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

**March 29, 2012 – 3:30 p.m.**
**March 30, 2012 – 8:30 a.m.**

On March 30, 2012, the Board of Trustees of the Texas Municipal Retirement System (TMRS) convened for a regular meeting at 8:30 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
Ben Gorzell
April Nixon
Jim Parrish
Roel ("Roy") Rodriguez *(arrived at 8:55 a.m.)*

**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
Kristin Qualls, Director of Equities
Dimitry Shishkoff, Director of Risk Management
Bill Wallace, Director of Communications
Dan Wattles, Director of Governmental Relations
Stacy White, Executive Assistant
Scott Willrich, Director of Information Resources
Robert Klausner, Klausner Kaufman Jensen & Levinson
Susan Warren, KPMG
Ed Schwartz, ORG Portfolio Management
Lynn Kehoe, ORG Portfolio Management
Marcia Beard, R. V. Kuhns & Associates
Todd Shupp, R. V. Kuhns & Associates
Nick Woodward, R. V. Kuhns & Associates
Jonathan Kowolik, R. V. Kuhns & Associates

Ben Friedman, Abacus Capital Group
Kyle Ellis, Abacus Capital Group
David Rubenstein, Rubenstein Properties LP
Eric Schiela, Rubenstein Properties LP
Steve Steppe, Stockbridge Capital Group
Sol Raso, Stockbridge Capital Group
Doug Sturiale Stockbridge Capital Group

**Also in attendance:**

Sherry Chapman, Investment Accountant
David Crow, Arlington Fire Fighters
Keith Dagan, Government Finance Officers Association of Texas (GFOAT)
Debbie Farahmandi, Investment Operations Specialist
Chris Jones, Combined Law Enforcement Associations of Texas (CLEAT)
Glenn Johnson, Garland Fire Fighters Association
George Kauffman, City of Garland
Scott Kerr, Texas State Association of Fire Fighters
Randall Meadows, Arlington Police Association
Jim Moore, Mesquite Fire Fighters
Lorraine Moreno, Regional Manager – City Services
Candace Nolte, Controller
Sean Thompson, Regional Representative, City Services
Tino Robleto, KPMG
Kate Reed, Investment Risk Analyst
Katie Reissman, Investment Analyst – Fixed Income
David Rodriquez, Regional Manager – City Services
Mel Thomas, Editor
Charles Windwehen, Retiree

Mr. Simpson called the meeting to order at 8:35 a.m. and Mr. Parrish gave the invocation.

2. **<u>Consider and Act on Consent Agenda</u>**
   Mr. Gavia presented the items contained in the consent agenda. He asked if there were any questions or revisions to the Minutes and there were none. Mr. Gorzell moved that the Board adopt the Consent Agenda as presented. Mr. Parrish seconded the motion, which passed unanimously by all Board members who were present, 5-0. Mr. Rodriguez was not present for the vote.

3. **<u>Review and Discussion of 2011 External Audit (SAS-114)</u>**
   Mr. Gavia introduced Ms. Warren to present the external audit plan. Ms. Warren reviewed the agenda for the presentation and informed the Board that the audit team had not changed. She reviewed the objective of the audit, which is to enable the auditor to express an opinion about whether the financial statements that have been prepared by management, with the oversight of the Board, are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and free from material misstatements. She outlined

management's responsibilities regarding preparation of the financial statements. She reviewed the Board's responsibilities, as well as the combined management and Board responsibilities, pointing out that the audit does not relieve management or the Board of those responsibilities. She also outlined KPMG's responsibilities in the audit process. She explained the audit approach and methodology. She outlined the scope of the audit plan, including the applicable financial reporting framework, applicable auditing standards and other terms of engagement. She defined and explained the term "materiality." She explained the deliverables and timelines. She discussed fraud risks, explaining how they are identified and how KPMG responds to identified fraud risks. She defined and explained "material weakness" and "significant deficiency," giving examples of each.

She then asked the Board a series of questions that are asked of them each year as part of the audit process. The questions concern issues regarding how best to communicate with the Board; the allocation of responsibility; the entity's business objectives and strategies; areas that warrant particular attention; significant communications with regulators; importance and effectiveness of internal controls and detection of fraud; and developments in other matters, including GASB changes and its effects. There were no changes to the Board's responses from last year. Ms. Warren then discussed how other groups are involved in the audit process, explaining the review of reports received from service organizations, such as State Street (SOC1, formerly SAS 70). She concluded by directing the Board to KPMG's website for additional information.

4. **<u>Consider and Act on Real Estate Manager Recommendations</u>**
Mr. Gavia introduced Ms. Macki, along with Mr. Schwartz and Ms. Kehoe from ORG Portfolio Management, to discuss the Real Estate manager recommendations. Before they began their presentation, Mr. Simpson requested a year-to-date update. Ms. Macki reviewed the allocations the board has already approved and Mr. Schwartz highlighted the managers that have been approved by the Board and the types of real estate currently being invested in.

Ms. Macki then provided an overview of her presentation. She began by discussing the real estate investment timeline from December 2, 2011, when the 2012 Real Estate Pacing Plan was adopted, to current day. She reviewed a flow chart of the real estate investment search process, which included real estate market research, manager screening, issuance of a Questionnaire, evaluation and preliminary due diligence, in-depth due diligence and a recommendation. She outlined the manager screening criteria, highlighting key points of the screening process. She explained the manager screening results, which produced nine (9) candidates for consideration. She reviewed the due diligence ranking factors, highlighting key points within each factor. Ms. Macki then reviewed the scoring matrix by category: Core, Value-Add and Opportunistic. In the Core category, all three managers scored average, so the decision was made to pass on these managers. Mr. Gorzell asked, since there were no managers selected for recommendation in the Core category, what is the next step in choosing Core sector managers? Ms. Kehoe and Mr. Schwartz explained that Core will be the focus of continued search in 2012. In the Opportunistic category, the two managers scored average, so the decision was made to pass on these managers, also.

Mr. Schwartz reviewed the real estate finalist characteristics. He reported that the top three (3) scoring managers were selected for recommendation by the evaluation team after completing the rigorous search process. He indicated that no suitable Opportunistic funds were found during this search; however, he reminded the Board that Walton Street Capital, an Opportunistic fund, was approved by the Board at the September 2011 board meeting with an allocation of $50 million and that this recommendation includes an additional allocation of $25 million to that fund.

At this point, Ms. Oakley departed the meeting.

**Abacus Capital Group**

Mr. Ben Friedman and Mr. Kyle Ellis introduced themselves to the Board and made the presentation for Abacus Capital Group. Mr. Friedman began with a company overview and then presented company performance highlights. He outlined the experience of the professional team and reviewed the diversification of their national investment portfolio. He discussed Abacus' investment strategy, outlining their research-based approach, and highlighted their eight target fundamentals. Mr. Ellis provided additional specifics about their investment strategy.

Mr. Friedman discussed the terms and conditions of the Fund and provided an in-depth analysis of underlying fundamentals. He discussed risk management, stating that they are an SEC registered investment adviser, with compliance reviews quarterly. Ms. Sweeney asked if they acknowledge their role as fiduciary. Mr. Friedman answered affirmatively. Mr. Ellis walked through current market conditions, demand trends, supply trends and secondary vs. primary markets. He highlighted several current opportunities, along with fundraising and the pace of capital deployment.

As there were no further questions from the Board, Mr. Friedman and Mr. Ellis thanked the Board for their time and consideration.

**Rubenstein Partners**

Mr. David Rubenstein and Mr. Eric Schiela introduced themselves and made the presentation for Rubenstein Partners. Mr. Rubenstein began his presentation by discussing predecessor Rubenstein companies. He then discussed the current company, the management team, their real estate expertise, relationship network and niche specialization (which focuses on the east coast market). The East Coast market includes 65% of the entire national office investment market. Mr. Rubenstein discussed the company's view of risk mitigation and discipline, along with their rigorous approach to financial underwriting including enhanced valuation and cash flow framework. He reviewed the types of fund investment strategies. Mr. Schiela explained how Rubenstein's infrastructure is designed for identification of unique opportunities. Mr. Rubenstein reviewed two current transactions. He then reviewed the summary of fund terms for the current opportunity, as well as fund raising status and pace of investing.

As there were no questions from the Board, Mr. Rubenstein and Mr. Schiela thanked the Board for their time and consideration.

**Stockbridge Capital Group**
Mr. Steve Steppe, Sol Raso and Doug Sturiale introduced themselves and made the presentation for Stockbridge Capital Group. Mr. Steppe introduced the company and reviewed Stockbridge's organizational structure, competitive advantage, market coverage, and Core and Value business performance. Mr. Raso reviewed the acquisition and underwriting process as well as risk management, investment committees and compliance. Mr. Sturiale reviewed the fund highlights and terms and presented an overview of Stockbridge's view of "value add." Next he reviewed the markets they would like to be in and the types of properties they expect to invest in. He reviewed the three existing properties in the portfolio.

As there were no questions from the Board, Mr. Steppe, Mr. Raso and Mr. Sturiale thanked the Board for their time and consideration.

Mr. Schwartz concluded that these managers all integrate well together by covering differing elements within this Sector. The Board discussed transparency as it relates to real estate managers. They also discussed Rubenstein's focus solely on the east coast and how that relates to the Investment Policy Statement (IPS) guideline for geographic diversification at the overall real estate asset class level and that staff and ORG would monitor the portfolio to ensure appropriate geographic diversity.

Mr. Simpson requested that Rubenstein Partners be voted on separately. Mr. Parrish moved that the Board approve Abacus Capital Group ($50 million/Value-Added focus), Stockbridge Capital Group ($75 million/Value-Added focus) and Walton Street Capital ($25 million/Opportunistic focus) for investment in real estate fund structures of the managers or their affiliates, as proposed and in accordance with the IPS Real Estate Guidelines, individually contingent on favorable background checks, registration under the Investment Advisor's Act of 1940 as amended, and successful negotiation of the contracts at management fees substantially comparable to those listed in the proposed Fee Analysis. Ms. Nixon seconded the motion, which passed unanimously, 5-0.

Mr. Parrish then moved that the Board approve Rubenstein Properties LP ($50 million/Value-Added focus) for investment in real estate fund structures of the managers or their affiliates, as proposed and in accordance with the IPS Real Estate Guidelines, individually contingent on favorable background checks of the three new management firms, registration under the Investment Advisor's Act of 1940 as amended, and successful negotiation of the contracts at management fees substantially comparable to those listed in the proposed Fee Analysis. Mr. Gorzell seconded the motion, which passed 4-1 with Mr. Simpson opposing due to (a) lack of geographic and property type diversification; (b) one person decision point; and (c) unclear delineation of lender and equity positions in the fund.

5. **Consider and Act on Appointments to the Advisory Committee on Retirement Matters**
Mr. Gavia presented this item out of order from the posted agenda. He outlined recent changes in membership in both the Group and Individual classes, including the recent decision by Mayor Garry Watts not to seek reelection, thus leaving a vacancy on the Advisory Committee. This vacancy is in addition to the vacancy created by Michelle

Leftwich, who recently decided not to seek reappointment on the Advisory Committee due to schedule conflicts.

Mr. Gavia mentioned that in the past, the Subcommittee has tried to retain three elected officials to serve in the Individual Class of the Advisory Committee. As a result, the Subcommittee's current search has concentrated on locating suitable elected officials for the two vacancies. He stated that Mayor Riddle from the City of Deer Park has been thoroughly vetted by the Board's Subcommittee. He reported that the Subcommittee is continuing its due diligence on vetting the second candidate. Mr. Parrish briefly reviewed the Subcommittee's due diligence process.

Mr. Gavia also mentioned that two Group Class organizations have submitted their nominations for alternate members, in the event their regular member is unable to attend a meeting and, in accordance with the Advisory Committee Charter, these alternate nominations are subject to Board approval. The Government Finance Officers Association of Texas (GFOAT) nominated Keith Dagen, Assistant Director of Finance for the City of Richardson. Texas Municipal Police Association (TMPA) nominated Mitch Landry, Deputy Executive Director of TMPA.

Mr. Rodriguez moved that the Board approve Mayor Wayne Riddle of the City of Deer Park to serve in the Individual Class of membership, and also approve Keith Dagan as alternate for GFOAT, and Mitch Landry as alternate for TMPA. Ms. Nixon seconded the motion, which passed unanimously, 5-0.

At this time, Mr. Rodriguez departed the meeting.

6. **Consider and Act on Adoption of Investment Policy Revisions Regarding Equity Structure and Authorization of Staff to Conduct Manager Search**

Mr. Gavia introduced this item concerning the possibility of adding an active management component to the equity allocation. Ms. Goerdel added that the original passive approach was a starting point in the implementation of this allocation and she explained that this is a progression in the implementation approach, rather than a change to the equity allocation. She reminded the Board that the passive approach is not risk free, and that by adding an active component to the allocation, the goal is to add return and add diversification thereby improving on the expected risk/return.

Ms. Qualls began her presentation by reviewing the TMRS Strategic Plan Goal #2 as it relates to this agenda item. Ms. Qualls reviewed the two primary questions facing the Board today: (1) whether the addition of an active component would benefit the equity allocation; and (2) which type of structure, core-satellite or style box, would be the best fit. She outlined the history of the TMRS equity allocation during 2008 – 2011 as well as the future timeline, which anticipates a very methodical, phased approach for the addition of active strategies, with a small allocation to rules-based strategies as an initial step. With the Core-Satellite (50/50 split), the ultimate make-up could be 50% passive and 50% active, of which some portion would be rules-based.

Mr. Woodward discussed the importance of tracking error, stating that it measures the standard deviation (volatility/risk) of a portfolio's returns from an index. Tracking error is a result of different investment exposures relative to a strategy's benchmark. The key is getting rewarded for the higher risks (higher tracking error). Mr. Woodward discussed various individual portfolio strategy excess return, total risk, and tracking error objectives for the equity asset class. These objectives should reflect the characteristics and expected performance of each strategy and will be developed and adopted prior to implementation.

Ms. Qualls stated that the first recommendation from staff and R.V. Kuhns is to allocate to both passive and active management. She reported that staff and R.V. Kuhns have researched the attributes and risks of both implementation methods and found that adding active management allows for increased return potential. The combination of both passive and active management may also help to lower risk. The active management comes with higher fees and costs and is not a guarantee of positive excess returns; however, the passive management lacks the potential for returns above the index.

Ms. Qualls stated that the second recommendation is to adopt the Core-Satellite approach. The Core allocation would include the System's current passively managed index funds in order to gain broad market exposure; the Satellite allocation would include rules-based strategies and/or active management.

Mr. Woodward discussed rules-based strategies as an initial step towards active management. He explained that rules-based strategies can be viewed as an interim step between passive management and active management. He explained the two approaches which are generally the most frequently utilized: (1) Fundamental Indexing, which weights stocks by the firms' fundamentals rather than their market capitalization; and (2) Low-Volatility strategies, which attempt to deliver index like returns with lower volatility. The fees for products tracking these alternative benchmarks range from 10 to 20 basis points and are higher than traditional passive strategies, but still lower than most active strategies. These strategies traditionally have resulted in higher returns. Mr. Woodward reviewed examples of how these strategies have acted on a risk/return basis within both domestic and international mandates. Mr. Woodward concluded that the recommendation from RVK and TMRS staff would be to complement TMRS' current passive domestic and international equity allocations with the rules-based strategies, fundamental indexing and low volatility passive strategies.

Ms. Qualls concluded by discussing the recommended next steps pending Board approval of these recommendations. Ms. Qualls added that in the future RVK and TMRS staff will evaluate the specifics of a global approach for the core allocation and will also provide educational presentations to the Board on additional active strategies. Mr. Gorzell asked if current staffing is adequate to proceed with these recommendations. The answer was affirmative.

Ms. Nixon moved that the Board (1) adopt a Core-Satellite Structure for each of the Domestic and International Equity allocations as presented and adopt revisions to the Investment Policy Statement, as presented; and (2) implement an initial allocation to Rules-Based Strategies for both the domestic and international equity allocations through

Fundamental Indexing and/or Low Volatility Passive Strategies, to be funded from the Russell 3000 and ACW-ex US IMI passive portfolios as presented; and (3) authorize manager searches for these initial Rules-Based Strategy allocations. Mr. Gorzell seconded the motion, which was passed unanimously by the Board members present, 4-0.

At this time, Mr. Parrish departed the meeting. As the Board had lost its quorum, the meeting was adjourned at 12:27 p.m.

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| David Gavia | Frank Simpson |
| Executive Director | Chair, Board of Trustees |