (CPI) | 2.1 | 2.1 | 2.4 |
| Actuarial Assumed Return | 8.0 | 8.0 | 8.0 |
| 2. Total Public Equity | | | |
| VRS | 24.1 | 1.9 | - 0.3 |
| Custom Benchmark | 24.0 | 1.8 | - 0.3 |
| 3. Total Fixed Income | | | |
| VRS | 1.0 | 6.5 | 7.1 |
| Custom Benchmark. | 0.3 | 6.3 | 6.9 |
| 4. Total Real Estate | | | |
| VRS | 13.1 | 10.2 | 11.0 |
| Custom Benchmark | 13.9 | 8.8 | 10.5 |
| 5. Total Hedge Funds | | | |
| VRS | 9.5 | n/a | n/a |
| Custom Benchmark | 8.1 | n/a | n/a |
| 6. Total Private Equity | | | |
| VRS | 27.8 | 1.2 | 16.9 |
| Custom Benchmark | 41.0 | 4.6 | 2.8 |

Investment return calculations were prepared using a time-weighted rate of return based on AIMR's performance presentation standards.

Investment Summary

In accordance with Section 51.1-124.31 of the *Code of Virginia* (1950), as amended, the Board of Trustees has pooled substantially all assets of the Virginia Retirement System, the State Police Officers' Retirement System, the Virginia Law Officers' Retirement System, the Judicial Retirement System, the Group Life Insurance Fund, the Retiree Health Insurance Credit Fund, and the Disability Insurance Trust Fund into a common investment pool. The common investment pool held the following composition of investments at June 30, 2004 and 2003 (in thousands):

| | 2004 Fair Value | % of Total Value | 2003 Fair Value | % of Total Value |
|--|-----------------------------|-----------------------|-----------------------------|-----------------------|
| Bonds and Mortgage Securities: | | | | |
| U. S. Government and agencies | \$ 2,284,001 | 5.67% | \$ 2,141,042 | 6.02% |
| Mortgage securities | 3,307,543 | 8.21% | 3,190,994 | 8.97% |
| Corporate and other bonds | 1,574,856 | 3.91% | 2,981,273 | 8.38% |
| Total bonds and mortgage securities | <u>7,166,400</u> | <u>17.79%</u> | <u>8,313,309</u> | <u>23.37%</u> |
| Common and Preferred Stocks | 14,224,149 | 35.33% | 8,657,200 | 24.34% |
| Index and Pooled Funds: | | | | |
| Equity index and pooled funds | 11,728,611 | 29.13% | 12,890,439 | 36.24% |
| Fixed income commingled funds | 1,225,707 | 3.04% | 104,739 | 0.30% |
| Total index and pooled funds | <u>12,954,318</u> | <u>32.17%</u> | <u>12,995,178</u> | <u>36.54%</u> |
| Real Estate: | | | | |
| Commingled funds | 466,521 | 1.16% | 415,365 | 1.17% |
| Properties | 5,500 | 0.01% | 11,335 | 0.03% |
| Real estate loans | 459 | 0.00% | 3,554 | 0.01% |
| Focused | 619,699 | 1.54% | 667,911 | 1.88% |
| Total real estate | <u>1,092,179</u> | <u>2.71%</u> | <u>1,098,165</u> | <u>3.09%</u> |
| Private Equity | 1,996,233 | 4.96% | 2,177,483 | 6.12% |
| Hedge Funds | 1,195,556 | 2.97% | - | 0.00% |
| Short-Term Investments: | | | | |
| Treasurer of Virginia – | | | | |
| Local Government Investment Pool | 262,700 | 0.65% | 138,620 | 0.39% |
| TBC Pooled Employee Trust Funds | 1,336,210 | 3.32% | 2,133,180 | 6.00% |
| Foreign currencies | 39,092 | 0.10% | 53,645 | 0.15% |
| Total short-term investments | <u>1,638,002</u> | <u>4.07%</u> | <u>2,325,445</u> | <u>6.54%</u> |
| Total investments | <u>\$ 40,266,837</u> | <u>100.00%</u> | <u>\$ 35,566,780</u> | <u>100.00%</u> |

Portfolio Highlights

Public Equity

The Total Public Equity Program totaled \$26.9 billion at year-end, approaching 67% of the total fund. Approximately 71% was invested in Domestic Equity and 29% in International Equity. Fifty-six percent of the Total Public Equity portfolio was invested in passive strategies and 23% managed internally. The objective of the portfolio is to exceed the return of the Strategic Benchmark over 3 year periods net of all costs. At year-end, the Strategic Benchmark was comprised of 70% Russell 3000 and 30% of the S&P/Citigroup BMI Global x US.

The Total Public Equity Program outperformed the Strategic Benchmark during the fiscal year by 0.15%. During the year, the Russell 3000 was up 20.5% and the BMI Global x US was up 34.0%.

Value stocks gained ground, especially in the mid and smaller capitalization companies both internationally and domestically.

| | VRS Return* | Benchmark Return* | VRS Weight | Benchmark Weight |
|-------------------------------|----------------|----------------------|---------------|---------------------|
| Russell 1000 | 20.2% | 19.5% | 48.1% | 52.4% |
| Russell 2000 | 30.2% | 33.4% | 4.7% | 4.5% |
| Russell 3000 | 19.9% | 20.5% | 5.3% | 5.4% |
| Russell Special Small Cap | 32.3% | 28.7% | 1.0% | 0.9% |
| S&P 500 | 20.3% | 19.1% | 4.6% | 4.4% |
| S&P/Citigroup PMI World | N/A | 24.2% | 12.1% | 8.1% |
| S&P/Citigroup PMI Emerging | 41.2% | 32.7% | 4.3% | 2.4% |
| S&P/Citigroup EMI World ex US | 48.6% | 44.4% | 5.8% | 4.9% |
| S&P/Citigroup PMI World ex US | 30.4% | 31.2% | 14.1% | 17.0% |
| Total Program | 24.1% | 24.0% | 100.0% | 100.0% |

*1-Year Total Return June 30, 2004

Weights as of June 30, 2004

The VRS portfolio remained fairly close to the Strategic Benchmark Sectors and Region weights.

| Sectors** | Strategic | | Regions ** | Strategic | |
|-------------------|-----------|-------|---------------------|-----------|-------|
| | VRS | BM | | VRS | BM |
| Energy | 9.1% | 9.4% | Americas | 72.8% | 71.1% |
| Materials | 4.8% | 4.6% | Europe | 16.0% | 17.9% |
| Capital Equipment | 12.1% | 11.7% | Pacific Rim | 10.4% | 10.5% |
| Consumer Goods | 19.8% | 20.3% | Middle East /Africa | 0.8% | 0.5% |
| Services | 27.3% | 28.0% | | | |
| Finance | 22.2% | 22.8% | | | |
| Multi-Industry | 2.9% | 2.9% | | | |
| Gold Mines | 0.1% | 0.3% | | | |
| Other | 1.7% | 0.0% | | | |

**Barra Sectors, Regions & Weights

The top 10 holdings in the Total Public Equity program comprised 12.4% of the program at year-end. In comparison to last year, three companies have fallen from the list. Merck & Co., International Business Machines and WAL-MART Stores were replaced with American International Group, Bank of America and Cisco Systems.

| Company | Market Value | Shares |
|--------------------------|----------------|------------|
| General Electric Co | \$ 468,633,406 | 14,475,665 |
| Microsoft Corp. | 404,837,457 | 14,174,981 |
| Pfizer Inc. | 400,730,149 | 11,689,911 |
| Exxon Mobil Corp. | 399,905,078 | 9,004,843 |
| Citigroup Inc. | 399,002,505 | 8,580,699 |
| Intel Corp. | 285,036,102 | 10,327,395 |
| Bank of America Corp. | 278,822,477 | 3,294,995 |
| Cisco Sys Inc. | 245,880,011 | 10,374,684 |
| Johnson & Johnson | 231,132,775 | 4,149,601 |
| American Intl Group Inc. | 223,135,054 | 3,130,402 |

Fixed Income

VRS invests a portion of its portfolio in fixed income investments in order to reduce total fund volatility, produce income, and provide for some protection in the event of a deflationary environment. At year-end, approximately \$8 billion was invested in fixed-income assets, representing 20% of the VRS portfolio. Of this amount, approximately 50% was invested actively using outside investment managers, and 50% was invested passively. Internally managed accounts made up approximately 37% of the passive portion of the portfolio. The objective of the program is to control risk and exceed the return of the VRS Custom Lehman Brothers Index, net of all costs.

Interest rates increased moderately over the last fiscal year as economic growth accelerated and the Federal Reserve began to remove the stimulative monetary policy that had been in place for several years. Despite the defensive interest rate environment, corporate bonds and other types of spread products continued to look relatively attractive to investors, and the extra yield on these investments helped offset the erosion in prices resulting from higher interest rates. While in the short run higher interest rates create a drag on total return, the portfolio will benefit from higher interest rates over the long term.

The fixed income program return was 1.0% for the fiscal year. This was below our long-term expected return for bonds, but well ahead of the program benchmark of 0.3%.

| VRS Fixed Income Top 10 Holdings By Market Value | | |
|--|--|----------------|
| As of June 30, 2004 | | |
| Par | Security Description | Market Value |
| 47,383,245 shares | SSGA Intermediate Credit Index SL Fund | \$ 813,143,873 |
| 13,006,795 shares | SSGA Long SL Fund | 226,357,254 |
| 12,924 shares | PRIVEST Commingled Fund | 186,332,638 |
| 153,000,000 | FNMA 5.5000% 30-year MBS | 152,576,649 |
| 101,200,000 | GNMA 5.50% 30-year MBS | 101,010,250 |
| 93,000,000 | FHLMC 5.5000% 30-year MBS | 92,772,150 |
| 81,400,000 | FNMA 5.5000% 30-year MBS | 80,980,285 |
| 76,620,000 | FNMA 6.000% 30-year MBS | 78,176,344 |
| 65,000,000 | FNMA 6.000% 30-year MBS | 66,455,610 |
| 40,015,000 | U.S. Treasury Bonds 8.125% due 8/15/2019 | 40,015,000 |
| 50,860,000 | U.S. Treasury Notes 2.500% due 5/31/2006 | 50,684,532 |

| Fixed Income Portfolio | |
|----------------------------------|----------------------|
| As of June 30, 2004 | |
| <i>Sector Allocation:</i> | |
| Sector | % Portfolio |
| Treasury | 18.1% |
| Agency | 10.5% |
| Corporate | 29.3% |
| Mortgage | 33.6% |
| Asset Backed | 1.3% |
| CMBS | 2.3% |
| Foreign | 1.6% |
| Other | 3.3% |
| Total | <u>100.0%</u> |
| <i>Credit Quality Breakdown:</i> | |
| Sector | % Portfolio |
| Government | 63.1% |
| AAA | 6.6% |
| AA | 2.4% |
| A | 17.9% |
| BBB | 7.2% |
| BB | 1.5% |
| B | 0.6% |
| Below B | 0.1% |
| NR | 0.6% |
| Total | <u>100.0%</u> |

Short-Term Investments

As a general rule, VRS desires to remain fully invested at all times and seeks to minimize its holdings of cash investments. Temporary cash balances are invested in short-term money market instruments with the goal of maintaining high credit quality and liquidity. The return on such investments approximates the return on 90-day U.S. Treasury bills, which was .98% over last year.

Alternative Investments

The VRS Board policy allows for up to 20% of the portfolio to be invested in an Alternative Investments program. The objective of the program is to improve the expected risk/return profile of the total fund. Currently the program has investments in Private Equity, Hedge Funds and Real Estate. At June 30, 2004, Alternative Investments comprised 11.5% of the total fund portfolio.

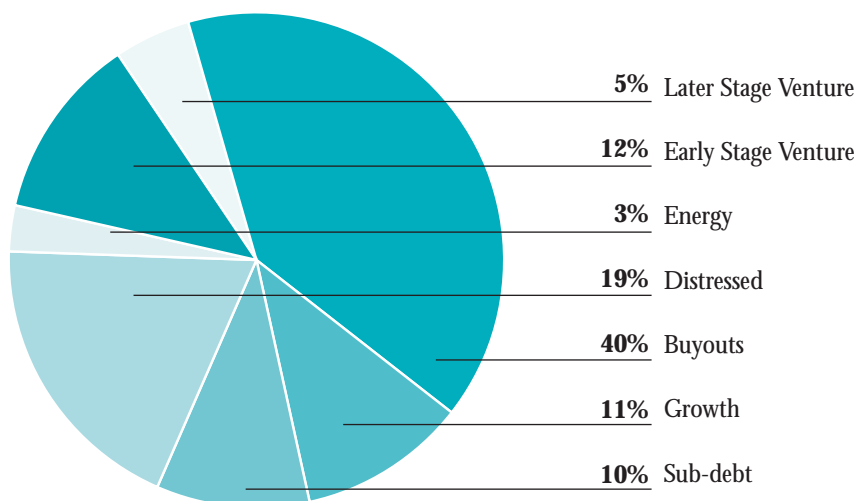
Private Equity

VRS invests in Private Equity in order to achieve returns greater than those available in the public equity markets. Specifically, the program seeks to outperform the Russell dollar weighted 3000 Index by 2.5% per year. The

program's results are measured differently from the publicly traded investments, in that a dollar-weighted or internal rate-of-return (IRR) calculation is considered more appropriate. Based on this methodology, the Private Equity IRR since program inception (1989) was an annualized 23.8%. By comparison, a dollar-weighted return for the Russell 3000 Index over the same time frame would be 17.2%.

As of June 30, 2004, the appraised value of the program was approximately \$2.0 billion. The majority of the program is invested in limited partnerships. Other sectors include growth, mezzanine, distressed, and energy.

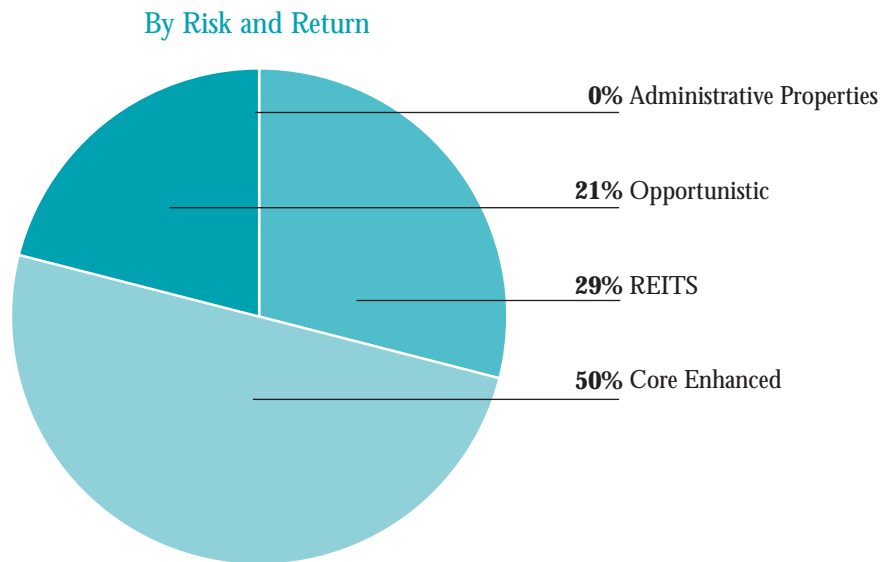
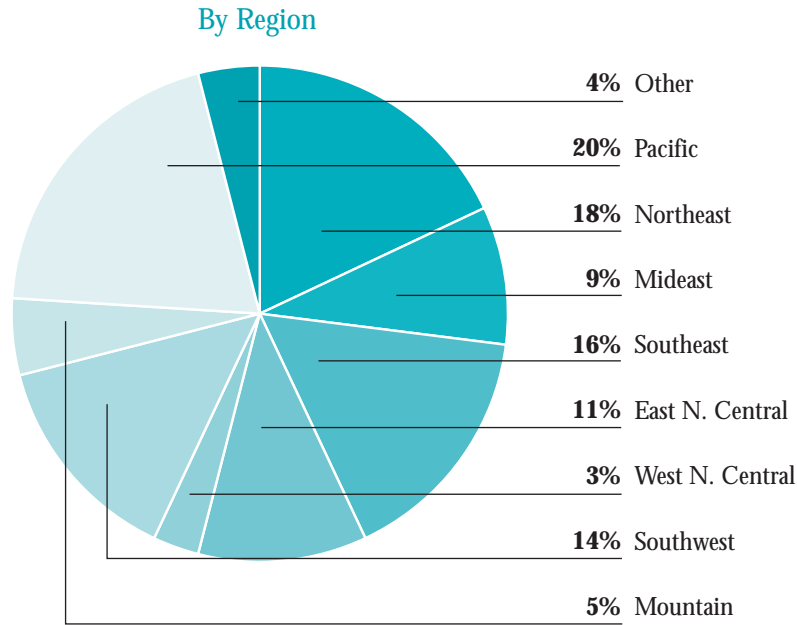
The Private Equity program rebounded substantially over the past twelve months, due primarily to a relaxation in debt capital markets and a more favorable macro-economic climate. The one-year time-weighted return as for 2004 was 27.8%, versus a negative 10.8% for 2003. Long-term returns remain strong, as evidenced by the five-year time-weighted return of 16.9% and the since inception annualized return of 16.2%. The breakdown of the Program by sub-class was as follows:



Real Estate

A portion of the portfolio is invested in real estate to help diversify the total fund by providing exposure to an asset class that has a low correlation with the public markets. Real estate produced a 13.1% return for the fiscal year, 10.2% over the past three years and 11.0% over five years, underperforming its benchmark by 81 basis points for the fiscal year, and outperforming by 143 basis points for three years and 49 basis points over the five-year period.

Over the course of the year, the percentage of the total fund represented by the real estate portfolio was reduced from 4.5% to 3.7% as our managers found better opportunities to sell properties than to buy and the total fund grew. At fiscal year end, the composition of the portfolio was approximately 29% public real estate (mostly REITs) and 71% in private assets. Debt as a percentage of total real estate assets remained at a conservative level of 32.4%.



VRS Money Managers

The diversified investment structure as of June 30, 2004 is reflected in the following table, which lists VRS managers by investment program and style.

| <i>VRS Public Equity Money Managers</i> | |
|---|-----------------------------------|
| <i>External</i> | <i>Style Description</i> |
| Acadian Asset Management | Non U.S. Small & Emerging Markets |
| Alliance Bernstein | Global |
| Aronson + Johnson + Ortiz | U.S. Small & U.S. Large |
| Arrowstreet Capital | Global |
| Ashmore Investment Management | Emerging Markets |
| BlackRock | Non U.S. Small |
| Capital Guardian Trust Company | Global |
| Credit Suisse Asset Management | U.S. Large |
| Franklin Portfolio Associates | U.S. Small |
| Freeman Associates Investment Management | U.S. Large |
| Fuller & Thaler Asset Management | U.S. Large |
| Goldman Sachs Asset Management | U.S. Small & Global |
| Grantham, Mayo and Van Otterloo & Company | Non U.S. Small |
| Hermes Focus Asset Management | Non U.S. Large |
| J.P. Morgan Investment Management | U.S. Large |
| LSV Asset Management | Non U.S. Small |
| Relational Investors | U.S. Large |
| State Street Global Advisors | U.S. Large & Non U.S. Large |
| Symphony Asset Management | U.S. Large |
| T. Rowe Price | Emerging Markets |
| The Boston Company | Emerging Markets |
| TimesSquare Capital Management | U.S. Small |
| Wellington Management | Non U.S. Large & Global |
| <i>Internal</i> | <i>Style Description</i> |
| Potomac Core | U.S. Large |
| Madison | U.S. Large |
| York Value | U.S. Large |
| <i>Fixed Income</i> | <i>Style Description</i> |
| Agincourt | Core/External Active |
| BlackRock | Core/External Active |
| Prudential | Core/External Active |
| Wellington Capital | Core/External Active |
| Western Asset Management | Core/External Active |
| W.R. Huff | Core/External Active |
| State Street Global Advisors | External Passive |
| VRS Internal | Internal Passive |

VRS Money Managers, continued

| | |
|--|---|
| <i>Real Estate Program</i> | |
| Public Real Estate Securities | Account |
| ING • Clarion | REIT Portfolio |
| Private Real Estate | Account |
| Blackstone Real Estate Partners Colonnade Capital Hines JER Partners Koll Bren Schreiber Lazard Frères Oaktree Capital Management Prudential Security Capital TA Associates | Fund IV MCPI 1997 and 1999 US Office Dev. Funds Funds I, II & III Funds IV & V Fund II and Strategic Realty Investors II Fund B PRISA II, Separate Account and SPF-II European Realty Separate Account |
| Directly Owned | Account |
| VRS | Parking Garage |

| | |
|--|---|
| Private Equity – Top 10 Managers | Style Description |
| Welsh, Carson, Anderson & Stowe Hellman & Friedman Madison Dearborn Summit Partners Charterhouse Development Capital Ltd. First Reserve Joseph Littlejohn & Levy TA Associates Nordic Capital Angelo Gordon & Co. | Buyout and Sub-Debt Buyout Buyout Growth and Sub-Debt International Buyout Energy Turnaround Growth and Sub-Debt International Buyout Distressed |

Virginia Retirement System
Top Brokers by Commissions
Fiscal Year 2004

| Broker name | Commission |
|--|-----------------------------|
| Merrill Lynch Pierce Fenner Smith Inc. | \$ 3,446,308 |
| Investment Tech Group Inc. | 2,375,860 |
| Deutsche Banc Alex Brown Inc. | 2,141,799 |
| Union Bank Switzerland Secs | 2,087,681 |
| Citigroup GBL Mkts/Salomon | 2,032,270 |
| Credit Lyonnais | 2,010,028 |
| Lehman Brothers, Inc. | 1,421,614 |
| Morgan Stanley & Co. | 1,133,204 |
| Goldman, Sachs & Co. | 1,113,121 |
| Banc of America Secs LLC | 687,687 |
| Weeden & Co. | 606,042 |
| Credit Suisse First Boston Corp | 510,360 |
| JP Morgan Chase | 465,522 |
| Bear Stearns & Co. Inc. | 414,493 |
| Instinet Corp. Institutional | 323,588 |
| SBC Warburg Dillon Read | 151,566 |
| Hong Kong & Shanghai BKG Corp. | 150,612 |
| Neuberger and Berman | 147,438 |
| Prudential Securities Inc. | 117,426 |
| Jeffries & Co. Inc. | 112,057 |
| Samsung Secs | 106,259 |
| Schwab Charles & Co Inc. | 100,956 |
| Other Brokers | 2,459,640 |
| Total U.S. Commissions | <u>\$ 24,115,531</u> |

NOTE: A complete list of the Investment Portfolio is available on request.



ACTUARIAL SECTION

Teamwork

DOING MORE THAN ONE'S PART OF
THE TEAM -DOING EVERYTHING POSSIBLE
TO MAKE THE ENTIRE TEAM SUCCEED.

**GABRIEL, ROEDER, SMITH & COMPANY****Consultants & Actuaries**

5605 N. MacArthur Blvd. • Suite 870 • Irving, Texas 75038-2631 • 469-524-0000 • fax 469-524-0003

November 6, 2003

Board of Trustees
Virginia Retirement System
P. O. Box 2500
Richmond, VA 23218-2500

Subject: Actuarial Valuation as of June 30, 2003

Dear Members of the Board:

We certify that the information contained in this report is accurate and fairly presents the actuarial Position of the Virginia Retirement System (VRS) as of June 30, 2003, with respect to the Virginia Retirement System (State Employee and Teacher members), the State Police Officers' Retirement System, the Judicial Retirement System, and the Virginia Law Officers Retirement System. Separate reports will be issued later for each of the local employer units which participate in VRS.

Rates shown in this report exclude the cost of the health care credit and the group life insurance program. The employer contribution rates calculated in this report are to be effective for the two-year period beginning one year after the valuation date. In other words, the employer contribution rate determined by the June 30, 2003 actuarial valuation will be effective for the period beginning July 1, 2004 and ending June 30, 2006.

Our firm, as actuary for the System, supplied the data presented in the schedule of funding progress in the financial section of the Comprehensive Annual Financial Report (CAFR) as well as the supporting schedules in the actuarial section of the CAFR.

All calculations have been made in conformity with generally accepted actuarial principles and practices, and with the Actuarial Standards of Practice issued by the Actuarial Standards Board. In our opinion the results presented also comply with the Virginia statutes and, where applicable, the Internal Revenue Code, ERISA, and the Statements of the Governmental Accounting Standards Board. The undersigned are independent actuaries and all are experienced in performing valuations for large public retirement systems.

Actuarial Valuation

The primary purposes of the valuation report are (i) to determine the employer contribution rate, (ii) to describe the current financial condition of VRS, and (iii) to analyze changes in VRS's condition. In addition, the report provides information required by VRS in connection with Governmental Accounting Standards Board Statement No. 25 (GASB No. 25), and it provides various summaries of the data.

Financing Objectives

The member contribution rates are established by statute. The employer contribution rates are intended to be calculated by the actuarial valuation. In consideration of the COLA implementation and the funded condition of the State Police, Virginia Law Officers, and the State Judges Systems, the Board of Trustees has set the employer contribution rate for these Systems to 25%, 25%, and 45% of annual payroll respectively. The Board mandated these rates to be effective until these Systems have funded ratios (the ratio of the actuarial value of assets to the actuarial accrued liability) of 90% or greater. None of these funds has achieved a 90% funded ratio as of the valuation date.

We have calculated the contribution rate for the State Employees and Teachers independently and on a “pooled” basis. The “pooled” rates are calculated by combining the liabilities and assets of the employee groups. The resulting “pooled” rate is tested to comply with GASB No. 27 requirements. Please note that if the “pooled” rate is contributed then the contribution to the Teacher’s Plan will be less than the Annual Required Contribution (ARC).

The contribution rates determined by this valuation are applicable for the two-year period beginning July 1, 2004, one year after the valuation date. The rates in this valuation are intended to be sufficient to pay the normal cost and to amortize the unfounded actuarial accrued liability (UAAL) in level percentage of payroll payments over a period of 23 years from the current valuation date, June 30, 2003. We consider this amortization period to be reasonable. Please note that we have recognized in the calculation of the contribution rates the delay (one-year for off- number valuations and two-years for even-numbered valuations) between the valuation date and the date the new rates become effective.

The contribution rates currently being contributed to the Systems are not the rates that were established by the Board. Instead the General Assembly legislated that lower rates be contributed for fiscal years 2002, 2003, and 2004 than the rates specified by the Board.

Progress Toward Realization of Financing Objectives

The funded ratio decreased for the State Employees, Teachers, and State Police plans since the last actuarial valuation. The decrease in the funded ratio is primarily due to asset losses on the actuarial value of assets. The Judicial and Virginia Law Officers plans saw their funded ratios improve slightly. These plans also suffered losses on the actuarial value of assets, but they also had large actuarial gains on the liability side that more than offset the asset losses from a funded ratio point of view.

The calculated employer contribution rates increased for all of the groups except for the Judicial plan which decreased slightly. The calculated rates reflect the full pre-funding of the automatic COLA benefits, in compliance with the requirements of Governmental Accounting Standards Board Statement 25.

Benefit Provisions

The actuarial valuation reflects the benefit provisions set forth in the Virginia statutes. There were several technical changes to the statutes along with a couple of minor benefit provision changes. None of the changes were material from an actuarial viewpoint.

There are no ancillary benefits (such as cost-of-living increase to retirees) funded by a source independent of VRS.

Assumptions and Methods

Actuarial assumptions and methods are set by the Board of Trustees, based upon recommendations made by the plan’s actuary. No assumptions in this valuation have been changed from those used for the 2002 valuation.

Data

Member data for retired, active, and inactive participants was supplied as of June 30, 2003, by the staff of VRS.

We have not subjected this data to any auditing procedures, but have examined the data for reasonableness and consistency with the prior valuation’s data. The VRS staff also supplied required asset information.

Sincerely,

Gabriel, Roeder, Smith & Company



W. Michael Carter, FSA
Senior Consultant



Lewis Ward
Consultant



Joe Newton
Senior Analyst

Solvency Test

(Expressed in Thousands)

| Valuation Date (June 30) | Aggregate Accrued Liabilities for | | | Valuation Assets | Portion of Accrued Liabilities Covered by Assets | | |
|--|-----------------------------------|--------------------------------|---------------------|------------------|--|---------|---------|
| | (1) Active Member Contributions | (2) Retirees and Beneficiaries | (3) Active Members* | | (1) | (2) | (3) |
| Virginia Retirement System (VRS) | | | | | | | |
| 2003 | \$ 5,703,557 | \$ 17,223,070 | \$ 17,770,944 | \$ 39,242,624 | 100.00% | 100.00% | 91.81% |
| 2002 | 5,285,338 | 15,878,494 | 17,101,328 | 38,957,256 | 100.00% | 100.00% | 104.05% |
| 2001 | 4,847,656 | 14,411,943 | 16,119,211 | 37,967,820 | 100.00% | 100.00% | 116.06% |
| 2000 | 4,639,007 | 12,652,663 | 15,350,685 | 34,392,303 | 100.00% | 100.00% | 111.40% |
| 1999 | 4,240,017 | 11,820,608 | 15,358,116 | 29,803,990 | 100.00% | 100.00% | 89.49% |
| 1998 | 3,937,941 | 10,732,243 | 14,359,783 | 25,480,634 | 100.00% | 100.00% | 75.28% |
| 1996 | 3,202,232 | 9,213,095 | 11,426,575 | 19,031,780 | 100.00% | 100.00% | 57.90% |
| 1994 | 2,842,030 | 7,257,368 | 10,305,790 | 14,890,663 | 100.00% | 100.00% | 46.49% |
| State Police Officers' Retirement System (SPORS) | | | | | | | |
| 2003 | \$ 59,097 | \$ 277,282 | \$ 279,243 | \$ 508,576 | 100.00% | 100.00% | 61.67% |
| 2002 | 57,152 | 253,687 | 283,797 | 507,889 | 100.00% | 100.00% | 69.43% |
| 2001 | 54,507 | 215,658 | 286,463 | 494,952 | 100.00% | 100.00% | 78.47% |
| 2000 | 50,044 | 199,822 | 262,761 | 440,903 | 100.00% | 100.00% | 72.70% |
| 1999 | 45,516 | 200,288 | 217,252 | 376,780 | 100.00% | 100.00% | 60.29% |
| 1998 | 42,154 | 190,196 | 192,348 | 321,696 | 100.00% | 100.00% | 46.45% |
| 1996 | 37,715 | 139,258 | 193,888 | 243,066 | 100.00% | 100.00% | 34.10% |
| 1994 | 37,211 | 80,867 | 158,520 | 201,149 | 100.00% | 100.00% | 52.40% |
| Virginia Law Officers' Retirement System (VaLORS)** | | | | | | | |
| 2003 | \$ 135,144 | \$ 195,554 | \$ 523,138 | \$ 457,615 | 100.00% | 100.00% | 24.26% |
| 2002 | 127,975 | 110,426 | 567,716 | 418,518 | 100.00% | 100.00% | 31.73% |
| 2001 | 111,143 | 5,639 | 510,857 | 392,815 | 100.00% | 100.00% | 54.03% |
| 2000 | 108,538 | 27,356 | 543,943 | 307,301 | 100.00% | 100.00% | 31.51% |
| Judicial Retirement System (JRS) | | | | | | | |
| 2003 | \$ 28,766 | \$ 198,005 | \$ 121,265 | \$ 282,326 | 100.00% | 100.00% | 45.81% |
| 2002 | 28,089 | 186,886 | 137,029 | 281,056 | 100.00% | 100.00% | 48.22% |
| 2001 | 23,595 | 176,142 | 142,095 | 276,542 | 100.00% | 100.00% | 54.05% |
| 2000 | 24,079 | 191,146 | 115,127 | 244,721 | 100.00% | 100.00% | 25.62% |
| 1999 | 20,978 | 171,136 | 110,328 | 209,992 | 100.00% | 100.00% | 16.20% |
| 1998 | 19,239 | 152,557 | 102,629 | 179,693 | 100.00% | 100.00% | 7.69% |
| 1996 | 16,885 | 140,964 | 84,918 | 137,886 | 100.00% | 85.80% | 0.00% |
| 1994 | 15,593 | 102,889 | 80,080 | 115,306 | 100.00% | 96.91% | 0.00% |

| Actuarial Assumptions and Methods: | 1994/1996 | 1998/1999 | 2000/2001 | 2002/2003 |
|---|-----------------|-----------------|-----------------|-----------------|
| Valuation interest rate..... | 8% | 8% | 8% | 8% |
| Salary scale inflation factor | 4% | 4% | 3% | 3% |
| Change in decremental assumptions..... | Yes | No | Yes | No |
| Value of ancillary benefits included | Yes | Yes | Yes | Yes |
| Value of post-retirement adjustments to date included | Yes | Yes | Yes | Yes |
| Assets valued at..... | Modified Market | Modified Market | Modified Market | Modified Market |

Aggregate Accrued Liabilities determined under the entry age normal cost method (system funded method used to determine employer contribution requirements).

The progress of a retirement system in accumulating assets to pay benefits when due can be measured by examining the extent to which assets accumulated for benefits cover 1) active member contributions to the system, 2) liabilities for future benefits to retirants and beneficiaries, and 3) liabilities for the employer-financed portion of service already rendered by active members. In a system receiving actuarially determined employer contributions, the liabilities for member contributions and future benefits to retirants and beneficiaries will generally be fully covered by accumulated assets. In addition, the liabilities for service already rendered will be partially covered by the remainder of accumulated assets and will increase over time.

* Employer-financed portion.

** Virginia Law Officers' Retirement System was effective October 1, 1999.

Schedule of Active Member Valuation Data

| Valuation Date (June 30) | Active Members | | | | |
|---|----------------|------------------------------|--------------------------|--|------------------------|
| | Number | Annual Payrolls (000s) | Average Annual Pay | Annualized % Increase in Average Pay | Number of Employers |
| Virginia Retirement System (VRS) | | | | | |
| 2003 | 300,612 | \$ 10,884,629 | \$ 36,208 | 1.1% | 559 |
| 2002 | 297,921 | 10,668,980 | 35,811 | 2.9% | 551 |
| 2001 | 291,621 | 10,145,212 | 34,789 | 3.9% | 551 |
| 2000 | 284,486 | 9,528,666 | 33,494 | 4.7% | 545 |
| 1999 | 285,596 | 9,138,060 | 31,996 | 2.7% | 532 |
| 1998 | 277,223 | 8,638,414 | 31,161 | 6.2% | 519 |
| 1996 | 264,656 | 7,769,043 | 29,355 | 5.9% | 513 |
| 1994 | 262,512 | 7,274,210 | 27,710 | 5.4% | 504 |
| State Police Officers' Retirement System (SPORS) | | | | | |
| 2003 | 1,727 | \$ 79,020 | \$ 45,756 | (1.3%) | 1 |
| 2002 | 1,740 | 80,680 | 46,368 | (1.5%) | 1 |
| 2001 | 1,771 | 83,339 | 47,058 | 2.7% | 1 |
| 2000 | 1,768 | 80,977 | 45,801 | 5.3% | 1 |
| 1999 | 1,761 | 76,628 | 43,514 | 11.9% | 1 |
| 1998 | 1,682 | 65,427 | 38,898 | 4.7% | 1 |
| 1996 | 1,604 | 59,599 | 37,156 | 3.2% | 1 |
| 1994 | 1,607 | 57,838 | 35,991 | 6.5% | 1 |
| Virginia Law Officers' Retirement System (VaLORS)* | | | | | |
| 2003 | 9,626 | \$ 291,801 | \$ 30,314 | (0.6%) | 1 |
| 2002 | 10,036 | 306,024 | 30,493 | (0.7%) | 1 |
| 2001 | 10,434 | 320,254 | 30,693 | 2.7% | 1 |
| 2000 | 10,542 | 315,158 | 29,895 | 0.0% | 1 |
| Judicial Retirement System (JRS) | | | | | |
| 2003 | 408 | \$ 47,568 | \$ 116,588 | 0.0% | 1 |
| 2002 | 408 | 47,568 | 116,588 | 0.0% | 1 |
| 2001 | 404 | 47,125 | 116,646 | 2.5% | 1 |
| 2000 | 399 | 45,394 | 113,769 | 6.7% | 1 |
| 1999 | 390 | 41,590 | 106,641 | 3.8% | 1 |
| 1998 | 383 | 39,332 | 102,695 | 8.5% | 1 |
| 1996 | 378 | 35,783 | 94,664 | 4.7% | 1 |
| 1994 | 362 | 32,716 | 90,376 | 4.4% | 1 |

* Virginia Law Officers' Retirement System was effective October 1, 1999.

Schedule of Retirants and Beneficiaries

| Valuation Date (June 30) | Retired Members and Beneficiaries | | | | |
|---|---|-------------------------------------|--------------------------------|--|---------------------------------|
| | Retirees and Beneficiaries Added/Removed* | Total Retirees and Beneficiaries | Annual Allowances (000)s | Annualized % Increase in Annual Allowances | Average Annual Allowances |
| Virginia Retirement System (VRS) | | | | | |
| 2003 | 7,920/3,554 | 106,418 | \$ 1,537,902 | 11.8% | \$ 14,452 |
| 2002 | 7,451/3,496 | 102,052 | 1,375,777 | 6.7% | 13,481 |
| 2001 | 7,962/3,337 | 98,097 | 1,289,657 | 12.1% | 13,147 |
| 2000 | 7,932/3,685 | 93,472 | 1,150,213 | 8.6% | 12,305 |
| 1999 | | 89,225 | 1,059,602 | 16.4%** | 11,786 |
| 1998 | | 88,500 | 896,409 | 3.4% | 10,129 |
| 1996 | | 80,499 | 838,147 | 8.9% | 10,412 |
| 1994 | | 72,422 | 711,518 | 7.9% | 9,825 |
| State Police Officers' Retirement System (SPORS) | | | | | |
| 2003 | 63/25 | 810 | \$ 23,737 | 18.2% | \$ 29,305 |
| 2002 | 72/12 | 772 | 20,077 | 7.1% | 26,006 |
| 2001 | 26/11 | 712 | 18,748 | 8.0% | 26,331 |
| 2000 | 38/8 | 697 | 17,362 | 9.9% | 24,910 |
| 1999 | | 667 | 15,793 | 23.2%** | 23,678 |
| 1998 | | 668 | 12,844 | 15.1% | 19,227 |
| 1996 | | 572 | 9,865 | 14.5% | 17,247 |
| 1994 | | 470 | 7,649 | 11.9% | 16,275 |
| Virginia Law Officers' Retirement System (VaLORS)*** | | | | | |
| 2003 | 248/10 | 765 | \$ 15,982 | 72.7% | \$ 20,892 |
| 2002 | 251/18 | 527 | 9,252 | 324.2% | 17,556 |
| 2001 | 197/13 | 294 | 2,181 | 198.8% | 7,418 |
| 2000 | 124/14 | 110 | 730 | 0.0% | 6,636 |
| Judicial Retirement System (JRS) | | | | | |
| 2003 | 35/26 | 375 | \$ 20,488 | 8.3% | \$ 54,635 |
| 2002 | 14/17 | 366 | 18,918 | 1.2% | 51,689 |
| 2001 | 21/16 | 369 | 18,699 | 7.6% | 50,675 |
| 2000 | 21/9 | 364 | 17,373 | 4.3% | 47,728 |
| 1999 | | 352 | 16,659 | 11.1%** | 47,327 |
| 1998 | | 347 | 14,787 | 4.1% | 42,615 |
| 1996 | | 330 | 13,666 | 12.4% | 41,412 |
| 1994 | | 305 | 10,944 | 5.9% | 35,882 |

* Number of retirees and beneficiaries added and removed is unavailable prior to FY2000.

** Increase in annual allowances due to 2% ad hoc increase in retiree benefit allowances effective January 1, 1999 and an increase in the benefit formula multiplier.

*** Virginia Law Officers' Retirement System was effective October 1, 1999.

Summary of Actuarial Assumptions and Methods

The following actuarial assumptions and methods were adopted by the VRS Board of Trustees on November 15, 2000 on the recommendation of its actuary. Assumptions were changed effective for the June 30, 2000 valuation based upon an analysis of plan experience for the four years then ending.

| | |
|--|---|
| Investment Return Rate | 8.00% per annum, compounded annually, composed of an assumed 3.00% inflation rate and a 5.00% real rate of return. Benefits are assumed to increase by 3.00% annually due to the COLA. |
| Mortality Rates | Virginia Retirement System, State Police Officers' Retirement System, Virginia Law Officers' Retirement System, and Judicial Retirement System. |
| <ul style="list-style-type: none"> • Pre-Retirement • Post-Retirement • Post-Disablement | <p>1994 Group Annuity Mortality Table for males and females.</p> <p>1994 Group Annuity Mortality Table for males and females (set back two years for male teachers, one year for female teachers, and three years for state police officers and other law enforcement and corrections officers).</p> <p>70% of PBGC Disabled Mortality Table 5a for Males. 90% of PBGC Disabled Mortality Table 6a for Females.</p> |

Retirement Rates

State Employees and Employees of Political Subdivisions

Sample rates of retirement are shown below for members eligible to retire.

| Age | Retirement Per 100 Members | | | |
|-----|----------------------------|--------|----------------------|--------|
| | Reduced Retirement | | Unreduced Retirement | |
| | Male | Female | Male | Female |
| 50 | 1.00 | 1.25 | 10.00 | 5.00 |
| 55 | 2.25 | 3.00 | 10.00 | 5.00 |
| 59 | 6.00 | 4.25 | 6.50 | 7.50 |
| 60 | 4.00 | 7.50 | 11.50 | 10.00 |
| 61 | 12.50 | 12.50 | 20.00 | 20.00 |
| 62 | 20.00 | 20.00 | 30.00 | 25.00 |
| 64 | 20.00 | 20.00 | 29.00 | 20.00 |
| 65 | – | – | 42.00 | 45.00 |
| 67 | – | – | 28.00 | 15.00 |
| 70 | – | – | 100.00 | 100.00 |

Retirement Rates, continued

Teachers

Sample rates of retirement are shown below for members eligible to retire.

| Retirement Per 100 Members | | | | | |
|----------------------------|--------------------|--------|----------------------|--------|--|
| Age | Reduced Retirement | | Unreduced Retirement | | |
| | Male | Female | Male | Female | |
| 50 | 1.0 | 1.5 | 7.5 | 6.5 | |
| 55 | 2.0 | 2.0 | 22.5 | 19.5 | |
| 59 | 5.0 | 5.0 | 22.5 | 19.5 | |
| 60 | 6.0 | 6.0 | 30.0 | 19.5 | |
| 61 | 8.0 | 8.0 | 30.0 | 26.0 | |
| 62 | 20.0 | 20.0 | 52.5 | 45.5 | |
| 64 | 20.0 | 20.0 | 30.0 | 32.5 | |
| 65 | - | - | 90.0 | 58.5 | |
| 67 | - | - | 30.0 | 39.0 | |
| 70 | - | - | 100.0 | 100.0 | |

State Police Officers' and Virginia Law Officers' Retirement Systems

| Retirement Per 100 Members | | |
|----------------------------|--------------------|----------------------|
| Age | Reduced Retirement | Unreduced Retirement |
| 50 | 3.0 | 18.0 |
| 55 | 6.0 | 27.0 |
| 56 | 6.0 | 36.0 |
| 60 | - | 100.0 |

Judicial Retirement System

50% of members are assumed to retire after age 60 when they reach the maximum benefit accrual.

| Retirement Per 100 Members | | | | | |
|----------------------------|--------------------|--------|----------------------|--------|--|
| Age | Reduced Retirement | | Unreduced Retirement | | |
| | Male | Female | Male | Female | |
| 50 | 5.0 | 5.0 | - | - | |
| 55 | 5.0 | 5.0 | 5.0 | 5.0 | |
| 65 | - | - | 5.0 | 5.0 | |
| 70 | - | - | 100.0 | 100.0 | |

Disability Rates

As shown below for selected ages.

State Employees and Employees of Political Subdivisions

14% of disability cases are assumed to be service-related.

| Disability Per 100 Members | | |
|----------------------------|-------|--------|
| Age | Male | Female |
| 20 | 0.030 | 0.009 |
| 30 | 0.120 | 0.036 |
| 40 | 0.270 | 0.081 |
| 50 | 1.020 | 0.306 |
| 60 | 3.000 | 0.900 |

Teachers

5% of disability cases are assumed to be service-related.

| Disability Per 100 Members | | |
|----------------------------|-------|--------|
| Age | Male | Female |
| 20 | – | – |
| 30 | 0.026 | 0.016 |
| 40 | 0.052 | 0.093 |
| 50 | 0.299 | 0.326 |
| 60 | 0.845 | 0.884 |

State Police Officers' and Virginia Law Officers' Retirement Systems

60% of disability cases are assumed to be service-related.

| Disability Per 100 Members | | |
|----------------------------|-------|--------|
| Age | Male | Female |
| 20 | – | – |
| 30 | 0.019 | – |
| 40 | 0.400 | – |
| 50 | 1.350 | – |
| 60 | – | – |

Judicial Retirement System

| Disability Per 100 Members | | |
|----------------------------|-------|--------|
| Age | Male | Female |
| 20 | – | – |
| 30 | 0.007 | 0.007 |
| 40 | 0.142 | 0.090 |
| 50 | 0.480 | 0.397 |
| 60 | – | – |

Termination Rates

Withdrawal rates are based on age and service. Sample rates for selected ages and years of service are shown below (for causes other than death, disability, or retirement).

State Employees and Employees of Political Subdivisions

| Probability of Decrement Due to Withdrawal | | | | | | | | | | |
|--|--------|--------|--------|--------|--------|---------------------------------|--------|--------|--------|--------|
| Years of Service–Male Members | | | | | | Years of Service–Female Members | | | | |
| Age | 1 | 3 | 6 | 9 | 10+ | 1 | 3 | 6 | 9 | 10+ |
| 25 | 0.1637 | 0.1170 | 0.0704 | 0.0433 | 0.0386 | 0.1847 | 0.1404 | 0.1110 | 0.0602 | 0.0533 |
| 35 | 0.1296 | 0.0925 | 0.0684 | 0.0433 | 0.0294 | 0.1366 | 0.1069 | 0.0802 | 0.0534 | 0.0393 |
| 45 | 0.0994 | 0.0663 | 0.0558 | 0.0354 | 0.0171 | 0.1052 | 0.0762 | 0.0574 | 0.0392 | 0.0218 |
| 55 | 0.0848 | 0.0518 | 0.0347 | 0.0226 | 0.0107 | 0.0924 | 0.0587 | 0.0381 | 0.0223 | 0.0110 |

Teachers

| Probability of Decrement Due to Withdrawal | | | | | | | | | | |
|--|--------|--------|--------|--------|--------|---------------------------------|--------|--------|--------|--------|
| Years of Service–Male Members | | | | | | Years of Service–Female Members | | | | |
| Age | 1 | 3 | 6 | 9 | 10+ | 1 | 3 | 6 | 9 | 10+ |
| 25 | 0.1302 | 0.1028 | 0.0565 | 0.0384 | 0.0643 | 0.1130 | 0.1053 | 0.0762 | 0.0891 | 0.0919 |
| 35 | 0.1174 | 0.0824 | 0.0567 | 0.0381 | 0.0280 | 0.1133 | 0.0932 | 0.0669 | 0.0494 | 0.0325 |
| 45 | 0.1030 | 0.0652 | 0.0480 | 0.0312 | 0.0117 | 0.0929 | 0.0634 | 0.0449 | 0.0292 | 0.0130 |
| 55 | 0.1051 | 0.0605 | 0.0322 | 0.0187 | 0.0074 | 0.0929 | 0.0532 | 0.0308 | 0.0197 | 0.0067 |

State Police Officers' and Virginia Law Officers' Retirement Systems

| Probability of Decrement Due to Withdrawal | | | | | | | | | | |
|--|--------|--------|--------|--------|--------|---------------------------------|--------|--------|--------|--------|
| Years of Service–Male Members | | | | | | Years of Service–Female Members | | | | |
| Age | 1 | 3 | 6 | 9 | 10+ | 1 | 3 | 6 | 9 | 10+ |
| 25 | 0.0569 | 0.0535 | 0.0485 | 0.0199 | 0.0240 | 0.0888 | 0.0698 | 0.0682 | 0.0362 | 0.0292 |
| 35 | 0.0624 | 0.0515 | 0.0343 | 0.0215 | 0.0165 | 0.0958 | 0.0664 | 0.0447 | 0.0399 | 0.0405 |
| 45 | 0.0681 | 0.0481 | 0.0292 | 0.0195 | 0.0094 | 0.0781 | 0.0656 | 0.0513 | 0.0426 | 0.0394 |
| 55 | 0.0766 | 0.0479 | 0.0278 | 0.0149 | 0.0065 | 0.0382 | 0.0682 | 0.1859 | 0.0447 | 0.0274 |

Judicial Retirement System

There are no assumed rates of withdrawal prior to service retirement (for causes other than death, disability, or retirement).

Salary Increase Rates

The sample salary increase rates are shown below.

State Employees and Employees of Political Subdivisions

Inflation rate of 3.00% plus productivity component of 1.25% plus step-rate/promotional component as shown.

| Years of Service | Annual Step Rate/Promotional Rates of Increase | Total Annual Rate of Increase |
|------------------|--|-------------------------------|
| 1 | 1.85% | 6.10% |
| 3 | 1.25% | 5.50% |
| 6 | 0.95% | 5.20% |
| 9 | 0.50% | 4.75% |
| 11-19 | 0.15% | 4.40% |
| 20 or more | 0.00% | 4.25% |

Teachers

Inflation rate of 3.00% plus productivity component of 1.00% plus step-rate/promotional component as shown.

| Years of Service | Annual Step Rate/Promotional Rates of Increase | Total Annual Rate of Increase |
|------------------|--|-------------------------------|
| 1 | 2.10% | 6.10% |
| 3 | 2.00% | 6.00% |
| 6 | 1.60% | 5.60% |
| 9 | 1.50% | 5.50% |
| 11-19 | 1.00% | 5.00% |
| 20 or more | 0.00% | 4.00% |

State Police Officers' and Virginia Law Officers' Retirement Systems

Inflation rate of 3.00% plus productivity component of 1.50% plus step-rate/promotional component as shown.

| Years of Service | Annual Step Rate/Promotional Rates of Increase | Total Annual Rate of Increase |
|------------------|--|-------------------------------|
| 1 | 1.25% | 5.75% |
| 3 | 1.25% | 5.75% |
| 6 | 0.90% | 5.40% |
| 9 | 0.90% | 5.40% |
| 11-19 | 0.50% | 5.00% |
| 20 or more | 0.00% | 4.50% |

Judicial Retirement System

Salary increase rates are 5.00%.

It is assumed state employees covered under the Virginia Sickness and Disability Program (VSDP) receive a 4.25% annual increase in pay and state police and Virginia law officers receive a 4.50% annual increase in pay while disabled. This adjusted pay is used to determine deferred retirement benefits.

Percent Electing a Deferred Termination Benefit***(Excludes Judicial Retirement System)***

Terminating members are assumed to elect a return of contribution or a deferred annuity, whichever is the most valuable benefit at the time of termination. Termination benefits are assumed to commence at the first age at which unreduced benefits are available.

Provision for Expense

The assumed investment return represents the anticipated net rate of return after payment of all administrative expenses.

Asset Valuation Method

The actuarial value of assets is equal to the market value of assets less a five-year phase in of the excess (shortfall) between expected investment return and actual income (both based on market value), with the resulting value not being less than 80% or more than 120% of the market value of assets.

Actuarial Cost Method

The funding period required to amortize the unfunded actuarial accrued liability (UAAL) is determined using the Entry Age Normal actuarial cost method. This method assigns the plan's total actuarial present value of future benefits to various periods. The actuarial accrued liability is assigned to years prior to the valuation, and the normal cost is assigned to the year following the valuation. The remaining costs are assigned to future years.

The normal cost rate is determined based on a group of new entrants. The actuarial accrued liability is the difference between the total present value of future benefits and the actuarial present value of future normal costs. The unfunded actuarial accrued liability (UAAL) is the excess of the actuarial accrued liability over the actuarial value of assets.

Payroll Growth Rate

3.00% based on a zero population growth assumption.

Funding Period

State employees, teachers, State police officers, Virginia law officers and judges 23 years (closed amortization, computed as a level percent of payroll). Calculation is pooled for state employees and teachers.

Political subdivision employees 0 to 30 years (open amortization, computed as level percent of payroll)

Cost of Living Increase

3.00% per year compounded annually for the basic benefit. The temporary supplement for state police and Virginia law officers is assumed to increase at the inflation rate (3.00% per year, compounded annually).

Summary of Benefit Plan Provisions

Retirement Plans

- Virginia Retirement System (VRS), effective March 1, 1952
- State Police Officers' Retirement System (SPORS), effective July 1, 1950
- Judicial Retirement System (JRS), effective July 1, 1970
- Virginia Law Officers' Retirement System; (VaLORS), effective October 1, 1999

Plan Year

Twelve-month period ending June 30th.

Administration

Plans are administered by the Board of Trustees of the Virginia Retirement System.

Type of Plans

- VRS is a qualified governmental defined benefit retirement plan. For Governmental Accounting Standards Board purposes, it is considered an agent multiple-employer Public Employee/Retirement System (PERS) for participating Virginia cities, counties, towns and political subdivisions, with separate cost-sharing pools for state employees and teachers.
- SPORS is a qualified governmental defined benefit retirement plan. For Governmental Accounting Standards Board purposes, it is considered a single-employer PERS.
- JRS is a qualified governmental defined benefit retirement plan. For Governmental Accounting Standards Board purposes, it is considered a single-employer PERS.
- VaLORS is a qualified governmental defined benefit retirement plan. For Governmental Accounting Standards Board purposes, it is considered a single-employer PERS.

Eligibility

All full-time, salaried, permanent employees of the Commonwealth of Virginia and all full-time, salaried, permanent employees of local Virginia school boards, or any participating Virginia county, city, town or political subdivision are eligible to become members of VRS. All state police officers of the Commonwealth of Virginia are eligible to become members of SPORS. All full-time judges of the Commonwealth of Virginia are eligible to become members of JRS. All full-time, salaried permanent Virginia law enforcement officers and correctional officers other than state police officers are eligible to become members of VaLORS.

Employee Contributions

All active members contribute 5.00% of their creditable compensation per year. The employer may "pick-up" the member's assessments under the provisions of Internal Revenue Code Section 414(h).

Creditable Compensation

Annual salary minus any overtime pay, payments of a temporary nature, or payments for extra duties.

Service

Employees, state police and Virginia law officers receive credit of one month of service for each month a contribution is made on their behalf to VRS, SPORS and VaLORS. Judges receive credit of one month of service multiplied by a weighting factor of 3.5 (2.5 for judges entering JRS on or after January 1, 1995) for each month a contribution is made to JRS on their behalf. A member may also purchase credit for certain periods, such as time spent in the military, by paying a purchase rate (5% of the larger of current credible compensation or final average compensation times the number of years to be purchased or actuarial cost). Special rules and limits govern the purchase of additional service.

Average Final Compensation

The average of the member's highest consecutive 36 months of creditable compensation.

Normal Retirement

Eligibility

Members of VRS and JRS may retire under Normal Retirement on or after age 65 with five years of service credit. A member of SPORS and VaLORS may retire under Normal Retirement on or after age 60 with five years of service credit.

Annual Benefit

For members of VRS and SPORS, 1.7% of average final compensation (AFC) times years of service. Members of VaLORS hired before July 1, 2001 were allowed to make a one-time election to have their benefit based on 2.0% of average annual compensation (AFC) instead of receiving a supplement. For members of JRS, 1.7% of average final compensation (AFC), times years of service, not to exceed 78% of AFC.

Supplement

Members of SPORS with 20 or more years of service in a hazardous position or with a hire date prior to July 1, 1974 receive an additional allowance payable annually from the date of retirement to their Social Security normal retirement age. This supplement is adjusted biennially based upon increases in Social Security benefits during the interim period. Electing members of VaLORS hired before July 1, 2001 with 20 or more years of service in a hazardous position or with a hire date prior to July 1, 1974, receive an additional allowance payable annually from the date of retirement to age 65.

Payment Form

Benefits are paid as a monthly life annuity, with a guarantee that if the payments made do not exceed the member's contributions plus interest, determined as of the date of retirement, the balance will be paid in a lump-sum to the member's beneficiary.

Early Retirement

Eligibility

A member of VRS may retire early after reaching age 50 with credit for 10 years of service, or age 55 with credit for five years of service. Members of SPORS and VaLORS may retire early after reaching age 50 with credit for five years of service. A member of JRS may retire early after reaching age 55 with credit for five years of service.

Annual Benefit

- Calculated the same as the normal retirement benefit, using actual service at retirement and multiplied by a reduction factor. For members of VRS no reduction applies if the member has credit for 30 years of service at retirement and is at least age 50 (25 years of service and is at least age 50 for members of SPORS and VaLORS, and 30 years of service and is at least age 60 for a member of JRS).
- For members of VRS and JRS at least age 55 (at least age 50 for members of SPORS and VaLORS), the reduction is 0.5% per month for the first 60 months and 0.4% per month for the next 60 months. This reduction is applied for each month the retirement age precedes 65 or, if more favorable, for each month the service at retirement is less than 30 (age 60 with service less than 25 for members of SPORS and VaLORS).
- For members of VRS younger than 55 at retirement, the reduction factor determined as though the member were 55 is further reduced by multiplying it by a second factor, to reflect a 0.6% reduction for each month retirement precedes age 55.

Supplement

Eligibility

Members of SPORS with 20 or more years of service in a hazardous position or with a hire date prior to July 1, 1974 receive an additional allowance payable annually from the date of retirement to their Social Security normal retirement age. This supplement is adjusted biennially based upon increases in Social Security benefits during the interim period. Electing members of VaLORS hired before July 1, 2001 with 20 or more years of service in a hazardous position or with a hire date prior to July 1, 1974, receive an additional allowance payable annually from the date of retirement to age 65.

Payment Form

Same as for Normal Retirement above.

Disability Retirement

Eligibility

VRS teacher and political subdivision members and JRS members are eligible from the first day of employment. VRS state employee, SPORS and VaLORS members hired prior to January 1, 1999 and who declined coverage under the Virginia Sickness & Disability Program (VSDP) are eligible from the first day of employment.

Annual Benefit

Members with less than five years of service credit receive the minimum guaranteed benefit. Members with more than five years of service credit receive the greater of (1) the minimum guaranteed benefit, which is 50% (66 2/3% if work related disability) of AFC if member does not qualify for primary Social Security and 33 1/3% of AFC (50% if work-related disability) if member qualifies for primary Social Security, or (2) 1.7% of AFC times service credit. The work-related benefit is reduced by Worker's Compensation (if any).

Service Credit

If a disability occurs before age 60, service is the lesser of (1) twice actual service, or (2) rendered service plus the number of years remaining between member's age at disability retirement and age 60.

Payment Form

The disability benefit commences immediately upon the member's retirement. Benefits cease upon recovery or reemployment. Disability benefits are payable as a monthly life annuity. If, at the member's death, payments made have not exceeded the sum of the member's contributions plus interest as of the date of retirement, the balance is paid in a lump-sum to the member's beneficiary. The 50% and 100% Survivor Options are also permitted for disability retirement. (A refund of the member's contribution account is paid for work-related disability.)

Virginia Sickness & Disability Program (VSDP)

In lieu of the above benefits, VRS state employee, VaLORS and SPORS members who elected this benefit (which is automatic for any new employee since January 1, 1999) are covered by the Virginia Sickness and Disability Program. These members will receive a deferred service retirement benefit payable at 65 (age 60 for SPORS and VaLORS). The deferred benefit will be computed like a normal retirement benefit. For this calculation, a member's creditable service will include the period of disability, and the Average Final Compensation will be adjusted to reflect increases in the cost of living between the date of disability and age 65. If the member dies while disabled, a death benefit will be determined as though the employee were an active member.

Deferred Retirement Benefit**Eligibility**

A member with at least five years of service who does not withdraw his or her contributions from the fund is eligible for a deferred retirement benefit.

Annual Benefit

The annual benefit is the same as normal retirement benefit, but both AFC and service are determined at the time the member leaves active employment. Reduced benefits may commence at or after age 55 with at least five years of service, or at age 50 with 10 years of service (age 50 with at least five years of service for members of SPORS and VaLORS).

Payment Form

The form of payment is the same as for Normal Retirement above.

Death Benefit

The beneficiary of a member who dies after leaving active service but before retiring is entitled to receive a lump-sum distribution of the deceased member's contribution account.

Withdrawal (Refund) Benefit**Eligibility**

All members leaving covered employment are eligible. Vested members (those with five or more years of service) may withdraw their contributions plus interest instead of receiving the deferred retirement benefits otherwise due.

Benefit

A member who takes a refund receives a lump-sum payment of his/her member contributions, plus the interest credited on these contributions. Interest is credited at 4%, compounded annually on contributions in the account for at least one year.

Death Benefit**Eligibility**

Death must have occurred while a member is an active or an inactive, non-retired member.

Benefit

Upon the death of a non-vested active or inactive member, a refund of the member's contributions and interest is paid to the beneficiary. Upon the death of a vested active member, if the named beneficiary is the spouse, minor child, mother or father of the member, the beneficiary is eligible to receive a monthly benefit under the 100% Survivor Option. If death occurs before age 55 (age 50 for members of SPORS and VaLORS), the member is assumed to be age 55 (age 50 for members of SPORS and VaLORS) for benefit calculation purposes. A beneficiary may elect to receive a refund of the member's contributions plus interest in lieu of the monthly benefit.

Work-related Death

If the member's death is work-related, the surviving spouse, minor child or parent is eligible to receive 50% of AFC if the survivor does not qualify for Social Security survivor benefits or 33 1/3% of AFC if the survivor does qualify for Social Security survivor benefits. This benefit is reduced by Worker's Compensation. The named beneficiary receives a refund of the member's contributions and interest. Benefits paid to a spouse cease upon remarriage.

Optional Forms of Payment

There are optional forms of payment available on an actuarially equivalent basis, as follows:

100% Survivor Option

This option is payable for the member's life. Upon member's death, 100% of the benefit continues to the contingent annuitant.

Variable Survivor Option

For the member, the benefit is more than the 100% survivor option. Upon the member's death, a designated percentage of the benefit continues to the contingent annuitant.

Leveling Option

Allows an advance on future benefits. The member receives the higher payments in the early years of retirement, and smaller payments at a future date the member specifies.

Partial Lump Sum Option

This option allows the member with earned service beyond their normal retirement date to elect a lump sum payment equal to the sum of 12, 24, or 36 payments of the standard monthly life annuity. The member's monthly benefit will be actuarially reduced to reflect the lump sum payment. The member may then elect to receive the reduced monthly annuity under any of the other optional forms of payment.

Cost-of-Living Increases

Members qualify for cost-of-living increases on July 1 of the second calendar year after retirement. Automatic cost-of-living increases are calculated as the first 3% of the Consumer Price Index increase plus half of each percentage increase from 3% to 7%. Cost-of-living increases are capped at 5%.

Summary of Plan Changes

1996 Valuation

1. Any member with at least 25 years of service may purchase up to three years of prior service credit for a) active duty military service in the armed forces of the United States, b) certified creditable service in the retirement system of another state, or c) both, at the rate of 5% of current compensation or average final compensation, if greater, times years of service purchased.
2. VRS may enter into an agreement with any political subdivision of the Commonwealth of Virginia which has a defined benefit plan that is not supplemental to VRS to permit portability of service credit on a cost-neutral basis.
3. Early retirement is allowed at age 50 with 10 years of service. The early retirement benefit is determined as if the member is age 55 (but using actual service and AFC), reduced by 6/10% for each month the member is younger than age 55. This benefit can be no smaller than the value of the member's contributions and interest paid in monthly installments over the member's lifetime.
4. The service multiplier for judges entering the Judicial Retirement System after January 1, 1995 is 2.5.
5. Effective July 1, 1998, a health insurance credit of \$1.50 per month per year of service (up to 30 years) is automatically provided to teachers in VRS who retire with at least 15 years of service. At local option, an additional credit of \$1.00 per month per year of service (up to 30 years) can be provided.

1998 Valuation

1. Effective January 1, 1999, the retirement benefit became 1.7% of average final pay times years of service. The 3% benefit adjustment was eliminated for future retirees. A 2% ad hoc benefit increase was provided for all retirees and beneficiaries receiving benefits as of December 31, 1998.
2. On January 1, 1999, the Virginia Sickness and Disability Program (VSDP) became effective. All future new members will be covered by this program; and thus will only receive a deferred retirement benefit from VRS. Members joining before 1999 were allowed to make a one-time irrevocable election to join this program. (Applies to State Employees and State Police.)
3. Effective July 1, 1999, state employees, teachers and employees of participating local units that had not elected out of this benefit may retire with an unreduced benefit if they are at least 50 years old and they have earned at least 30 years of service.

1999 Valuation

1. 100% Joint and Survivor Option is payable in the case of a death of a member who dies while in active service.
2. 100% Joint and Survivor Option is payable for disability retirement.

2000 Valuation

1. On October 1, 1999, the Virginia Law Officers' Retirement System became effective.
2. On November 15, 2000 the VRS Board of Trustees adopted the recommended economic and demographic assumptions proposed by the actuary as a result of the June 2000 actuarial experience study.
3. The Board of Trustees adopted the use of a "pooled" contribution rate for State Employees and Teachers.

2001 Valuation

1. The State Police System had their temporary supplement starting at retirement extended from age 65 to their Social Security retirement age.
2. The Virginia Law Officers' System has changed their benefit multiplier from 1.7% to 2.0% of pay with no temporary supplement for all new hires and rehires after July 1, 2001 as well as for current participants who have made an election to change formulas.
3. The Partial Lump Sum Option was added as an additional optional form of payment. This option provides the retiring member with a lump sum payment equal to the sum of either 12, 24, or 36 payments of the standard monthly life annuity. The member's monthly annuity is actuarially reduced to reflect the lump sum payment.

2002 Valuation

No material changes were made in the plan provisions.

2003 Valuation

No actuarilly material changes were made in the plan provisions. Listed below are two minor changes of note.

1. School superintendents with five years of service may now purchase an additional ten years of out-of-state service. The superintendent must not be eligible for an out-of-state benefit.
2. The leveling option was restored as an optional form of payment. Benefits may be leveled to age 62 or older, and the benefits cannot reduce more than 50%. Any COLAs are calculated on the basic benefit amount.

A woman is shown in profile, resting her chin on her hand. The image is overlaid with a teal color. The text is centered and reads: STATISTICAL SECTION

Customer Service

NOT ONLY MEETING EXPECTATIONS
IN CUSTOMER SERVICE BUT
SETTING NEW BENCHMARKS.

STATISTICAL SECTION

Customer Service

NOT ONLY MEETING EXPECTATIONS
IN CUSTOMER SERVICE BUT
SETTING NEW BENCHMARKS.

Pension Trust Funds

Analysis of Changes and Growth in Plan Net Assets

For the Years Ended June 30

(Expressed in Millions)

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|--------|--------|---------|---------|---------|---------|---------|---------|---------|---------|
| Net Assets Available, Beginning of Year | 15,449 | 18,215 | 21,460 | 26,057 | 30,784 | 34,634 | 39,786 | 36,693 | 33,456 | 33,781 |
| Employee and Employer Contributions | 900 | 879 | 913 | 1,131 | 1,141 | 1,291 | 1,270 | 1,044 | 1,042 | 1,185 |
| Benefit and Administration Expenses | (834) | (934) | (1,017) | (1,090) | (1,176) | (1,282) | (1,394) | (1,529) | (1,687) | (1,865) |
| Net Funding | 66 | (55) | (104) | 41 | (35) | 9 | (124) | (485) | (645) | (680) |
| Investment Income: | | | | | | | | | | |
| Interest, Dividends, and Other Investment Income | 707 | 413 | 504 | 534 | 551 | 705 | 785 | 624 | 569 | 461 |
| Net Appreciation (Depreciation) in Fair Value | 1,993 | 2,887 | 4,197 | 4,152 | 3,334 | 4,438 | (3,754) | (3,376) | 401 | 5,477 |
| Net Investment Income | 2,700 | 3,300 | 4,701 | 4,686 | 3,885 | 5,143 | (2,969) | (2,752) | 970 | 5,938 |
| Net Assets Available, End of Year | 18,215 | 21,460 | 26,057 | 30,784 | 34,634 | 39,786 | 36,693 | 33,456 | 33,781 | 39,039 |

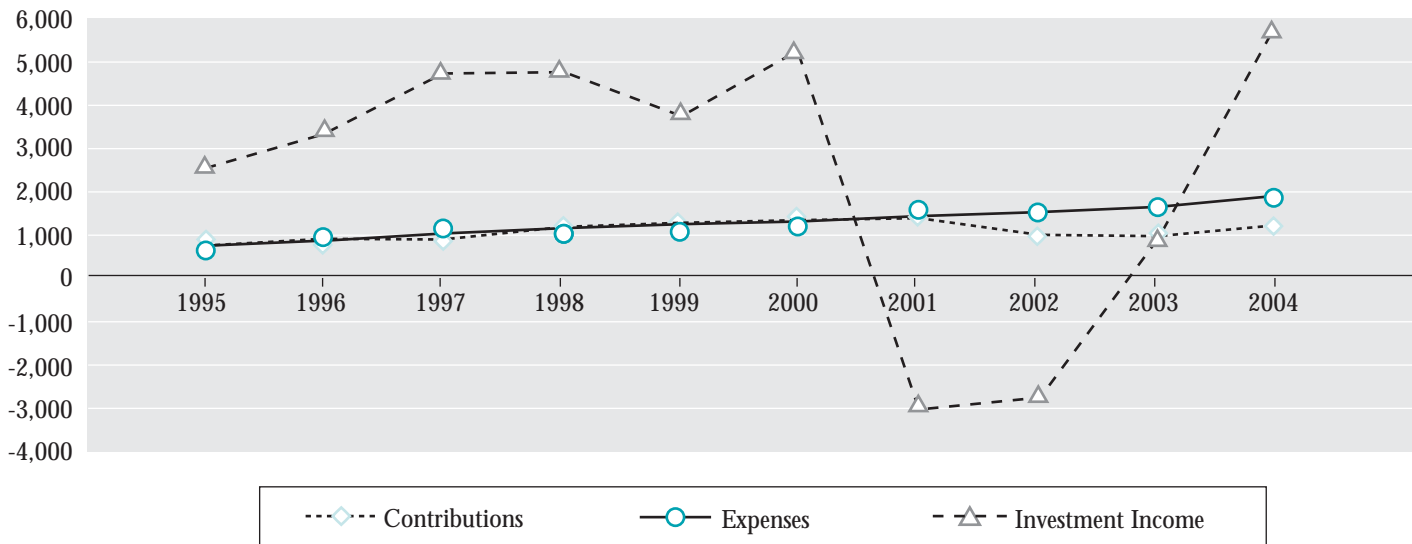
FY 1995 and 1996 Net Appreciation was restated to reflect adjustments from conversion to GASB 25 presentation.

FY 1996 Investment Income categories were restated to reflect recategorization of Index Fund, Real Estate and Private Equity income as Net Appreciation (Depreciation) in Fair Value.

Pension Trust Funds Additions Versus Deductions

Fiscal Years 1995 – 2004

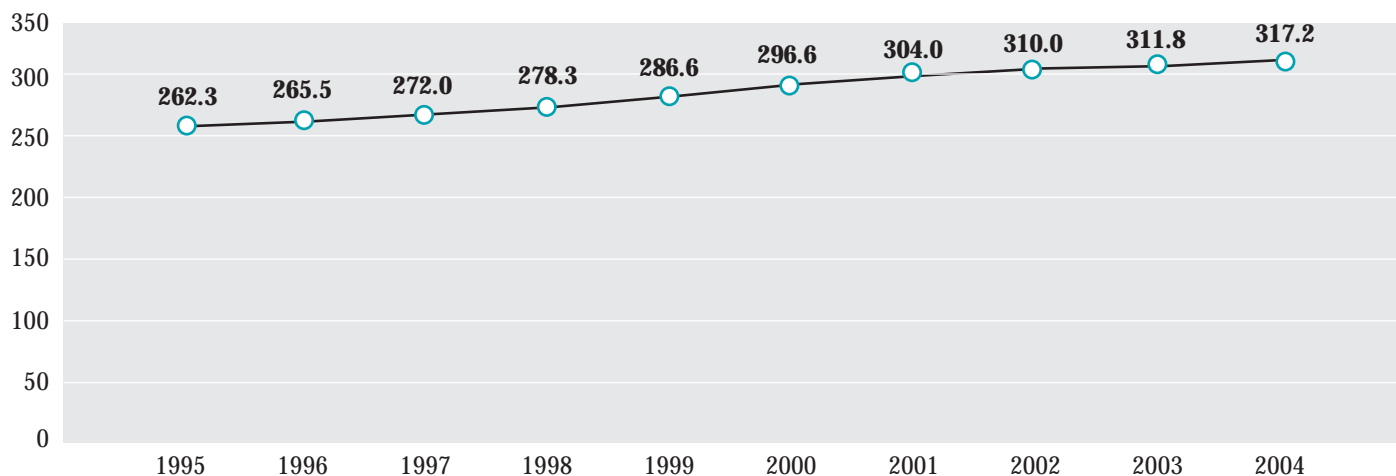
(Millions of Dollars)



Number of Active Members

Fiscal Years 1995 – 2004

(Expressed in Thousands)



Schedule of Retirement Contributions by System

Fiscal Years 1995 – 2004

(Expressed in Thousands)

| Year Ended June 30 | Virginia Retirement System | | | | State Police Officers' Retirement System | Virginia Law Officers' Retirement System | Judicial Retirement System | Total |
|-----------------------|----------------------------|------------|------------|--------------|---|---|----------------------------------|--------------|
| | State | Teacher | Political | Sub-Total | | | | |
| 2004 | \$ 292,895 | \$ 515,750 | \$ 287,228 | \$ 1,095,873 | \$ 15,232 | \$ 56,292 | \$ 17,758 | \$ 1,185,155 |
| 2003**** | 199,217 | 492,562 | 270,280 | 962,059 | 13,305 | 50,433 | 16,038 | 1,041,835 |
| 2002**** | 234,992 | 455,488 | 283,756 | 974,236 | 14,974 | 42,148 | 13,100 | 1,044,458 |
| 2001 | 299,079 | 591,620 | 264,229 | 1,154,928 | 24,632 | 67,040 | 23,149 | 1,269,749 |
| 2000 | 314,044 | 631,344 | 284,641 | 1,230,029 | 19,170 | 25,192*** | 17,131 | 1,291,522 |
| 1999 | 296,748 | 556,712 | 257,140 | 1,110,600 | 15,298 | – | 15,034 | 1,140,932 |
| 1998** | 265,364 | 603,579* | 237,736 | 1,106,679 | 11,767 | – | 13,107 | 1,131,553 |
| 1997 | 242,380 | 439,490 | 203,427 | 885,297 | 16,035* | – | 11,957 | 913,289 |
| 1996 | 240,393 | 442,600* | 176,545 | 859,538 | 8,330 | – | 11,087 | 878,955 |
| 1995 | 308,978* | 406,670* | 166,497 | 882,145 | 7,603 | – | 10,614 | 900,362 |

* Increased as a result of the Workforce Transition Act of 1995 for state agencies and school board contributions for the 1991 early retirement program.

** In fiscal year 1998, employer contributions increased to begin prefunding cost of living adjustments (COLAs) for retirees.

*** The Virginia Law Officers' Retirement System was effective on October 1, 1999.

**** The General Assembly suspended employer contributions for all State employees effective January, 2002.

Employer contributions for SPORS, VaLORS, and JRS were resumed in July 2002 and State in July 2003.

STATISTICAL SECTION

Pension Trust Funds Additions by Source

Fiscal Years 1995 – 2004

(Expressed in Thousands)

| Year Ended June 30 | Member Contributions | Employer Contributions | | Investment Income | Other | Total |
|--|-------------------------|------------------------|-------------------|----------------------|--------|--------------|
| | | For Members | Employer Share | | | |
| Virginia Retirement System (VRS) | | | | | | |
| 2004 | \$ 85,769 | \$ 564,020 | \$ 446,084 | \$ 5,751,277 | \$ 908 | \$ 6,848,058 |
| 2003 | 127,578 | 499,077 | 335,404 | 935,415 | 2,682 | 1,900,156 |
| 2002 | 115,979 | 482,516 | 375,741 | (2,667,982) | 286 | (1,693,460) |
| 2001 | 65,810 | 453,133 | 635,985 | (2,907,769) | 381 | (1,752,460) |
| 2000 | 68,208 | 426,088 | 735,733 | 5,042,490 | 269 | 6,272,788 |
| 1999 | 55,710 | 406,543 | 648,347 | 3,809,905 | 703 | 4,921,208 |
| 1998*** | 57,032 | 379,953 | 669,694 | 4,594,358 | 116 | 5,701,153 |
| 1997 | 58,003 | 356,759 | 470,535 | 4,608,323 | – | 5,493,620 |
| 1996 | 51,595 | 340,645 | 467,298 | 3,235,211 | – | 4,094,749 |
| 1995* | 50,376 | 331,880 | 499,889 | 2,645,875 | – | 3,528,020 |
| State Police Officers' Retirement System (SPORS) | | | | | | |
| 2004 | \$ 790 | \$ 4,037 | \$ 10,405 | \$ 73,977 | \$ – | \$ 89,209 |
| 2003 | 556 | 3,972 | 8,777 | 11,929 | – | 25,234 |
| 2002 | 755 | 4,039 | 10,180 | (34,596) | – | (19,622) |
| 2001 | 125 | 4,087 | 20,420 | (37,192) | – | (12,560) |
| 2000 | 192 | 3,922 | 15,056 | 63,638 | – | 82,808 |
| 1999 | 179 | 3,548 | 11,571 | 47,974 | – | 63,272 |
| 1998 | 121 | 3,152 | 8,494 | 58,661 | 2 | 70,430 |
| 1997** | 136 | 2,923 | 12,976 | 58,840 | – | 74,875 |
| 1996 | 270 | 2,984 | 5,076 | 41,865 | – | 50,195 |
| 1995 | 18 | 2,965 | 4,620 | 33,965 | – | 41,568 |
| Virginia Law Officers' Retirement System (VaLORS) | | | | | | |
| 2004 | \$ 880 | \$ 14,703 | \$ 40,709 | \$ 70,668 | \$ – | \$ 126,960 |
| 2003 | 927 | 14,559 | 34,947 | 13,069 | – | 63,502 |
| 2002 | 1,007 | 15,630 | 25,511 | (31,330) | – | 10,818 |
| 2001 | 77 | 15,858 | 51,105 | (4,057) | – | 62,983 |
| 2000**** | 33 | 11,405 | 13,754 | 690 | – | 25,882 |
| Judicial Retirement System (JRS) | | | | | | |
| 2004 | \$ 197 | \$ 2,371 | \$ 15,190 | \$ 40,947 | \$ – | \$ 58,705 |
| 2003 | 88 | 2,346 | 13,604 | 6,543 | – | 22,581 |
| 2002 | 73 | 2,365 | 10,662 | (19,248) | – | (6,148) |
| 2001 | 4 | 2,315 | 20,830 | (20,637) | – | 2,512 |
| 2000 | 16 | 2,180 | 14,935 | 35,297 | – | 52,428 |
| 1999 | 6 | 2,049 | 12,979 | 26,569 | – | 41,603 |
| 1998 | 49 | 1,892 | 11,166 | 32,637 | – | 45,744 |
| 1997 | 25 | 1,780 | 10,152 | 32,952 | – | 44,909 |
| 1996 | 10 | 1,745 | 9,332 | 23,492 | – | 34,579 |
| 1995 | – | 1,662 | 8,952 | 19,194 | – | 29,808 |

* In fiscal year 1995, employer contributions increased by \$75.6 million for state agencies as a result of the Workforce Transition Act of 1995, and by \$31.7 million for school boards toward the cost of the 1991 early retirement program.

** In fiscal year 1997, employer contributions increased by \$5.9 million for SPORS as a result of the Workforce Transition Act of 1995.

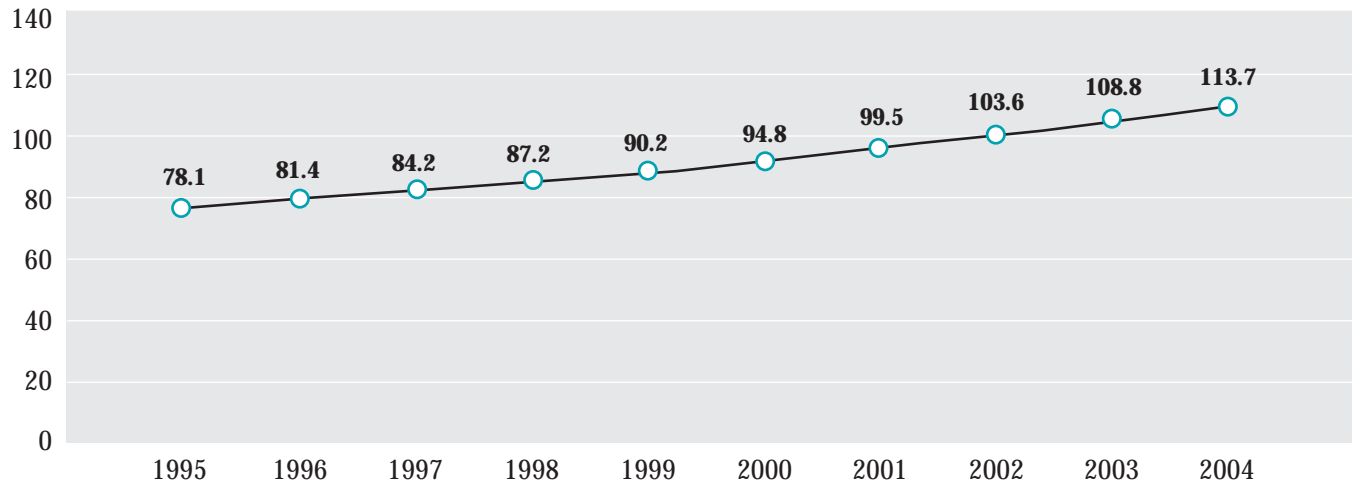
*** In fiscal year 1998, employer contributions increased to begin prefunding cost of living adjustments (COLAs) for retirees.

**** The Virginia Law Officers' Retirement System was effective on October 1, 1999.

Number of Retired Members

Fiscal Years 1995 – 2004

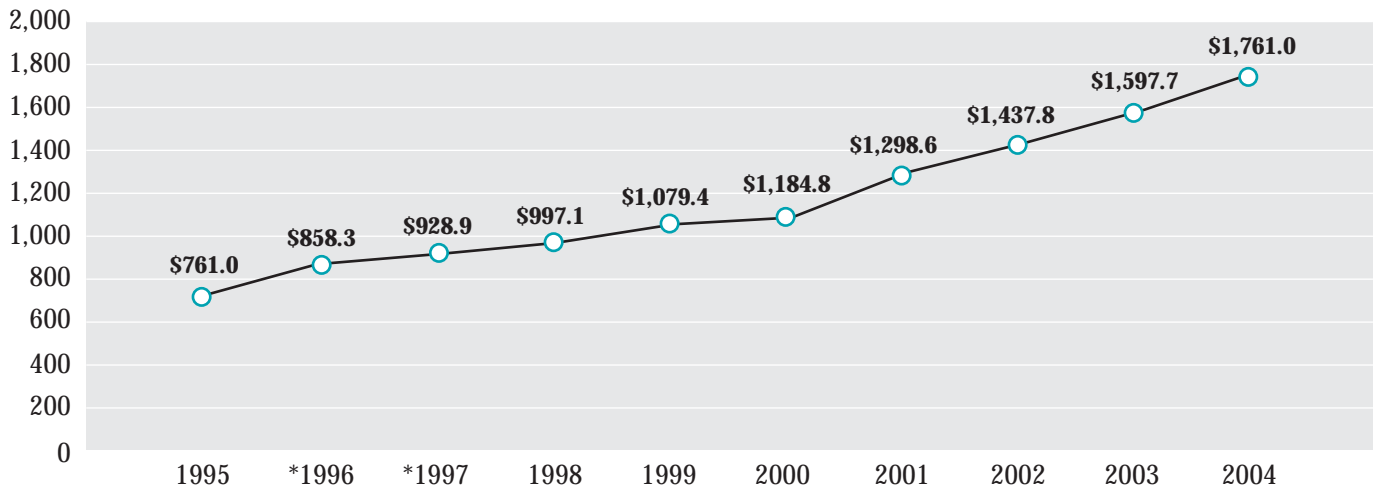
(Expressed in Thousands)



Retirement Benefits Paid

Fiscal Years 1995 – 2004

(Millions of Dollars)



* Increased by the Workforce Transition Act of 1995 for State Agencies

STATISTICAL SECTION

Pension Trust Funds Deductions by Type

Fiscal Years 1995 – 2004

(Expressed in Thousands)

| Year Ended June 30 | Retirement Benefits | Refunds | Administrative Expenses | Other | Total |
|--|------------------------|-----------|----------------------------|-------|--------------|
| Virginia Retirement System (VRS) | | | | | |
| 2004 | \$ 1,692,166 | \$ 80,237 | \$ 18,119 | \$ – | \$ 1,790,522 |
| 2003 | 1,537,762 | 67,473 | 16,201 | – | 1,621,436 |
| 2002 | 1,389,815 | 69,235 | 15,039 | 2,449 | 1,476,538 |
| 2001 | 1,261,348 | 79,439 | 14,100 | – | 1,354,887 |
| 2000 | 1,150,694 | 83,412 | 12,613 | – | 1,246,719 |
| 1999 | 1,047,362 | 84,797 | 11,359 | – | 1,143,518 |
| 1998 | 966,876 | 81,168 | 10,980 | 123 | 1,059,147 |
| 1997 | 900,241* | 76,884 | 10,395 | – | 987,520 |
| 1996 | 833,927* | 65,157 | 10,189 | 3 | 909,276 |
| 1995 | 740,639 | 63,182 | 8,801 | 12 | 812,634 |
| State Police Officers' Retirement System (SPORS) | | | | | |
| 2004 | 26,336 | \$ 731 | \$ 213 | \$ – | \$ 27,280 |
| 2003 | 23,594 | 863 | 205 | – | 24,662 |
| 2002 | 20,607 | 559 | 185 | – | 21,351 |
| 2001 | 17,980 | 289 | 170 | – | 18,439 |
| 2000 | 16,946 | 314 | 137 | – | 17,397 |
| 1999 | 16,020 | 420 | 141 | – | 16,581 |
| 1998 | 15,324 | 474 | 139 | – | 15,937 |
| 1997 | 14,634 | 465 | 131 | – | 15,230 |
| 1996 | 11,039* | 420 | 134 | – | 11,593 |
| 1995 | 8,448 | 457 | 109 | – | 9,014 |
| Virginia Law Officers' Retirement System (VaLORS) | | | | | |
| 2004 | \$ 19,784 | \$ 3,998 | \$ 196 | \$ – | \$ 23,978 |
| 2003 | 15,020 | 3,763 | 151 | – | 18,934 |
| 2002 | 8,485 | 3,657 | 57 | – | 12,199 |
| 2001 | 1,511 | 862 | 17 | – | 2,390 |
| 2000** | 330 | 149 | 2 | – | 481 |
| Judicial Retirement System (JRS) | | | | | |
| 2004 | \$ 22,706 | \$ – | \$ 117 | \$ – | \$ 22,823 |
| 2003 | 21,359 | 51 | 113 | – | 21,523 |
| 2002 | 18,884 | – | 104 | – | 18,988 |
| 2001 | 17,788 | 32 | 94 | – | 17,914 |
| 2000 | 16,872 | 24 | 105 | – | 17,001 |
| 1999 | 16,050 | 6 | 79 | – | 16,135 |
| 1998 | 14,856 | – | 78 | – | 14,934 |
| 1997 | 13,986 | – | 74 | – | 14,060 |
| 1996 | 13,380 | – | 74 | – | 13,454 |
| 1995 | 11,893 | 56 | 62 | – | 12,011 |

* Retirement benefits increased as a result of the Workforce Transition Act of 1995 for state agencies.

** The Virginia Law Officers' Retirement System was effective on October 1, 1999.

Schedule of Retirement Benefits by System

Fiscal Years 1995 – 2004

(Expressed in Thousands)

| Year Ended June 30 | Virginia Retirement System | | | | State Police Officers' Retirement System | Virginia Law Officers' Retirement System | Judicial Retirement System | Total |
|-----------------------|----------------------------|------------|------------|--------------|---|---|----------------------------------|--------------|
| | State | Teacher | Political | Sub-Total | | | | |
| 2004 | \$ 552,282 | \$ 855,113 | \$ 284,771 | \$ 1,692,166 | \$ 26,336 | \$ 19,784 | \$ 22,706 | \$ 1,760,992 |
| 2003 | 503,249 | 782,652 | 251,861 | 1,537,762 | 23,594 | 15,020 | 21,359 | 1,597,735 |
| 2002 | 454,123 | 710,538 | 225,154 | 1,389,815 | 20,607 | 8,485 | 18,884 | 1,437,791 |
| 2001 | 421,033 | 639,760 | 200,555 | 1,261,348 | 17,980 | 1,511 | 17,788 | 1,298,627 |
| 2000 | 394,601 | 575,876 | 180,217 | 1,150,694 | 16,946 | 330** | 16,872 | 1,184,842 |
| 1999 | 372,503 | 514,124 | 160,735 | 1,047,362 | 16,020 | – | 16,050 | 1,079,432 |
| 1998 | 354,862 | 467,367 | 144,647 | 966,876 | 15,324 | – | 14,856 | 997,056 |
| 1997 | 339,687* | 429,892 | 130,662 | 900,241 | 14,634* | – | 13,986 | 928,861 |
| 1996 | 317,398* | 400,111 | 116,418 | 833,927 | 11,039* | – | 13,380 | 858,346 |
| 1995 | 267,238 | 370,088 | 103,313 | 740,639 | 8,448 | – | 11,893 | 760,980 |

* Increased as a result of the Workforce Transition Act of 1995 for state agencies.

** The Virginia Law Officers' Retirement System was effective on October 1, 1999.

Schedule of Retirement Benefits by Type

Fiscal Years 1995 – 2004

(Expressed in Thousands)

| Year Ended June 30 | Service Benefits | Disability Benefits | Survivor Benefits | Total |
|-----------------------|---------------------|------------------------|----------------------|--------------|
| 2004 | \$ 1,537,173 | \$ 210,385 | \$ 13,434 | \$ 1,760,992 |
| 2003 | 1,386,236 | 199,391 | 12,108 | 1,597,735 |
| 2002 | 1,242,235 | 184,582 | 10,974 | 1,437,791 |
| 2001 | 1,121,588 | 167,931 | 9,108 | 1,298,627 |
| 2000 | 1,021,185 | 155,450 | 8,207 | 1,184,842 |
| 1999 | 928,862 | 143,181 | 7,389 | 1,079,432 |
| 1998 | 861,377 | 128,637 | 7,042 | 997,056 |
| 1997 | 805,391* | 117,133 | 6,337 | 928,861 |
| 1996 | 745,864* | 106,449 | 6,033 | 858,346 |
| 1995 | 661,231 | 94,239 | 5,510 | 760,980 |

* Increased as a result of the Workforce Transition Act of 1995 for state agencies.

Schedule of Refunds by Type

Fiscal Years 1995 – 2004

(Expressed in Thousands)

| Year Ended June 30 | Separation | Death | Total |
|-----------------------|------------|-----------|-----------|
| 2004 | \$ 73,715 | \$ 11,251 | \$ 84,966 |
| 2003 | 64,203 | 7,947 | 72,150 |
| 2002 | 65,893 | 7,558 | 73,451 |
| 2001 | 73,659 | 6,963 | 80,622 |
| 2000 | 77,027 | 6,872 | 83,899 |
| 1999 | 78,530 | 6,693 | 85,223 |
| 1998 | 74,731 | 6,911 | 81,642 |
| 1997 | 72,077 | 5,272 | 77,349 |
| 1996 | 61,126 | 4,451 | 65,577 |
| 1995 | 59,225 | 4,470 | 63,695 |

Schedule of Retired Members by Type of Benefit and Option Selected

As of June 30, 2004

| Amount of Retirement Benefit | Number of Retirants | Service | Type of Retirement | | | | | | | |
|------------------------------|---------------------|---------------|-------------------------|--------------------------|-----------------------------------|--------------------|-----------------------------------|-------------------------|--|-----------------|
| | | | Early Retirement Window | 50/30 Service Retirement | 1991 Fac. Early Retirement Window | Regular Disability | Survivor Payment-Death in Service | Line-of-Duty Disability | Survivor Payment-Death in Line-of-Duty | 50/10 Provision |
| \$ 1 - 200 | 14,120 | 12,019 | 3 | - | 1 | 1,013 | 520 | 68 | 4 | 492 |
| 201 - 400 | 18,185 | 14,396 | 132 | - | - | 2,394 | 391 | 136 | 19 | 717 |
| 401 - 600 | 14,711 | 10,866 | 358 | 4 | - | 2,612 | 208 | 238 | 28 | 397 |
| 601 - 800 | 11,507 | 8,170 | 463 | 19 | 1 | 2,100 | 131 | 354 | 21 | 248 |
| 801 - 1,000 | 9,272 | 6,366 | 608 | 67 | 3 | 1,555 | 79 | 357 | 8 | 229 |
| 1,001 - 1,200 | 7,448 | 4,962 | 661 | 177 | 3 | 1,136 | 65 | 252 | 5 | 187 |
| 1,201 - 1,400 | 6,092 | 4,011 | 629 | 215 | 16 | 831 | 30 | 200 | 4 | 156 |
| 1,401 - 1,600 | 5,435 | 3,574 | 616 | 282 | 25 | 590 | 35 | 164 | 3 | 146 |
| 1,601 - 1,800 | 5,037 | 3,257 | 496 | 544 | 37 | 424 | 19 | 135 | 1 | 124 |
| 1,801 - 2,000 | 5,122 | 3,322 | 375 | 799 | 37 | 357 | 22 | 128 | - | 82 |
| Over 2,001 | 16,788 | 12,296 | 752 | 2,309 | 175 | 731 | 59 | 285 | 2 | 179 |
| Totals | 113,717 | 83,239 | 5,093 | 4,416 | 298 | 13,743 | 1,559 | 2,317 | 95 | 2,957 |

Min. Guar. Amount of Retirement Benefit

| Min. Guar. Amount of Retirement Benefit | Option Selected | | | | | | | | | | | | | | | | | |
|---|-----------------|------------|--------------|--------------|--------------|------------|----------|--------------|------------|----------|------------|--------------|------------|--------------|------------|--------------|------------|--|
| | A | B | C | D | E | F | G | H | K | L | M | N | R | V | X | Y | Z | |
| \$ 1 - 200 | 11,190 | 102 | 542 | 234 | 1,203 | 3 | 1 | 90 | 6 | - | 2 | 656 | 11 | 72 | 1 | 6 | 1 | |
| 201 - 400 | 14,277 | 42 | 624 | 460 | 1,040 | 7 | - | 824 | 34 | 2 | 19 | 651 | 5 | 175 | 6 | 15 | 4 | |
| 401 - 600 | 10,736 | 41 | 521 | 522 | 977 | 15 | - | 1,161 | 77 | - | 27 | 450 | 3 | 152 | 7 | 18 | 4 | |
| 601 - 800 | 8,036 | 30 | 442 | 553 | 879 | 13 | - | 893 | 69 | - | 38 | 334 | 4 | 170 | 14 | 24 | 8 | |
| 801 - 1,000 | 6,243 | 10 | 371 | 584 | 841 | 23 | - | 598 | 45 | 1 | 22 | 292 | 3 | 178 | 8 | 41 | 12 | |
| 1,001 - 1,200 | 4,835 | 2 | 352 | 535 | 768 | 16 | - | 381 | 30 | 1 | 14 | 225 | 5 | 192 | 14 | 59 | 19 | |
| 1,201 - 1,400 | 4,002 | 3 | 288 | 461 | 521 | 21 | - | 235 | 23 | 1 | 10 | 178 | 11 | 199 | 15 | 89 | 35 | |
| 1,401 - 1,600 | 3,575 | 1 | 283 | 419 | 424 | 34 | - | 145 | 6 | - | 5 | 161 | 4 | 221 | 18 | 115 | 24 | |
| 1,601 - 1,800 | 3,488 | - | 208 | 379 | 292 | 35 | - | 66 | 5 | - | 1 | 142 | 6 | 199 | 14 | 160 | 42 | |
| 1,801 - 2,000 | 3,615 | - | 166 | 362 | 219 | 37 | - | 56 | 5 | - | 1 | 161 | 7 | 190 | 21 | 228 | 54 | |
| Over 2,001 | 11,086 | 1 | 556 | 1,107 | 372 | 201 | - | 71 | 12 | - | 1 | 716 | 135 | 1,037 | 195 | 1,010 | 288 | |
| Totals | 81,083 | 232 | 4,353 | 5,616 | 7,536 | 405 | 1 | 4,520 | 312 | 5 | 140 | 3,966 | 194 | 2,785 | 313 | 1,765 | 491 | |

- A = Basic Benefit
- B = Increased Basic Benefit
- C = 100% Survivor Benefit
- D = 50% Survivor Benefit
- E = Social Security Leveling Benefit
- F = Special Survivor Option
- G = Lump Sum
- H = Minimum Guaranteed Disability Basic Benefit
- K = Minimum Guaranteed Disability - 50% Survivor
- L = 100% Survivor - Disability
- M = Special Survivor Option - Disability
- N = Leveling Benefit
- R = Leveling Benefit - Rollover
- V = Survivor Option
- Y = PLOP Basic
- X = Advance Pension Option
- Z = PLOP with survivor

Retirement Breakdown: During fiscal year 2004, 90% of all retirements were service retirements, and 10% were certified as disability retirements by the Medical Board.

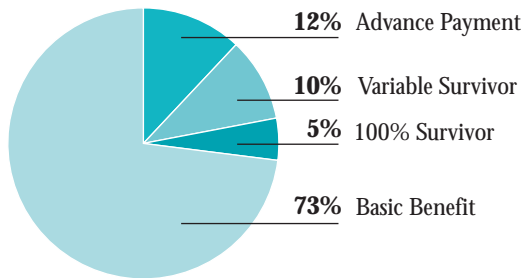
Schedule of Average Benefit Payments

Retirement Effective Date July 1, 1999, to June 30, 2004

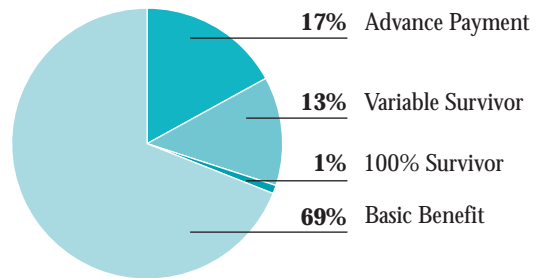
| | | Years of Credited Service | | | | | |
|---------|---------------------------------|---------------------------|-----------|-----------|-------------|-------------|-------------|
| | | 1-10 | 11-15 | 16-20 | 21-25 | 26-30 | Over 30 |
| FY 2004 | Average Monthly Benefit..... | \$ 311.29 | \$ 492.98 | \$ 716.50 | \$ 1,057.30 | \$ 1,726.91 | \$ 2,396.00 |
| | Number of Active Retirants..... | 694 | 711 | 867 | 851 | 1,582 | 2,935 |
| FY 2003 | Average Monthly Benefit..... | \$ 326.30 | \$ 473.50 | \$ 686.13 | \$ 1,052.83 | \$ 1,739.64 | \$ 2,389.74 |
| | Number of Active Retirants..... | 659 | 794 | 798 | 958 | 1,575 | 2,904 |
| FY 2002 | Average Monthly Benefit..... | \$ 294.63 | \$ 450.29 | \$ 671.40 | \$ 1,010.69 | \$ 1,757.42 | \$ 2,316.68 |
| | Number of Active Retirants..... | 627 | 715 | 743 | 988 | 1,538 | 2,277 |
| FY 2001 | Average Monthly Benefit..... | \$ 306.46 | \$ 452.17 | \$ 678.20 | \$ 999.05 | \$ 1,689.12 | \$ 2,302.94 |
| | Number of Active Retirants..... | 623 | 803 | 805 | 1,037 | 1,504 | 2,453 |
| FY 2000 | Average Monthly Benefit..... | \$ 234.76 | \$ 414.85 | \$ 686.39 | \$ 911.42 | \$ 1,587.73 | \$ 2,218.68 |
| | Number of Active Retirants..... | 673 | 742 | 762 | 1,039 | 1,385 | 2,482 |

Distribution of Retirees by Payment Option Selected

All Retirees at June 30, 2004



2004 Retirees



Options for Retirement

VRS offers several options for retirement:

Basic Benefit:

Monthly annuity payments are based on the normal benefit formula. Any accumulated contributions that have not been used between the date of contributions and the date of death are paid in a lump sum to the designated beneficiary.

Variable Survivor:

For the retiree, the benefit is more than the 100% survivor option benefit. At death, a percentage of the monthly benefit is continued to the designated contingent annuitant.

Advance Payment:

Leveling/Social Security

Allows an advance on the benefit; therefore, the retiree receives a higher benefit in the early years of retirement. The advance is paid from retirement date until the age specified by the retiree (between 59½ and 70½, or age 65 under the Social Security option). This benefit reduces at the level age.

Partial Lump Sum

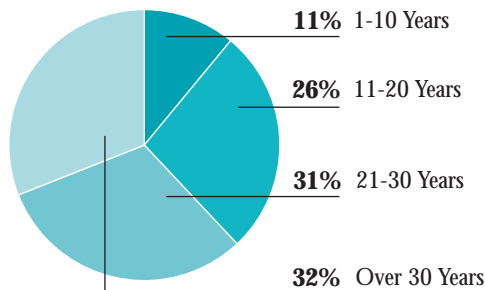
This option allows the member with earned service beyond their normal retirement date to elect a lump sum payment equal to the sum of 12, 24, or 36 payments of the standard monthly life annuity. The member's monthly benefit will be actuarially reduced to reflect the lump sum payment.

100% Survivor:

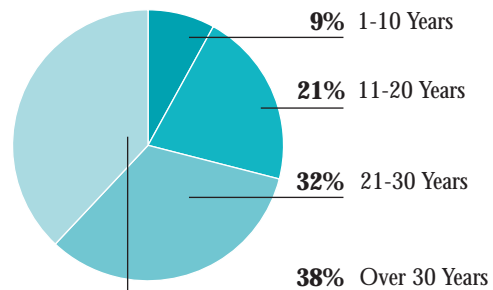
The basic benefit is reduced during the member's lifetime. At death, the benefit is continued in the same amount to the designated contingent annuitant.

Distribution of Retirees by Years of Service

All Retirees at June 30, 2004

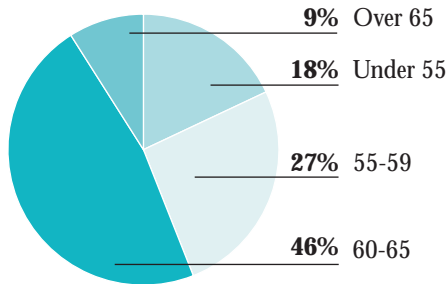


2004 Retirees

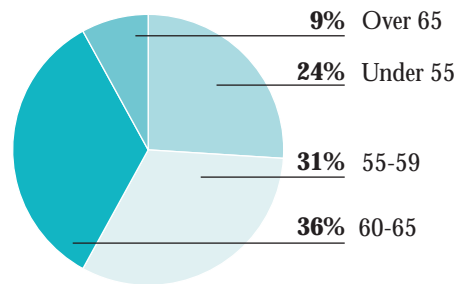


Distribution of Retirees by Age at Retirement

All Retirees at June 30, 2004

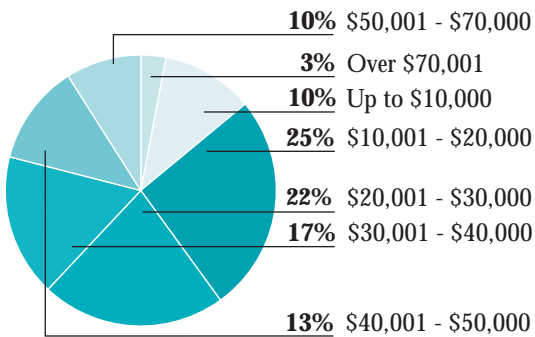


2004 Retirees

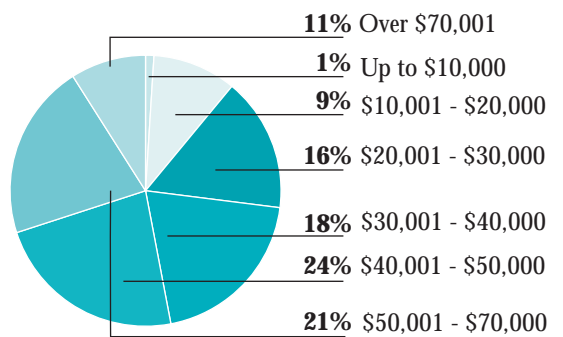


Distribution of Retirees by Average Final Salary

All Retirees at June 30, 2004



2004 Retirees



Other Employee Benefit Trust Funds

Schedule of Group Insurance Additions by Source

Fiscal Years 1995–2004

(Expressed in Thousands)

| Year Ended June 30 | Contributions | | | | Investment Income (Loss) | Other | Total |
|-----------------------|---------------|---------|-----------|-----------|-----------------------------|-------|------------|
| | State | Teacher | Political | Sub-Total | | | |
| 2004* | \$ 1 | \$ – | \$ 19 | \$ 20 | \$ 133,715 | \$ – | \$ 133,735 |
| 2003* | 5 | 22 | 17 | 44 | 18,297 | – | 18,341 |
| 2002* | 22,919 | 28,267 | 17,614 | 68,800 | (72,021) | – | (3,221) |
| 2001 | 29,703 | 37,027 | 21,894 | 88,624 | (77,363) | – | 11,261 |
| 2000* | 1 | 2 | 41 | 44 | 139,707 | 277 | 140,028 |
| 1999* | (1) | 1 | 22 | 22 | 110,393 | – | 110,415 |
| 1998 | 8,973 | 10,958 | 6,435 | 26,366 | 145,280 | – | 171,646 |
| 1997* | 12 | (39) | 33 | 6 | 154,091 | – | 154,097 |
| 1996 | 9,904 | 12,136 | 6,924 | 28,964 | 116,840 | – | 145,804 |
| 1995 | 5,025 | 5,853 | 3,311 | 14,189 | 95,497 | – | 109,686 |

* The group life insurance contribution rates for fiscal years 2004, 2003, 2000, 1999 and 1997 were zero. Amounts shown are adjustments and contributions for new employers. For fiscal years 2000, 1999 and 1997 the rate change was the result of a statutory premium holiday. There was also a premium holiday beginning in April 2002.

Schedule of Group Insurance Claims by Type

Fiscal Years 1995 – 2004

(Expressed in Thousands)

| Year Ended June 30 | Active Claims | Retired Claims | Total |
|-----------------------|------------------|-------------------|------------|
| 2004 | \$ 42,290 | \$ 63,741 | \$ 106,031 |
| 2003 | 44,614 | 59,661 | 104,275 |
| 2002 | 39,617 | 56,008 | 95,625 |
| 2001 | 36,899 | 51,280 | 88,179 |
| 2000 | 34,113 | 48,912 | 83,025 |
| 1999 | 23,309 | 36,772 | 60,081 |
| 1998 | 26,854 | 45,919 | 72,773 |
| 1997 | 27,461 | 44,644 | 72,105 |
| 1996 | 25,081 | 40,095 | 65,176 |
| 1995 | 28,659 | 35,372 | 64,031 |

Schedule of Retiree Health Insurance Credit Additions and Reimbursements

Fiscal Years 1995 – 2004

(Expressed in Thousands)

| Year Ended June 30 | Additions | | | Total | Health Insurance Reimbursements |
|-----------------------|---------------|-----------------------------|-------|-----------|---------------------------------------|
| | Contributions | Investment Income (Loss) | Other | | |
| 2004 | \$ 78,383 | \$ 15,582 | \$ – | \$ 93,965 | \$ 64,920 |
| 2003 | 74,123 | 3,265 | – | 77,388 | 61,027 |
| 2002 | 85,209 | (5,080) | – | 80,129 | 57,590 |
| 2001 | 73,901 | (3,089) | – | 70,812 | 54,628 |
| 2000** | 17,592 | 6,323 | – | 23,915 | 50,456 |
| 1999* | 35,260 | 7,689 | 1 | 42,950 | 30,254 |
| 1998 | 22,123 | 7,637 | 14 | 29,774 | 17,372 |
| 1997 | 20,357 | 7,158 | – | 27,515 | 16,810 |
| 1996 | 20,180 | 3,592 | – | 23,772 | 13,594 |
| 1995 | 20,057 | 3,023 | – | 23,080 | 13,652 |

* Data for FY 1999 reflect extension of coverage to all teachers on July 1, 1998, and a premium holiday for state agencies in May and June, 1999.

** No contributions were paid for state employees during FY 2000. The maximum health credit increased for state employees to \$120.00 per month and for teachers to \$75.00 effective July 1, 1999.

Participating Employers as of June 30, 2004

Political Subdivisions (419)

| | | | |
|----------------------|--------------------------|------------------------|------------------------|
| Accomack County | Montgomery County | City of Norton | Town of Grottoes |
| Albemarle County | Nelson County | City of Petersburg | Town of Grundy |
| Alleghany County | New Kent County | City of Poquoson | Town of Halifax |
| Amelia County | Northampton County | City of Portsmouth | Town of Hamilton |
| Amherst County | Northumberland County | City of Radford | Town of Herndon |
| Appomattox County | Nottoway County | City of Richmond | Town of Hillsville |
| Augusta County | Orange County | City of Roanoke | Town of Hurt |
| Bath County | Page County | City of Salem | Town of Independence |
| Bedford County | Patrick County | City of Staunton | Town of Iron Gate |
| Bland County | Pittsylvania County | City of Suffolk | Town of Jarratt |
| Botetourt County | Prince Edward County | City of Virginia Beach | Town of Jonesville |
| Brunswick County | Prince George County | City of Waynesboro | Town of Kenbridge |
| Buchanan County | Prince William County | City of Williamsburg | Town of Kilmarnock |
| Buckingham County | Pulaski County | City of Winchester | Town of La Crosse |
| Campbell County | Rappahannock County | Town of Abingdon | Town of Lawrenceville |
| Caroline County | Richmond County | Town of Alberta | Town of Leesburg |
| Carroll County | Roanoke County | Town of Altavista | Town of Louisa |
| Charles City County | Rockbridge County | Town of Amherst | Town of Luray |
| Charlotte County | Rockingham County | Town of Appomattox | Town of Madison |
| Chesterfield County | Russell County | Town of Ashland | Town of Marion |
| Clarke County | Scott County | Town of Berryville | Town of McKenney |
| Craig County | Shenandoah County | Town of Big Stone Gap | Town of Middleburg |
| Culpeper County | Smyth County | Town of Blacksburg | Town of Middletown |
| Cumberland County | Southampton County | Town of Blackstone | Town of Montross |
| Dickenson County | Spotsylvania County | Town of Bluefield | Town of Mt. Jackson |
| Dinwiddie County | Stafford County | Town of Bowling Green | Town of Narrows |
| Essex County | Surry County | Town of Boyce | Town of New Market |
| Fauquier County | Sussex County | Town of Boydton | Town of Onancock |
| Floyd County | Tazewell County | Town of Bridgewater | Town of Onley |
| Fluvanna County | Warren County | Town of Broadway | Town of Orange |
| Franklin County | Washington County | Town of Brookneal | Town of Parksley |
| Frederick County | Westmoreland County | Town of Burkeville | Town of Pearisburg |
| Giles County | Wise County | Town of Cape Charles | Town of Pembroke |
| Gloucester County | Wythe County | Town of Chase City | Town of Pennington Gap |
| Goochland County | York County | Town of Chatham | Town of Pound |
| Grayson County | City of Alexandria | Town of Chillumie | Town of Pulaski |
| Greene County | City of Bedford | Town of Chincoteague | Town of Purcellville |
| Greensville County | City of Bristol | Town of Christiansburg | Town of Quantico |
| Halifax County | City of Buena Vista | Town of Clarksville | Town of Remington |
| Hanover County | City of Chesapeake | Town of Clifton Forge | Town of Rich Creek |
| Henrico County | City of Colonial Heights | Town of Coeburn | Town of Rocky Mount |
| Henry County | City of Covington | Town of Colonial Beach | Town of Round Hill |
| Highland County | City of Danville | Town of Courtland | Town of Rural Retreat |
| Isle of Wight County | City of Emporia | Town of Craigsville | Town of Saltville |
| James City County | City of Fairfax | Town of Crewe | Town of Scottsville |
| King & Queen County | City of Falls Church | Town of Culpeper | Town of Shenandoah |
| King George County | City of Franklin | Town of Dayton | Town of Smithfield |
| King William County | City of Fredericksburg | Town of Dillwyn | Town of South Boston |
| Lancaster County | City of Galax | Town of Dublin | Town of South Hill |
| Lee County | City of Hampton | Town of Dumfries | Town of St. Paul |
| Loudoun County | City of Harrisonburg | Town of Edinburg | Town of Stanley |
| Louisa County | City of Hopewell | Town of Elkton | Town of Strasburg |
| Lunenburg County | City of Lexington | Town of Exmore | Town of Stuart |
| Madison County | City of Lynchburg | Town of Floyd | Town of Tappahannock |
| Mathews County | City of Manassas | Town of Front Royal | Town of Tazewell |
| Mecklenburg County | City of Manassas Park | Town of Gate City | Town of Timberville |
| Middlesex County | City of Martinsville | Town of Glasgow | Town of Urbanna |
| | City of Norfolk | Town of Gretna | Town of Victoria |

| | | | |
|-------------------------------------|-----------------------------------|---------------------------------------|---------------------------------------|
| Town of Vienna | Chesterfield County | Harrisonburg-Rockingham | Pepper's Ferry Regional |
| Town of Vinton | Health Center Commission | Regional Sewer Authority | Wastewater Authority |
| Town of Wakefield | Clinch Valley Soil & Water | Henricopolis Soil & | Peter Francisco Soil & Water |
| Town of Warrenton | Conservation District | Water Conservation District | Conservation District |
| Town of Warsaw | Coeburn-Norton-Wise Regional | Henry County Public | Petersburg Redevelopment & |
| Town of Waverly | Water Treatment Authority | Service Authority | Housing Authority |
| Town of Weber City | Colonial Services Board | Highlands Juvenile Detention | Peumansend Creek Regional Jail |
| Town of West Point | Colonial Soil & Water | Center Commission | Piedmont Planning |
| Town of Windsor | Conservation District | Holston River Soil & | District Commission |
| Town of Wise | Covington Redevelopment & | Water Conservation District | Piedmont Regional Jail |
| Town of Woodstock | Housing Authority | Hopewell Redevelopment & | Piedmont Regional Juvenile |
| Town of Wytheville | Crater Juvenile Detention | Housing Authority | Detention Center |
| Accomack-Northampton | Home Commission | Industrial Development Authority of | Pittsylvania County Service Authority |
| Planning District Commission | Culpeper Soil & | Henrico County | Planning District One |
| Albemarle County | Water Conservation District | James City Service Authority | Behavioral Health Services Board |
| Service Authority | Cumberland Mountain | John Marshall Soil & Water | Potomac and Rappahannock |
| Albermarle-Charlottesville | Community Services Board | Conservation District | Transportation Commission |
| Regional Jail | Cumberland Plateau | Lee County Redevelopment & | Potomac River Fisheries Commission |
| Alexandria Redevelopment | Regional Housing Authority | Housing Authority | Prince William Soil & Water |
| & Housing Authority | Daniel Boone Soil & | Lee County Public Service Authority | Conservation District |
| Alexandria Sanitation Authority | Water Conservation District | Lenwisco Planning District Commission | Rappahannock Area |
| Alleghany Highlands | Danville-Pittsylvania | Lonesome Pine Regional Library | Community Services Board |
| Community Services Board | Community Services Board | Loudoun County Sanitation Authority | Rappahannock Juvenile Center |
| Amherst County | Danville Redevelopment & | Massanutten Regional Library | Rappahannock-Rapidan |
| Service Authority | Housing Authority | Meherrin Regional Library | Community Services Board |
| Anchor Commission | Dinwiddie County Water Authority | Middle Peninsula-Northern Neck | Rappahannock-Rapidan Regional |
| Appomattox Regional Library | District 19 Mental Health & | Community Services Board | Planning District Commission |
| Appomattox River Water Authority | Mental Retardation Services Board | Middle Peninsula Regional | Rappahannock Regional Jail |
| Augusta County Service Authority | Eastern Shore | Security Center | Region Ten Community Services |
| Bedford County | Community Services Board | Monacan Soil & | Board |
| Public Service Authority | Eastern Shore Public Library | Water Conservation District | Richmond Metropolitan Authority |
| Bedford Public Library | Evergreen Soil and Water | Montgomery Regional | Richmond Redevelopment & |
| Big Walker Soil & Water | Conservation District | Solid Waste Authority | Housing Authority |
| Conservation District | Fauquier County Water & | Nelson County Service Authority | Richmond Regional |
| Blacksburg-Christiansburg- | Sanitation Authority | New River Resource Authority | Planning District Commission |
| VPI Water Authority | Ferrum Water & Sewage Authority | New River Soil & | Rivanna Solid Waste Authority |
| Blacksburg-VPI Sanitation Authority | Franklin Redevelopment & | Water Conservation District | Rivanna Water & Sewer Authority |
| Blue Ridge Juvenile | Housing Authority | New River Valley | Riverside Regional Jail |
| Detention Center | Frederick County | Community Services Board | Roanoke Higher Education Authority |
| Blue Ridge Regional Jail Authority | Sanitation Authority | New River Valley Juvenile Detention | Roanoke River Service Authority |
| Bristol Redevelopment & | Fredericksburg-Stafford | Home Commission | Robert E. Lee |
| Housing Authority | Park Authority | New River Valley Planning | Soil & Water Conservation District |
| Brunswick Industrial | Giles County Public Service | District Commission | Rockbridge Area |
| Development Authority | Authority | New River Valley Regional Jail | Community Services Board |
| Campbell County Utilities & | Goochland-Powhatan | Norfolk Airport Authority | Rockbridge Area |
| Service Authority | Community Services Board | Norfolk Redevelopment & | Social Services Department |
| Capital Regional Airport Commission | Great Southwest Regional | Housing Authority | Rockbridge County |
| Central Rappahannock | Group Home Commission | Northern Neck-Essex County Group | Public Service Authority |
| Regional Library | Greensville County Water & | Home Commission | Rockbridge Regional Library |
| Central Virginia Community | Sewer Authority | Northern Neck Planning | Russell County |
| Services Board | Greensville-Emporia | District Commission | Water & Sewage Authority |
| Central Virginia Regional Jail | Department of Social Services | Northern Neck Regional Jail | Scott County Public Service Authority |
| Central Virginia | Hampton-Newport News | Regional Commission | Scott County Redevelopment and |
| Waste Management Authority | Community Services Board | Northern Shenandoah Valley | Housing Authority |
| Charles Pickney Jones | Hampton Redevelopment & | Center Commission | Scott County |
| Memorial Library | Housing Authority | Northern Virginia Health Care | Soil & Water Conservation District |
| Charlottesville-Albemarle | Hampton Roads | Center Commission | Shenandoah Valley Juvenile |
| Airport Authority | Planning District Commission | Northern Virginia Juvenile | Detention Home Commission |
| Charlottesville Redevelopment & | Hampton Roads | Detention Home | Shenandoah Valley |
| Housing Authority | Regional Jail Authority | Northwestern Community | Regional Airport Commission |
| Chesapeake Bay Bridge & | Hampton Roads Sanitation District | Services Board | South Central Wastewater Authority |
| Tunnel District | Handley Library Board | Opportunity Inc. of Hampton Roads | Southeastern Virginia |
| Chesapeake Redevelopment & | Harrisonburg-Rockingham | Pamunkey Regional Jail | Public Services Authority |
| Housing Authority | Community Services Board | Peaks of Otter Soil & | Southside Community |
| | | Water Conservation District | Services Board |
| | | Peninsula Airport Commission | |

Southside Planning
District Commission
Southside Regional Jail
Southside Regional Juvenile
Group Home Commission
Southside Regional Library Board
Southwest Virginia Regional Jail
Spotsylvania-Stafford-Fredericksburg
Group Home Commission
Staunton Redevelopment &
Housing Authority
Suffolk Redevelopment &
Housing Authority
Sussex Service Authority
Tazewell Soil & Water
Conservation District
Thomas Jefferson
Planning District Commission
Thomas Jefferson
Soil & Water Conservation District
Tidewater Regional
Group Home Commission
Tidewater Transportation
District Commission
Tri-County/City Soil & Water
Conservation District
Upper Occoquan Sewage Authority
Valley Community Services Board
Virginia Biotechnology
Research Park Authority
Virginia Coalfield Economic
Development Authority
Virginia Highlands
Airport Commission
Virginia Peninsula Regional Jail
Virginia Peninsulas
Public Service Authority
Washington County Service Authority
Waynesboro Redevelopment &
Housing Authority
Western Tidewater
Community Services Board
Western Tidewater Regional Jail
Wise County
Public Service Authority
Wise County Redevelopment &
Housing Authority
Wythe-Grayson Regional Library
Wytheville Redevelopment &
Housing Authority

**Public School Boards—Professional
Employees**

City/Town Schools (39)
Alexandria City Schools*
Bristol City Schools*
Buena Vista City Schools*
Charlottesville Public Schools*
Chesapeake Public Schools*
Colonial Beach Schools
Colonial Heights City Schools*
Covington City Schools*
Danville City Schools*

Fairfax City Schools
Falls Church Public Schools
Franklin City Schools*
Fredericksburg City Schools*
Galax City Schools*
Hampton City Schools*
Harrisonburg City Schools*
Hopewell City Schools*
Lexington City Schools*
Lynchburg Public Schools*
Manassas City Schools*
Manassas Park City Schools*
Martinsville City Schools*
Newport News Public Schools
Norfolk Public Schools*
Norton City Schools*
Petersburg City Schools*
Poquoson City Schools*
Portsmouth City Schools*
Radford City Schools*
Richmond Public Schools*
Roanoke City Schools
Salem City Schools*
Staunton City Schools*
Suffolk City Schools*
Virginia Beach City Schools*
Waynesboro City Schools*
West Point Schools
Williamsburg-James City
County Schools*
Winchester Public Schools*

County Schools (94)

Accomack County Schools*
Albemarle County Schools*
Alleghany County Schools*
Amelia County Schools*
Amherst County Schools*
Appomattox County Schools*
Arlington County Schools*
Augusta County Schools*
Bath County Schools*
Bedford County Schools*
Bland County Schools*
Botetourt County Schools*
Brunswick County Schools*
Buchanan County Schools*
Buckingham County Schools*
Campbell County Schools*
Caroline County Schools*
Carroll County Schools*
Charles City County Schools*
Charlotte County Schools*
Chesterfield County Schools*
Clarke County Schools*
Craig County Schools*
Culpeper County Schools*
Cumberland County Schools*
Dickenson County Schools*
Dinwiddie County Schools*
Essex County Schools*

Fairfax County Schools
Fauquier County Schools*
Floyd County Schools*
Fluvanna County Schools*
Franklin County Schools*
Frederick County Schools*
Giles County Schools*
Gloucester County Schools*
Goochland County Schools*
Grayson County Schools*
Greene County Schools*
Greensville County Schools*
Halifax County Schools*
Hanover County Schools*
Henrico County Schools*
Henry County Schools*
Highland County Schools*
Isle of Wight County Schools*
King & Queen County Schools*
King George County Schools*
King William County Schools*
Lancaster County Schools*
Lee County Schools*
Loudoun County Schools*
Louisa County Schools*
Lunenburg County Schools*
Madison County Schools*
Mathews County Schools*
Mecklenburg County Schools*
Middlesex County Schools*
Montgomery County Schools*
Nelson County Schools*
New Kent County Schools*
Northampton County Schools*
Northumberland County Schools*
Nottoway County Schools*
Orange County Schools*
Page County Schools*
Patrick County Schools*
Pittsylvania County Schools*
Powhatan County Schools*
Prince Edward County Schools*
Prince George County Schools*
Prince William County Schools*
Pulaski County Schools*
Rappahannock County Schools*
Richmond County Schools*
Roanoke County Schools*
Rockbridge County Schools*
Rockingham County Schools*
Russell County Schools*
Scott County Schools*
Shenandoah County Schools*
Smyth County Schools*
Southampton County Schools*
Spotsylvania County Schools*
Stafford County Schools*
Surrey County Schools*
Sussex County Schools*
Tazewell County Schools*
Warren County Schools*

Washington County Schools*
Westmoreland County Schools*
Wise County Schools*
Wythe County Schools*
York County Schools*

Other Schools (12)

Amelia-Nottoway Vocational Center
Appomattox Region
Governor's School
Charlottesville-Albemarle
Vocational Technical Center
Governor's School for
Global Economics and Technology
Jackson River Vocational
Technical Center*
Maggie Walker Governor's School
for Government and International
Studies
New Horizons Technical Center*
Northern Neck Regional
Special Education Program
Northern Neck Regional
Vocational Center*
Rowanty Vocational
Technical Center
The Pruden Center for
Industry and Technology*
Valley Vocational Technical Center*

*Non-Professional employees also
covered (131 School Boards)

**Agencies of the Commonwealth of
Virginia (234)**

Program with Oversight by VRS

Deferred Compensation Plan of the Commonwealth of Virginia

The Deferred Compensation Plan is regulated by Chapter Six of Title 51.1 of the *Code of Virginia* and is intended to be an eligible plan within the meaning of Internal Revenue Code Section 457(b). The purpose of the Plan is to provide participants with a convenient way to save for retirement through deferrals of compensation. The Plan is available, on a voluntary basis, to all salaried (full-time or part-time) employees, including elected and appointed officials providing services to the Commonwealth, and to eligible employees of participating political subdivisions.

Statement of Changes in Plan Assets

Years Ended June 30, 2004 and 2003

| | 2004 | 2003 |
|---|------------------------------|------------------------------|
| Plan Assets on July 1 | \$ 513,766,036 | \$ 450,283,729 |
| Contributions | 81,146,682 | 75,891,469 |
| Distributions | (30,962,780) | (25,947,422) |
| Plan Transfers ¹ | 492,087 | 155,412 |
| Third Party Administration Fees ² | (1,615,771) | (1,279,994) |
| Period Earnings | 69,344,804 | 15,365,921 |
| Net Decrease/Increase in the Present Value of Annuity's Future Benefits | (748,846) | (703,079) |
| Plan Assets on June 30 | <u>\$ 631,422,212</u> | <u>\$ 513,766,036</u> |

¹ Represents plan transfers from other eligible Section 457(b) plans into the Commonwealth's Plan.

² The current third party administrator, Great-West/BenefitsCorp. Corporation, is compensated based on an annual recordkeeping and communication fee of 30 basis points (0.30%) capped at account balances of \$150,000 on total non-annuitized assets.

Deferred Compensation Plan – Operational Overview

A total of 5,505 employees enrolled in the Commonwealth's 457 Deferred Compensation Plan during the 2003–2004 fiscal year. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) became effective January 1, 2002, allowing increased tax deferred savings and to have increased portability of benefits. In addition, during the year the Plan was modified to allow employee bonuses, as well as unused vacation and sick leave payments to be contributed to the Plan. Contributions to the Plan during FY 2004 increased to \$81,146,682 from \$75,891,469 in FY 2003.

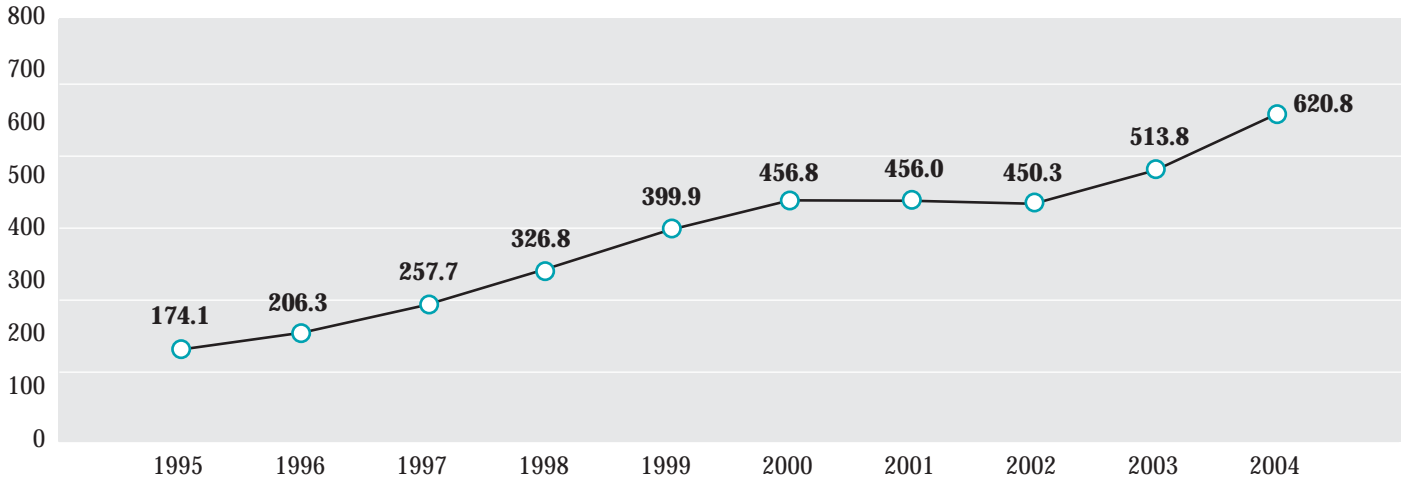
EGTRRA also made the 457 Plan attractive for employees of colleges and universities by removing the coordination between 457 Plans and 403(b) tax-deferred accounts. From the effective date of EGTRRA to June 30, 2004 the number of college and university employee Plan accounts increased from 287 in FY 2001* to 2,203 in FY2004.

*2001 is the baseline year. EGTRRA was effective January 1, 2002.

The 2001 legislation also allowed 457 Plan participants to use monies in their accounts to purchase permissive service credit in the defined benefit plan. During the fiscal year ended June 30, 2004, 1,121 Plan participants used the trustee to trustee transfer provision to buy VRS service credit with \$5,273,742 transferring from the 457 Plan to the defined benefit plan.

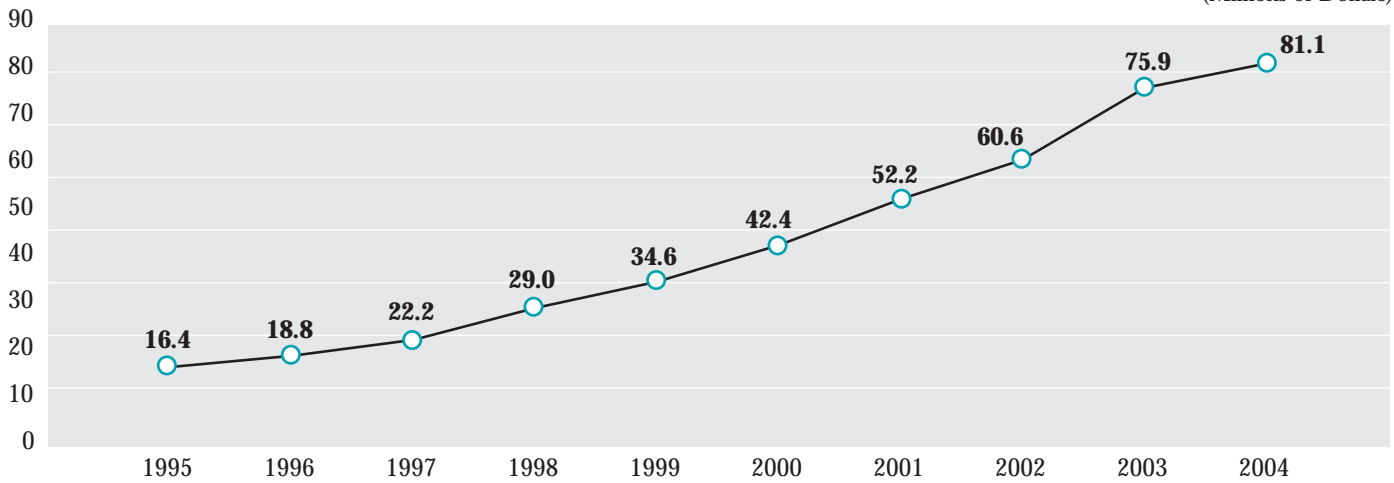
Deferred Compensation Program Assets

(Millions of Dollars)



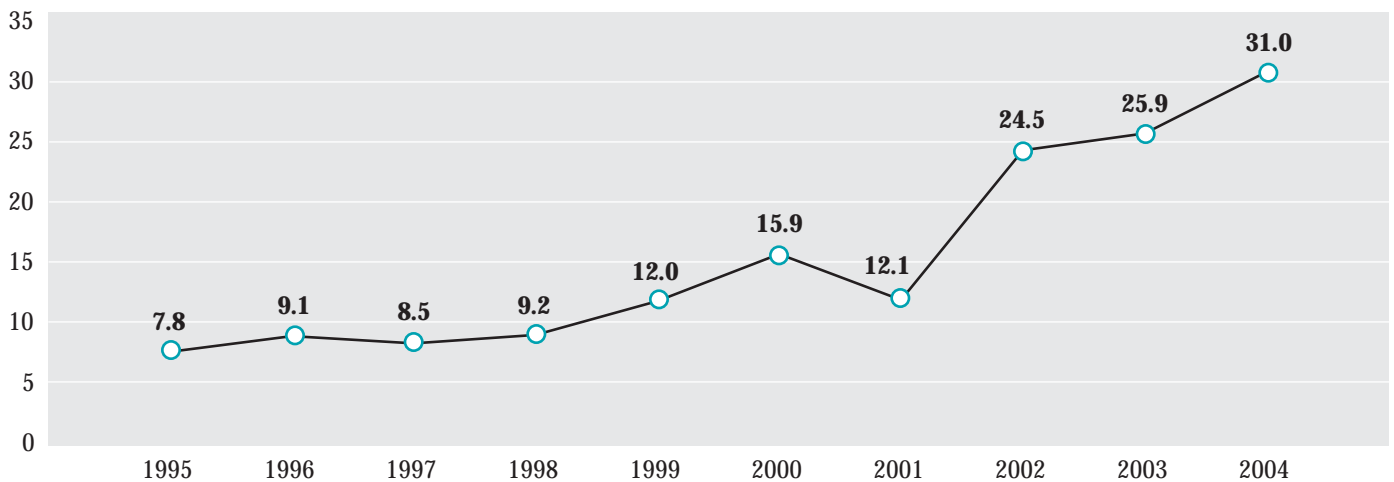
Contributions to the Deferred Compensation Plan

(Millions of Dollars)

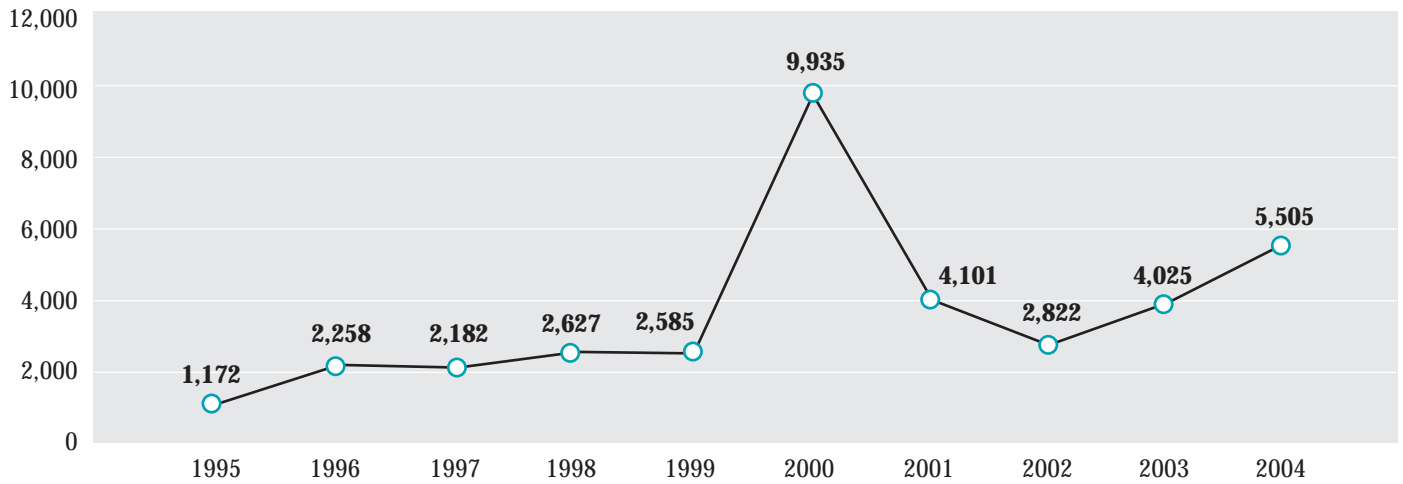


Distributions from the Deferred Compensation Plan

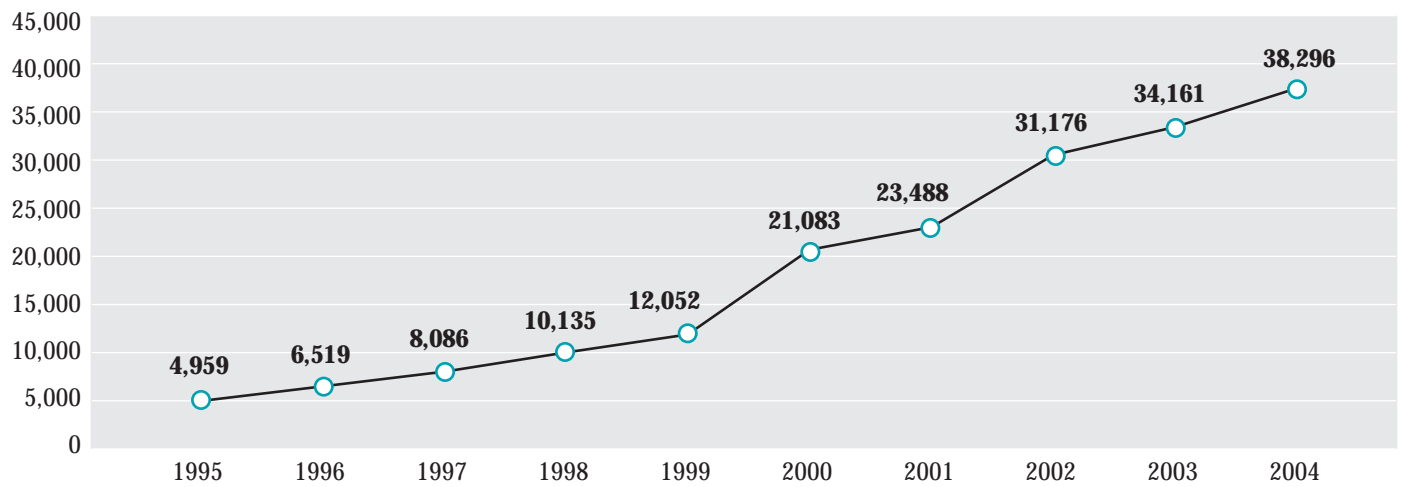
(Millions of Dollars)



New Enrollments in the Deferred Compensation Plan



Active and Inactive Deferred Compensation Plan Participants



Total Participant Accounts in Each Fund Option

| Fund Name | Total Participant Accounts |
|----------------------------------|----------------------------|
| Bond Index Fund | 5,238 |
| Real Estate Investment Trust | 2,236 |
| Harris Direct Money Market | 48 |
| Harris Direct Self-Directed | 49 |
| International Equity Index Fund | 5,598 |
| Money Market Fund | 2,369 |
| Russell 1000 Growth Index Fund | 2,599 |
| Russell 1000 Value Index Fund | 3,670 |
| S&P 500 Index Fund | 22,301 |
| Small/Mid Cap Equity Index Fund | 5,583 |
| Stable Value Fund | 14,763 |
| Active Inflation-Protected Bond | 966 |
| Active Bond Fund | 4,034 |
| Active High Yield Bond Fund | 603 |
| Active Large Cap Equity | 0* |
| Active International Equity | 0** |
| Balanced Growth Fund | 9,203 |
| Income & Growth Fund | 3,778 |
| Long-Term Growth Fund | 5,351 |
| Active Small/Mid Cap Equity Fund | 6,064 |

* The Active Large Cap Equity fund closed on June 1, 2004; account balances in that fund were transferred into the S&P 500 Index Fund.

** The Active International Equity fund closed on June 1, 2004; account balances in that fund were transferred into the International Equity Index Fund

Plan Assets

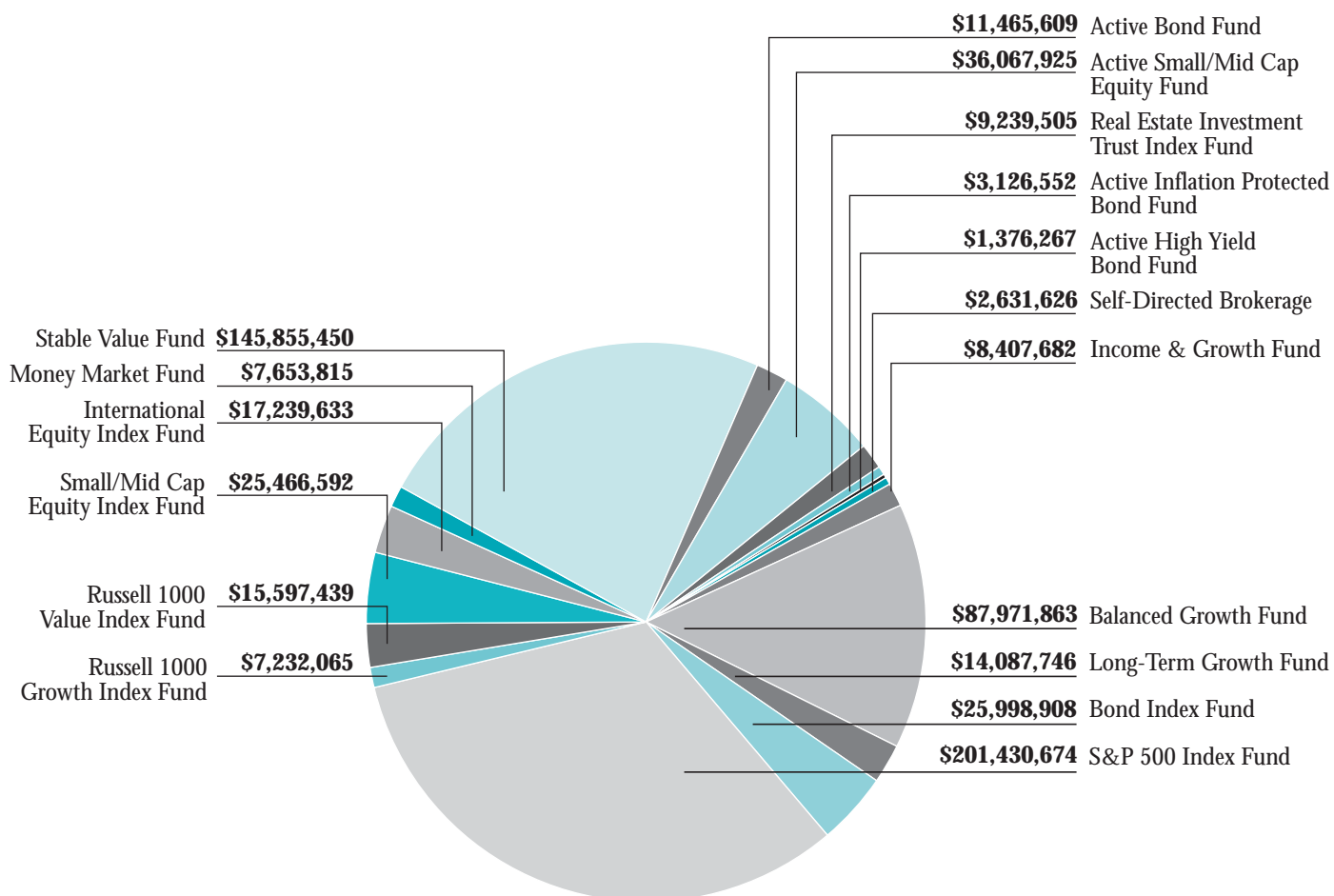
Plan Assets are divided into two categories—Annuity Plan Assets and Accumulation Plan Assets. Annuity Plan Assets represent the present value of future benefits for those participants who chose an annuity as a distribution payment. Accumulation Plan Assets represent funds invested among the 18 core investment options and two self-directed brokerage options.

Annuity Plan Assets

| | |
|---|----------------------|
| The Hartford Life Insurance Company Annuity Plan Assets at June 30, 2004 | \$ 8,096,154 |
| Metropolitan Life Annuity Plan Assets at June 30, 2004 | 2,476,707 |
| Total at June 30, 2004 | \$ 10,572,861 |

Accumulation Plan Assets

Total at June 30, 2004 – \$620,849,351



Description of Funds

Tier I: Asset Allocation Funds

Income & Growth Fund: Seeks to provide income and a modest level of capital growth by investing in a combination of bonds and stocks that is anticipated to provide long-term total returns that are slightly higher than inflation with the possibility of occasional short-term losses.

U.S. Bonds – 75%
U.S. Stocks – 22%
Foreign Stocks – 3%

Balanced Growth Fund: Seeks to provide income and a modest level of capital growth by investing in a combination of bonds and stocks that is anticipated to provide long-term total returns that are higher than inflation with the possibility of short-term losses.

U.S. Bonds – 50%
U.S. Stocks – 43%
Foreign Stocks – 7%

Long-Term Growth Fund: Seeks to provide capital growth by investing in a combination of bonds and stocks that is anticipated to provide long-term returns that are higher than inflation with the possibility of significant short-term losses.

U.S. Stocks – 64%
U.S. Bonds – 25%
Foreign Stocks – 11%

Tier II: Passively Managed Funds

Bond Index Fund: Seeks to track the performance of the Lehman Brothers Aggregate Bond Index. This Index is a combination of government, corporate, mortgage-backed, and asset-backed bonds.

| | |
|----------------------------------|-------------------|
| Mortgage-Backed Securities – 36% | Corporate – 24% |
| Treasury – 24% | Agency – 11% |
| CMBS – 3% | Asset-Backed – 2% |

S&P 500 Index Fund: Seeks to track the performance of the Standard & Poor's 500 Index. This Index comprises 500 widely held U.S. stocks chosen by Standard & Poor's.

| | |
|---------------------------------|------------------------------|
| Financials – 20% | Information Technology – 17% |
| Consumer Discretionary – 13% | Health Care – 13% |
| Industrials – 12% | Energy – 6% |
| Telecommunication Services – 4% | Materials – 3% |
| Consumer Staples – 9% | Utilities – 3% |

Russell 1000 Growth Index Fund: Seeks to track the performance of the Russell 1000 Growth Index. This Index comprises stocks in the Russell 1000 that have higher price-to-book ratios and higher forecasted growth values.

| | |
|------------------------------|---------------------------------|
| Health Care – 24% | Consumer Staples – 11% |
| Energy – 1% | Financials – 9% |
| Industrials – 9% | Information Technology – 28% |
| Utilities – 1% | Telecommunication Services – 1% |
| Consumer Discretionary – 16% | |

Russell 1000 Value Index Fund: Seeks to track the performance of the Russell 1000 Value Index. This Index comprises stocks in the Russell 1000 that have lower price-to-book ratios and lower forecasted growth values.

| | |
|---------------------------------|-----------------------|
| Consumer Discretionary – 11% | Consumer Staples – 6% |
| Energy – 11% | Financials – 33% |
| Health Care – 4% | Industrials – 12% |
| Information Technology – 6% | Materials – 5% |
| Telecommunication Services – 6% | Utilities – 6% |

Small/Mid Capitalization Equity Index Fund: Seeks to track the performance of the Russell Small Capitalization Completeness Index. This Index is a measure of the small to mid-capitalization sector of the U.S. stock market.

| | |
|---------------------------------|-----------------------|
| Consumer Discretionary – 18% | Consumer Staples – 3% |
| Energy – 4% | Financials – 24% |
| Health Care – 14% | Industrials – 12% |
| Information Technology – 16% | Materials – 4% |
| Telecommunication Services – 1% | Utilities – 4% |

International Equity Index Fund: Seeks to track the performance of the Morgan Stanley Capital International Europe, Australasia, Far East Index (MSCI EAFE). This Index comprises approximately 1,000 stocks in 20 countries in Europe and the Pacific Basin.

| | |
|---------------------------------|-----------------------|
| Consumer Discretionary – 13% | Consumer Staples – 9% |
| Energy – 8% | Financials – 26% |
| Health Care – 9% | Industrials – 9% |
| Information Technology – 7% | Materials – 7% |
| Telecommunication Services – 7% | Utilities – 5% |

Real Estate Investment Trust Index Fund: The Fund seeks to track the performance of the Dow Jones Wilshire REIT Index. The Index is a market capitalization weighted index of publicly traded REITs whose charter is the equity ownership and operation of commercial real estate.

| | |
|-------------------------|--------------------|
| Apartments – 17% | Diversified- 7% |
| Factory Outlets – 2% | Hotels – 5% |
| Industrial – 9% | Local Retail – 13% |
| Manufactured Homes – 1% | Office - 24% |
| Regional Retail – 18% | Storage – 4% |

Tier III: Actively Managed Funds

Money Market Fund: Seeks to provide short-, medium-, and long-term returns that provide for a high level of current income while preserving capital.

| | |
|-------------------------------------|-----------------------------|
| CDs, ECDs, TDs, BAs, – 37% | Floating Rate Agencies – 4% |
| Floating Rate Corporate Notes – 23% | Repurchase Agreements – 14% |
| Agency – 4% | Other 1% |
| | Commercial Paper – 17% |

Stable Value Fund: The Fund seeks to provide safety of principal and a stable credited rate of interest, while generating competitive returns over time compared to other conservative investments, such as money market funds or short-term yields available in the fixed-income (bond) market.

| |
|---|
| Wells Fargo Stable Return Fund – 28% |
| AIG Financial Products Security Backed Contract – 25% |
| JP Morgan Chase Bank Security Backed Contract – 23% |
| Union Bank of Switzerland AG Security Backed Contract – 24% |

Active Inflation-Protected Bond Fund: The Fund seeks to provide inflation protection and income consistent with investment in inflation-indexed securities and seeks to provide long-term returns that exceed the performance of the Lehman Brothers U.S. Treasury Inflation Notes Index. This Index is a measure of the inflation-indexed sector of the U.S. Bond Market.

Treasury 100%

Active High-Yield Bond Fund: The Fund seeks to provide a high level of current income and provide long-term returns that exceed the performance of a custom benchmark consisting of 95% Lehman Brothers High yield ex-CCC Index and 5% Lehman Brothers 1-3 Year Treasury Index.

| | |
|----------------------------|-------------------------|
| Basic Industry – 16% | Capital Goods – 9% |
| Communication- 19% | Consumer Cyclical – 16% |
| Consumer Non-cyclical – 9% | Energy – 6% |
| Finance – 2% | Industrial/Other – 2% |
| Technology – 6% | Treasury/Agency – 6% |
| Transportation – 1% | Utilities – 8% |

Active Bond Fund: Seeks to provide long-term returns that exceed the performance of the Lehman Brothers Aggregate Bond Index. This Index is a combination of government, corporate, mortgage-backed, and asset backed bonds.

| | |
|----------------------------|-----------------------|
| Corporate – 3% | Emerging Markets – 2% |
| Foreign – 13% | Mortgage-Backed |
| Other – 10% | Securities – 19% |
| U.S. Treasury/Agency – 53% | |

Active Small/Mid Capitalization Equity Fund: Seeks to provide long-term returns that exceed the performance of the Russell Small Capitalization Completeness Index. This Index is a measure of the small to mid-capitalization sector of the U.S. stock market.

| | |
|---------------------------------|------------------------------|
| Consumer Discretionary – 20% | Consumer Staples – 5% |
| Energy – 6% | Financials – 24% |
| Health Care – 13% | Information Technology – 13% |
| Industrials – 11% | Materials – 3% |
| Telecommunication Services – 1% | Transportation – 1% |
| | Utilities – 3% |

Tier IV: Self-Directed Brokerage Option

The Self-Directed Brokerage (SDB) Option from Harris *direct* allows investors to elect from thousands of mutual funds in addition to the core investment options in Tier I, Tier II, and Tier III. The SDB option is for knowledgeable investors who acknowledge and understand the risks associated with the mutual fund investments contained within the option. (Participants cannot invest in individual securities such as stocks, bonds, or options.)

In addition to the annual record keeping and communication services fee, there is a plan fee of \$15 per quarter as well as transaction fees charged by the brokerage provider and investment management fees charged by the investment managers.

Investment Option Performance Summary

Below are the totals for the period ending June 30, 2004

(Returns greater than one year are annualized)

| Investment Options | 1 Year | 3 Years | 5 Years | Expense Ratio |
|--|---------------|---------------|---------------|---------------|
| Tier I: Asset Allocation Funds ¹ | | | | |
| Income & Growth Fund | 5.31% | 5.19% | n/a | 0.07% |
| Benchmark (75% Lehman Bros. Aggregate Bond Index, 22% Russell 3000, 3% MSCI EAFE) | 5.45% | 5.23% | 5.25% | |
| Balanced Growth Fund | 10.67% | 3.80% | n/a | 0.07% |
| Benchmark (50% Lehman Bros. Aggregate Bond Index, 43% Russell 3000, 7% MSCI EAFE) | 10.81% | 3.92% | 3.37% | |
| Long-Term Growth Fund | 16.22% | 2.19% | n/a | 0.07% |
| Benchmark (25% Lehman Bros. Aggregate Bond Index, 64% Russell 3000, 11% MSCI EAFE) | 16.42% | 2.43% | 1.34% | |
| Tier II: Passively Managed Funds ^{1,2} | | | | |
| Bond Index Fund | 0.25% | 6.43% | 7.00% | 0.06% |
| Lehman Bros. Aggregate Bond Index | 0.33% | 6.36% | 6.95% | |
| S&P 500 Index Fund | 19.08% | -0.70% | -2.20% | 0.02% |
| S&P 500 Index | 19.11% | -0.69% | -2.20% | |
| Russell 1000 Value Index Fund | 21.04% | 2.87% | 1.79% | 0.09% |
| Russell 1000 Value Index | 21.13% | 2.96% | 1.87% | |
| Russell 1000 Growth Index Fund | 17.65% | -3.90% | -6.52% | 0.10% |
| Russell 1000 Growth Index | 17.89% | -3.74% | -6.48% | |
| Real Estate Investment Trust Index Fund | 26.75% | 14.59% | n/a | 0.25% |
| Dow Jones Wilshire REIT Index | 27.16% | 15.26% | 15.14% | |
| Small/Mid Cap Equity Index Fund ³ | 28.34% | 3.96% | 3.09% | 0.10% |
| Russell Small Cap Completeness Index | 28.68% | 4.12% | 3.02% | |
| International Equity Index Fund ^{4,5} | 32.11% | 2.46% | -1.03% | 0.15% |
| MSCI EAFE Index | 32.35% | 3.87% | 0.06% | |
| Tier III: Actively Managed Funds | | | | |
| Money Market Fund | 1.01% | 1.72% | 3.40% | 0.11% |
| 91-Day Treasury Bill | 1.00% | 1.54% | 3.16% | |
| Active Inflation-Protected Bond Fund | 3.55% | 9.08% | n/a | 0.18% |
| Lehman Bros. US Treas. Inflation Notes Index | 3.86 | 9.26% | 9.58% | |
| Active Bond Fund | 1.03% | 7.64% | 7.67% | 0.43% |
| Lehman Bros. Aggregate Bond Index | 0.33% | 6.36% | 6.95% | |
| Active High-Yield Bond Fund | 7.05% | 6.71% | 4.52% | 0.23% |
| Benchmark (95% Lehman Bros. High Yield ex-CCC, 5% Leman Bros. 1-3 Year Treasury Index) | 8.62% | 8.04% | 4.93% | |
| Active Small/Mid Cap Equity Fund ^{1, 3} | 32.22% | 6.34% | n/a | 0.57% |
| Russell Small Cap Completeness Index | 28.68% | 4.12% | 3.02% | |
| Stable Value Fund ⁶ | 5.04% | 5.33% | 5.69% | 0.20% |
| The projected estimated yield range from 7/1/04 - 9/30/04 is 4.75% - 5.00%. ⁷ | | | | |

¹ The VRS Defined Contribution Plans purchase units in various State Street Global Advisors (SSgA) Series A or Series T collective trust funds in order to provide plan participants with the ability to purchase and redeem units on a daily basis. SSgA Series A or Series T Funds invest in other SSgA collective trust funds referred to as Base Funds.

² Inception dates shown reflect the inception dates of the Base Funds. Performance returns for the Series A Funds have been linked to those Base Funds' returns. The actual performance for the Base Funds have been restated to reflect the Plans' investment management fees. Inception dates for the Series A Funds commenced as follows:

| | | | |
|--|-------|--|------|
| SSgA Bond Index Series A | 10/97 | SSGA REIT Index Series A | 5/01 |
| SSGgA S&P Index Series A | 3/96 | SSgA Russell Small Cap Completeness Index Series A | 9/97 |
| SSGgA Russell 1000 Value Index Series A | 3/99 | SSgA EAFE Index Series A | 1/97 |
| SSGgA Russell 1000 Growth Index Series A | 8/99 | | |

³ Equity Securities of companies with relatively small market capitalization may be more volatile than securities of larger, more established companies.

⁴ Foreign investments involve special risks, including currency fluctuations and political developments.

⁵ The inception date shown reflects the inception date of the Base Fund. Performance returns for the Series T Fund have been linked to the returns of the Series A and Base Funds. The actual performance for the Base Fund has been restated to reflect the Plans' investment management fees. The inception date of VRS' participation in the Series T Fund was April 21, 2003.

⁶ Performance returns have been linked to the previous investment manager. Returns prior to May 5, 2003 represent performance by MetLife.

⁷ The estimated yield range is provided to help participants make choices concerning their investment options. **There is no guarantee that the Fund will earn the projected estimated yield.**

Report design and production:

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Virginia Department of General Services



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