MINUTES OF THE
TEXAS MUNICIPAL RETIREMENT SYSTEM
Special Meeting of the Board of Trustees

February 16, 2012 – 2:00 p.m.
February 17, 2012 – 9:00 a.m.

On February 17, 2012, the Board of Trustees of the Texas Municipal Retirement System (TMRS) reconvened for a regular meeting at 9:00 a.m. at TMRS Headquarters, located at 1200 North IH 35 in Austin, Texas, with the following members present:

Board of Trustees
Frank Simpson, Chair
Julie Oakley, Vice Chair
Jim Parrish
Roel ("Roy") Rodriguez

Absent: Ben Gorzell and April Nixon

Present also were:
David Gavia, Executive Director
Ian Allan, Director of Internal Audit
Rhonda Covarrubias, Director of Finance
Eric Davis, Deputy Executive Director
Bernie Eldridge, Director of Human Resources
Nancy Goerdel, Chief Investment Officer
Leslee Hardy, Staff Actuary
Cindy Morse, Executive Assistant
Christine Sweeney, General Counsel
Holly Macki, Director of Real Estate
Michelle Mellon-Werch, Associate General Counsel
Debbie Munoz, Director of Member Services
Dev Outlaw, Director of Fixed Income
Dimitry Shishkoff, Director of Risk Management
Bill Wallace, Director of Communications
Dan Wattles, Director of Governmental Relations
Scott Willrich, Director of Information Resources
Mark Randall, GRS
Marcia Beard, R. V. Kuhns & Associates
Todd Shupp, R. V. Kuhns & Associates
Nick Woodward, R. V. Kuhns & Associates

Also in attendance:

Gary Anderson, Retiree
Sherry Chapman, Investment Accountant
David Crow, Arlington Fire Fighters
Debbie Farahmandi, Investment Operations Specialist
Chris Jones, CLEAT
Glenn Johnson, Garland Fire Fighters
Scott Kerr, Texas Association of Fire Fighters
Randall Meadows, Arlington Police Association
Jim Moore, Mesquite Fire Fighters
Candace Nolte, Controller
Sean Thompson, Regional Representative, City Services
Kristin Qualls, Assistant Investment Officer for Equities
Katie Reissman, Investment Analyst – Fixed Income
David Rodriquez, Regional Manager – City Services
Bob Scott, GFOA
Mel Thomas, Editor

Mr. Simpson called the meeting to order at 9:04 a.m. and Ms. Oakley gave the invocation.

3. **Consider and Act Adoption of Minutes from the December 1-2, 2011 Regular Meeting of the Board of Trustees**
Mr. Simpson presented this item and asked if there were any changes or questions. There being none, Mr. Parrish moved that the Minutes from the December 1-2, 2011 Regular Meeting of the Board be adopted as presented. Ms. Oakley seconded the motion, which passed unanimously.

4. **Consider and Act on 2011 Interest Credit Allocation to the Benefit Accumulation Fund and Interest Reserve Account**
Mr. Gavia introduced this item stating that it was the third year we have made such an allocation, and that this is the first allocation since SB 350. Mr. Randall began his presentation by briefly discussing the smoothed 10-year average. He provided an example of the corridor that fluctuates around the market value, which is designed to keep the actuarial value of assets in line with the market value. He recapped the 2009 and 2010 returns and the redistribution of the interest reserve, recognizing 10% in the actuarial value of assets, with the remaining 90% standing as a deferred gain to each municipality that could be used to offset adverse investment returns. He reported that this has helped provide the rate stabilization the System is currently seeing. Mr. Parrish asked what would happen to the rates if we see similar returns for the next couple of years. Mr. Randall answered that we would not see significant increases in rates due to the smoothing policy; rates would be very stable, unless there was a significant decline in the investment markets. Mr. Randall added that having a good actuarial assumption set will aid in the rate stabilization.

Mr. Randall recommended crediting the Benefit Accumulation Fund (BAF) approximately 2.37% and maintaining the $100 million Interest Reserve Account. The 2.37% produces an actuarial rate of return of approximately 7.1% for 2011 on the BAF due to the deferred gain from the 2010 actuarial valuation. He mentioned that the System has used a lot of the deferred gains, but the smoothing and assumption set has allowed rates to remain stable. He illustrated the market and actuarial value of assets and briefly showed the impact on the contribution rates of different groups of TMRS cities.

Mr. Rodriguez moved that the Board credit the BAF with the investment income remaining after the statutory requirements have been fulfilled, an estimated 2.37%, and that $100 million is maintained in the Interest Reserve Account. Mr. Parrish seconded the motion, which passed unanimously.

5. **Consider and Act on Ratification of Ordinances Adopting Updated Service Credit and/or Annuity Increases Effective January 1, 2012**

Mr. Gavia mentioned that this agenda item is a follow up to the action taken by the Board in December, where the Board approved the Updated Service Credit (USC) Ordinances, with or without annuity increases, which had been received at that time. He reported that, in accordance with Fiduciary Counsel's recommendation, Ordinances received after the last Board meeting, although they have already been implemented, should be ratified by the Board at this meeting.

Mr. Davis reported that the listing attached to the agenda item indicates all new adoptions or re-adoptions that occurred during 2011 for a January 1, 2012 effective date. He stated that all Ordinances shown in the attachment were properly adopted in accordance with the TMRS Act.

Mr. Davis provided a brief overview of the process that TMRS uses with regard to the transmission of Ordinances, as well as the follow up procedures for cities requesting Ordinances during a given year. He indicated that if TMRS staff provides an Ordinance to a city, staff begins following up with each city (as needed) in September in order to make sure the city gets the Ordinance in to TMRS before the end of the year. Mr. Davis reported that most cities with repeating benefits had that feature previously, but that they made other changes to their plan which required the Updated Service Credit provision to be re-adopted.

Ms. Oakley moved that the Board, in accordance with the advice of Fiduciary Counsel, ratify those Ordinances adopting Updated Service Credit and/or Annuity Increases that were not included on the listing presented at the December 2, 2011 Board meeting. Mr. Parrish seconded the motion, which passed unanimously.

6. **Investment Performance Update as of December 31, 2011**

Mr. Gavia reported that a more in-depth investment performance review for the year 2011 will be presented at the March Board meeting. Ms. Goerdel added that the March presentation will include performance relative to the investment objectives, peer universe comparisons, and much more detailed information.

Ms. Beard began the review of 2011 markets. She stated that investors' appetite for risk was greatly diminished during the last quarter. The System's total fund composite return was 2.41% compared to the actual allocation benchmark's return of 2.33%. The 3-year return was 7.17% and the 10-year was 6.99%.

Ms. Goerdel stated that year-to-date the fund's return is over 4%. Ms. Beard added that compared to peers, in a difficult year, TMRS did quite well in 2011.

7. **Consider and Act on Adoption of Investment Policy Statement (IPS) Revisions Presented at the December 1-2, 2011 Board Meeting**

Mr. Gavia introduced this agenda item and reminded the Board that these proposed changes were brought before the Board at the December meeting. Ms. Goerdel mentioned that the changes to the Investment Policy Statement (IPS) were broken down into three types of changes: clarifying changes, changes that document current practices (both of these groups include non-substantive changes), and policy revisions. Mr. Gavia discussed the policy changes that grant the Executive Director authority to respond as needed in protection of the TMRS assets. Ms. Goerdel discussed one technical change to the policy that was added since the December presentation which related to establishing a more appropriate measure for the duration guideline for global inflation linked bonds. Currently, the guideline used is the "effective" duration and the proposed revision will change this to "modified" duration.

Mr. Parrish asked that the Board Chair be added to the list of contacts in Item III.B. of the IPS relating to the roles and responsibilities of the Executive Director. Mr. Simpson stated that Mr. Gorzell had previously requested that, going forward, staff maintain a log of changes to the IPS in order to document the history of changes to the IPS. Ms. Goerdel acknowledged that this had been done for the December presentation of these revisions, but was not included in the current Board packet, and that they would do so going forward.

Mr. Parrish moved that the Board adopt the revisions to the Investment Policy Statement as proposed. Mr. Rodriquez seconded the motion, which passed unanimously.

8. **Educational Session: Absolute Return Strategies, Part II**

Ms. Beard introduced Mr. Shupp from R. V. Kuhns and mentioned that Mr. Shupp now focuses on Absolute Return Strategies (ARS) within R.V. Kuhns' Manager Research area. Ms. Beard reminded the Board of the items discussed in the first educational session about ARS in October 2011. She reviewed the current asset allocation and the final target allocation which includes a 5% allocation to ARS, and reviewed the efficient frontier model results. She stated that ARS is liked by investors primarily for diversification purposes and its alpha component.

Mr. Shupp began his presentation by stressing the importance of diversification and he reiterated that ARS is typically utilized by investors to increase portfolio returns; to decrease portfolio risk; and to provide performance with low correlation to traditional asset classes. He stated that ARS can have a positive impact on the expected risk/return profile of a portfolio, even with a relatively small allocation. ARS have attractive risk adjusted returns over the long-term with attractive correlations.

Mr. Shupp reviewed the basics of ARS. He said that funds seek to generate positive returns, regardless of traditional market benchmarks. He stated that as compared to traditional asset classes, ARS are typically less transparent, less liquid and have higher fees relative to traditional asset classes. Leverage, short-selling and derivatives are typically utilized by these strategies. These techniques can add complexity but also bring added value through increased flexibility.

Mr. Shupp then discussed three broad types of hedge fund strategies: Directional Strategies; Non-Directional Value Strategies (which identify and capitalize on arbitrage opportunities); and Event Driven Strategies (which anticipate and attempt to capitalize on certain corporate events occurring). Mr. Shupp next gave examples of funds under these broad categories. Ms. Goerdel added that hedge funds are now regulated and must register with the Securities and Exchange Commission (SEC). Mr. Shupp then illustrated how these broad strategies are characterized on the risk/return spectrum.

Mr. Shupp next showed the Risk and Return performance for 5 and 10 year periods, stating that individual ARS have historically produced lower standard deviations as compared to equities, while achieving similar or higher returns. He reviewed the up/down market capture, diversification within ARS, 7-year risk analysis and other performance characteristics. He stated that compared to equities, hedge fund strategies have produced positive returns during equity up markets, while protecting during equity down markets. He discussed TMRS' benchmark for this asset class.

Mr. Shupp concluded his presentation by stating that there is a wide spectrum of ARS, and that diversification across individual hedge fund strategies should be considered when creating an ARS portfolio.

9. <u>Discuss Equity Structure Study and Related Policy Revisions</u>

Mr. Gavia introduced this agenda item and said that a couple of fundamental questions arise now that we have reached the target allocation in equities: whether equities should be actively managed, and if so, how do we go about doing that. Ms. Goerdel added that TMRS initially adopted an allocation to equities in November 2007 at the recommendation of R. V. Kuhns to begin diversifying the portfolio. She said this initial allocation was done through commingled passive index funds in order to gain broad market representation at a relatively low cost. In June 2009, TMRS adopted a broadly diversified asset allocation strategy in order to satisfy a total return objective of meeting the actuary's assumed long term rate of return.

Ms. Qualls reviewed the TMRS Strategic Plan's Vision Statement and Strategic Plan Goal #2, which is to implement a prudent asset allocation strategy to achieve total return objectives to provide sound benefit funding. She also reviewed the objectives related to the equity structure study which includes developing a comprehensive education plan for the Board for new investment initiatives; developing strategic allocations within each asset class to add value relative to the asset class benchmarks; and identifying opportunities to realize value-added returns through additional active management strategies.

Ms. Qualls said that the first decision to be made concerns whether the combination of passive and active management benefits TMRS' equity investment strategy. Ms. Qualls reported that after reviewing the issue, she believes the answer to be yes. Therefore, it is the recommendation of staff and R. V. Kuhns to add some active management strategies to the equity allocation and to take a phased approach over the next 3 years. She stated that active management has historically shown the ability to add value in some styles and capitalization levels. Active U.S. Small Cap, non-U.S. Small Cap and Emerging Market managers have typically benefited from less efficient markets.

Ms. Qualls said that the second decision to be made concerns what structure type best fits TMRS' needs, i.e., implementation, flexibility, control, cost and level of oversight. Ms. Qualls reported that it is the recommendation of staff and R. V. Kuhns to use a core-satellite approach to structure the total equity portfolio. The Core component offers reliable "beta" exposure through broad market exposure and controls risk and costs through passive implementation. The Satellite component allows managers more freedom to add value within less constrained mandates.

Ms. Qualls said that the third decision point concerns whether TMRS should stay with its current balanced approach of U.S./non-U.S. equity (50/50), transition to a global approach or incorporate a combination of both global and balanced. Ms. Qualls reported that it is the recommendation of staff and R. V. Kuhns to use a global approach for the passive (core) allocation and a balanced approach for the active (satellite) allocation. She then discussed the structure costs and mentioned that Core Satellite requires fewer mandates and fewer managers than a Style Box approach; has the potential for overall lower fees; and requires less staff for oversight.

Mr. Woodward then went into greater detail about each of the recommendations. He first explained how R.V. Kuhns arrived at the active management recommendation. He reviewed TMRS and R. V. Kuhns' research on the attributes and risks of both passive and active management and stated that diversification is not only important between asset classes but also within a specific asset class. He indicated that rules-based strategies and/or enhanced index products could be an initial step in that direction.

With regard to options for structuring the asset class, Mr. Woodward discussed what led R. V. Kuhns' to recommend a core-satellite approach, with the rules-based approach as the initial satellite piece. The recommendation is based, in part, on the lessons learned by funds and consultants over the years. Mr. Simpson asked about the difference between our current 50% domestic and 50% international versus the global approach. Mr. Woodward responded that combining the two current passive funds into a single, global fund would simplify oversight and would keep the country exposures similar to the country weights in TMRS' current balanced approach. However, those regional exposures would change over time and that is something that R.V. Kuhns and TMRS staff would stay abreast of. However, further review of the appropriateness of a global approach will be conducted in conjunction with the 2012 R.V. Kuhns Asset Allocation Study.

Ms. Oakley inquired how the percentage of Core versus Satellite was determined. Mr. Woodward responded with a review of Asset Structure Optimization, describing the optimization process and illustrating the output from this process. Mr. Woodward continued that the 50% Core and 50% Satellite structure would potentially provide the most excess return, a positive information ratio and manageable tracking error.

Ms. Goerdel mentioned that proposed revisions to the Investment Policy Statement related to the Equity Structure Recommendations are also attached to the agenda item for discussion. She stated that the basic IPS is not changing.

Mr. Woodward reviewed the proposed implementation timeline and explained that the equity structure recommendation will be brought back to the Board for approval at the March meeting. The recommended next steps were then outlined, which included items such as providing further education on rules-based strategies, approval of the structure, manager searches, hiring managers and implementation. He indicated that there would be a slow and methodical 2 - 3 year transition to the final equity structure. Mr. Simpson asked if staff and R. V. Kuhns can handle staging all three asset classes and staff answered affirmatively.

In reference to the potential excess returns, net of fees, which were shown as a percentage of assets, Mr. Parrish asked what those would be in dollars and Mr. Woodward offered an approximation of what the management fees would look like for the proposed core satellite structure in dollars.

At this time, the Board took a break from 10:35 a.m. until 10:50 a.m.

10. Consider and Act on Appointments to the Advisory Committee

Mr. Gavia reported that there are currently two vacancies on the Advisory Committee. One vacancy is due to the departure of Nikki Ramos, the representative for the City of San Antonio, and the second vacancy is due to the departure of Michelle Leftwich with the City of Mercedes. Mr. Gavia reported that the City of San Antonio has nominated Flor Garcia, Assistant Human Resources Director, to replace Ms. Ramos. Mr. Gavia indicated that due diligence has not been completed regarding the Ms. Leftwich's vacant position, so he is not prepared to make a recommendation concerning that vacancy at this time.

Mr. Rodriguez moved that the Board approve the nomination of Flor Garcia to replace Nikki Ramos to represent the City of San Antonio in the Group Class of membership on the Advisory Committee on Retirement Matters. Mr. Parrish seconded the motion, which passed unanimously.

11. Consider and Act on Final Adoption of Proposed Amended Rule 34 TAC §127.7 to Address Compliance with the Pension Protection Act of 2006 (PPA)

Mr. Gavia introduced this agenda item and stated that these emergency and proposed rules were brought before the Board at the December Board meeting and staff is now requesting that the Board adopt the rules.

Ms. Sweeney discussed the emergency rule and proposed change to Rule 34 TAC Section 127.7 to address compliance with the Pension Protection Act of 2006. Ms. Sweeney reported that the System's current operations meet the current Internal Revenue Service (IRS) guidelines, but that our written plan rules also need to reflect the current guidelines. This is a routine formalization of the rules in order to comply with the IRS guidelines. Ms. Sweeney stated that there were no comments received regarding the published rule change.

Mr. Parrish moved that the Board approve the Order and adopt the amendments to Rule 34 TAC §127.7 to be effective 20 days after it is filed with *Texas Register*, without changes to the proposed language. Ms. Oakley seconded the motion, which passed unanimously.

12. <u>Call For Future Agenda Items</u>

Mr. Simpson asked if there were any future agenda items to discuss. Mr. Gavia mentioned that the next three Advisory Committee meetings will be held on the morning and early afternoon of March 29, May 3 and June 21, immediately before the regularly scheduled Board meeting that will begin mid to late afternoon on the same day, and he mentioned that the Advisory Committee would be made aware of the meeting schedule.

David Gavia
Executive Director

Frank Simpson
Chair, Board of Trustees