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

June 19, 2013 – 2:00 p.m.
June 20, 2013 – 8:30 a.m.

On June 19, 2013, the Board of Trustees of the Texas Municipal Retirement System (TMRS) convened for a meeting at 2:00 p.m. at TMRS Headquarters, located at 1200 North IH 35 in Austin, Texas, with the following members present:

Board of Trustees
Roel "Roy" Rodriguez, Chair
Jim Parrish, Vice Chair
April Nixon
Bill Philibert

Absent: Julie Oakley

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, Director of Actuarial Services
Debbie Munoz, Director of Member Services
Christine Sweeney, General Counsel
Bill Wallace, Director of Communications
Dan Wattles, Director of Governmental Relations
Scott Willrich, Director of Information Resources
Holly Macki, Director of Real Estate
Bonnie Mitra, Director of Fixed Income
Debbie Munoz, Director of Member Services
Kristin Qualls, Director of Equities
Dimitry Shishkoff, Director of Risk Management
Karen Jackson, Executive Assistant
Stacy White, Executive Assistant
Marcia Beard, R. V. Kuhns & Associates
Robert Klausner, Klausner Kaufman Jensen & Levinson
Tracey Nykiel, R. V. Kuhns & Associates
Nancy Williams, Hewitt EnnisKnupp

Also in attendance:
Nick Ballard, Pension Review Board
Sherry Chapman, Investment Accountant
Debbie Farahmandi, Investment Operations Specialist
Howell Hollis, Investment Analyst

Peter Jeske, Support Services Analyst
Chris Jones, Combined Law Enforcement Associations of Texas (CLEAT)
George Kauffman, City of Garland
Kevin Lawrence, Texas Municipal Police Association
Carol Leung, Investment Analyst
Randle Meadows, Arlington Police Association
Michelle Mellon-Werch, Associate General Counsel
Anthony Mills, Regional Manager – City Services
Candace Nolte, Controller
Nick O'Keefe, Senior Staff Attorney
Cindy Morse, Investment Support Analyst
Kate Reed, Investment Risk Analyst
David Rodriquez, Regional Manager – City Services
Eddie Schultz, Real Estate Analyst
Greg Shipley, Combined Law Enforcement Associations of Texas (CLEAT)
Mel Thomas, Editor
Barbara Whitehorn, City of Arlington

Mr. Rodriguez called the meeting to order at 2:02 p.m. and gave the invocation.

1. **Consider and Act on Equity Strategy and Authorize Manager Search**
Mr. Gavia introduced Kristin Qualls and Tracey Nykiel of R.V. Kuhns to discuss the Satellite allocation structure within the Equity portfolio. Ms. Qualls began by stating that transition into the satellite, or actively managed, portion of the equity portfolio will be a multi-year process. She reminded the Board of the strategic reasons for this process and the historical steps that had been taken in the overall equity portfolio. She reviewed the past decision process for the core-satellite structure that took place in 2012. In 2013, Phase I will initially focus only on US strategies to be followed by non-US strategies, and going forward with Phases II and III, TMRS may recommend implementing both US and non-US strategies concurrently. Phase II will occur in 2014 and the final phase is projected to take place in 2015. Ms. Qualls also explained that ongoing implementation of the satellite allocation could include additional allocation to existing and/or new rules-based strategies if deemed prudent for the equity portfolio.

As an initial step into active management, Ms. Nykiel presented U.S. All Cap strategies. She reviewed various All Cap strategies that fall into three different management styles: 1) Traditional which are benchmark-aware/constrained; 2) Opportunistic, which are benchmark-agnostic or unconstrained; and 3) style-based which could be either traditional or opportunistic. She further discussed general characteristics between Traditional and Opportunistic. Ms. Qualls briefly discussed tracking error and explained that a strategy with a higher tracking error can be considered more risky but that it is not necessarily a negative aspect if the strategy is producing performance returns reflective of the additional risk. Ms. Nykiel further discussed the pros and cons to US All Cap strategies. She showed two examples of managers representing traditional and opportunistic styles, and showed historical risk return and style analysis metrics for the different approaches. Ms. Nykiel next reviewed the efficient frontier for the active strategy, noting where the current target structure falls on the efficient frontier and where the initial phase could take TMRS with regard to risk and excess return.

Ms. Qualls next moved into the Board recommendations: 1) Approve All Cap equity strategies for initial phase; and 2) approve search process for US and non-US managers, with initial focus on US All Cap. She also discussed other points for the Board's consideration as well as the timeline and implementation for 2013 and 2014 – 2015 time frame. For the US All Cap allocation, they will probably look at one or two managers. The manager search process and scoring of the All Cap candidates will be a collaborative effort between TMRS and RVK. We will be funding the satellite from the core (passive) equity portfolio.

Mr. Jim Parrish moved that the Board 1) approve All Cap equity strategies for both the US and non-US Equity Asset Class, and 2) authorize searches for US and non US All cap investment managers, with the initial focus on US All Cap managers. Ms. April Nixon seconded the motion; which passed unanimously by the members of the Board present, 4-0.

2. **Consider and Act on Non-Core Fixed Income Strategy and Authorize Manager Search**
Bonnie Mitra and Marsha Beard began this presentation much of which was discussed with the Board in March. Mr. Mitra began by giving an overview of the current US Bond market. Approximately half of the system assets are in the core and core-plus portfolios, so diversification here should be reviewed. With duration of five plus years, if yields increase 300 basis points, we could lose 15% in market value. Mr. Mitra reviewed the Asset Class Structure including: US High Yield; Emerging Market Debt; US Bank Loans and Collateral Loan Obligations (CLS); US Commercial Mortgage Backed Securities (CMBS); and US non-Agency Residential Mortgage Backed Securities (RMBS).

Mr. Mitra began by discussing CLOs and US Bank Loans. These instruments are very short duration, so they are not subject to material interest rate risk. They offer higher income to compensate for greater credit risk. He then reviewed US Bank Loan default rates. The recovery range on default has been in the 70% to 80% range. Bank Loans are attractive because the excess return is greater than the potential default losses, and with short duration, they are not subject to material interest rate risks. By comparison, the High Yield sector has more exposure to call loss and duration risks.

A "CLO" is a securitization of bank loans by a manager. The debt-only strategy insulates the portfolio from the first 10% of losses in the event of defaults in the underlying asset pool. CLOs offer attractive relative values compared to loan-only portfolios, similarly rated securitized products and corporate debt. CLOs also offer attractive relative value compared to historical pricing.

Mr. Mitra briefly reviewed Emerging Market Debt, US CMBS and US Non Agency RMBS. He next reviewed the fixed income non-core efficient frontier. Mr. Mitra concluded by saying that implementing a non-core fixed income strategy will reduce risk and duration in the fixed income portfolio, increase yield and improve overall portfolio diversification.

He next presented the Staff's recommendations and implementation timeline. Mr. Mitra concluded by reviewing the requested Board action. Ms. Goerdel stated the preferred motion is on page two of the Board Communication page.

Mr. Jim Parrish moved that the Board: 1) approve implementation of the Non-Core Fixed Income allocation as follows:

Non-Core Fixed Income Structure		
Allocation	**Sector**	**Benchmark**
50%	High Yield Debt	Barclays US Corporate High Yield Index
50%	Emerging Market Debt	
	25%	JPM GBI Global Diversified Unhedged Index
	25%	JPM CEMBI Broad Diversified Index

Permissible Sectors and Limits		
Sector	**Sub-Sector**	**Limit**
1	Corporate Debt (including sub-investment grade)	0-50%
	Bank Loans	0-50%
	Collateralized Loan Obligations (CLO)	0-50%
	High Yield Bonds	0-10%
2	Emerging Market Debt	0-50%
3	Securitized Mortgages (including sub-investment grade)	0-25%
	CMBS (Commercial Mortgage Backed Bonds)	0-25%
	Non-Agency RMBS (Residential Mortgage-Backed Securities)	0-25%

2) Authorize manager searches for Bank Loan/CLO allocation.

Ms. April Nixon seconded the motion; which passed unanimously by the members of the Board present, 4-0.

3. **<u>Investment Report: March Quarterly Performance Review and Portfolio Update</u>**
Marsha Beard began the quarterly performance review with the capital markets update. In the first quarter of 2013, equity performance was up despite political uncertainty in the US and Europe, and continued weakness in the global economy. TMRS' current equity allocation is moderately in line with its peers although the target has been lowered from 40% to 35%. On the Fixed Income (FI) side, TMRS is overweight compared to its peers, but is funding real estate and absolute return from this allocation. Ms. Beard reviewed the performance compared to the long term objective, as well as the Actual Allocation and Policy Allocation Benchmarks. She also reviewed performance compared to peers, noting that this is not a policy objective, but is of general interest for information purposes. With regard to risk/return profile, over the short term (5 years), the total fund has experienced

higher returns than the median plan in the universe, with less risk. Over the long term (10 years), TMRS has had lower return with similar risks.

Ms. Beard then reviewed asset class composite performance noting that while fixed income, real return and real estate provided diversification benefits during the trailing one-year period, equities added strong performance. Ms. Beard next provided an update to performance for the month ended April 30, 2013. As of this period market value exceeded $21 billion for the first time and performance was generally positive.

Ms. Goerdel began the staff report by noting that the yield on the ten-year Treasury has increased by 30 bps quarter-to-date, negatively affecting the fixed income portfolio. She discussed the spreads in corporate and agency MBS comparing pre-crisis and quarter-to-date periods. She reviewed the global linkers market environment noting a slight decline in implied inflation. She also noted that fund flows into equities were at the expense of money-markets and commodities, and that the US market had been outperforming non-US equities; finally, real estate market return increased as asset appreciations improved and REITS are out-performing the S&P 500.

On a total performance basis, May and June have not been stellar with total portfolio returns declining slightly dragged down by bond returns.

On the Risk Report, there were no compliance test violations. Risk measures did not change significantly, with portfolio, benchmark and tracking error risk metrics all declining slightly.

4. **<u>Executive Session</u>**
At 4:28 p.m., the Board entered into Executive Session, pursuant to Texas Government Code §§551.071 and 551.074 to consult with Legal Counsel to receive legal advice, and to discuss personnel matters. No action was taken during the Executive Session and the meeting was opened to the public again at 5:48 p.m. All members of the Board who had been present when the Board went into Executive Session were again present.

5. **<u>Consider and Act on Performance and Compensation of Executive Director</u>**
Ms. Nixon moved that the Board approve a 4% increase in salary for the Executive Director and $2,000 in deferred compensation effective one year from his last pay increase. Mr. Parrish seconded the motion; which passed unanimously, 4-0.

6. **<u>Consider and Act on Performance Internal Auditor and General Counsel</u>**
Ms. Nixon moved that the Board grant a 3.0% merit increase for the Director of Internal Audit effective one year from his last pay increase. Mr. Parrish seconded the motion, which passed unanimously by all Board members who were present, 4-0.

Ms. Nixon moved that the Board grant a 3.5% merit increase for the General Counsel effective one year from her last pay increase Mr. Parrish seconded the motion, which passed unanimously by all Board members who were present, 4-0.

At 5:50 p.m. the meeting recessed until 8:30 a.m. on Friday, June 20, 2013.

Ms. Nixon made a motion to adjourn. Mr. Parrish seconded the motion; the motion carried 4-0 by all members present.

David Gavia	Roel "Roy" Rodriguez
Executive Director	Chair, Board of Trustees