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

June 21, 2012 – 3:30 p.m.
June 22, 2012 – 8:30 a.m.

On June 21, 2012, the Board of Trustees of the Texas Municipal Retirement System (TMRS) convened for a meeting at 3:30 p.m. at TMRS Headquarters, located at 1200 North IH 35 in Austin, Texas, with the following members present:

<u>Board of Trustees</u>
Frank Simpson, Chair
Julie Oakley, Vice Chair
April Nixon
Jim Parrish
Roel ("Roy") Rodriguez

Absent: Ben Gorzell, Jr.

Present also were: David Gavia, Executive Director
Eric Davis, Deputy Executive Director
Bernie Eldridge, Director of Human Resources
Nancy Goerdel, Chief Investment Officer
Christine Sweeney, General Counsel
Dan Wattles, Director of Governmental Relations
Bill Wallace, Director of Communications
Michelle Mellon-Werch, Associate General Counsel
Stacy White, Executive Assistant
Robert Klausner, Klausner Kaufman Jensen & Levinson

Mr. Simpson called the meeting to order at 3:31 p.m. and Mr. Rodriguez gave the invocation.

1. <u>Executive Session</u>

At 3:33 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 4:56 p.m. All members of the Board who had been present when the Board went into Executive Session were again present. No public action was taken.

At 4:56 p.m., the meeting recessed until 8:30 a.m. on Friday, June 22, 2012.

Signed by David Gavia | Signed by Frank Simpson

David Gavia
Executive Director

Frank Simpson
Chair, Board of Trustees

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TEXAS MUNICIPAL RETIREMENT SYSTEM
Meeting of the Board of Trustees

June 21, 2012 – 3:30 p.m.
June 22, 2012 – 8:30 a.m.

On June 22, 2012, the Board of Trustees of the Texas Municipal Retirement System (TMRS) convened for a meeting at 8:30 a.m. at TMRS Headquarters, located at 1200 North IH 35 in Austin, Texas, with the following members present:

<u>Board of Trustees</u>
Frank Simpson, Chair
Julie Oakley, Vice Chair
April Nixon
Jim Parrish
Roel ("Roy") Rodriguez *(arrived at 8:50 a.m.)*

Absent: Ben Gorzell, Jr.

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
Bonnie Mitra, Director of Fixed Income
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
Diana Mayes, KPMG
Marcia Beard, R. V. Kuhns & Associates
Todd Shupp, R. V. Kuhns & Associates

Also in attendance:

Nikolas Ballard, Pension Review Board
Sherry Chapman, Investment Accountant
David Crow, Arlington Fire Fighters
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
Cindy Morse, Investment Support Analyst
Candace Nolte, Controller
Kate Reed, Investment Risk Analyst
Katie Reissman, Investment Analyst – Fixed Income
David Rodriquez, Regional Manager – City Services

Mr. Simpson called the meeting to order at 8:34 a.m. and gave the invocation.

2. <u>Consider and Act on Performance and Compensation of Internal Auditor and General Counsel *(taken out of order)*</u>

Mr. Gavia reminded the Board that it sets the compensation of the Internal Auditor and the General Counsel and is not required to use regular staff merit increase guidelines in compensating either of these positions, based on Board Policy. During the 2012 budget process, the Board approved a 2.5% merit increase pool for one-half of the year to be awarded in accordance with the merit increase guidelines that were approved by our internal Compensation Committee for use in awarding 2012 merit increases. Discussion centered on the General Counsel's salary compared to other similar positions. Mr. Parrish moved that the Board grant a 2.5% merit increase for the Director of Internal Audit. Ms. Nixon seconded the motion, which passed unanimously by all Board members who were present, 5-0. Ms. Nixon moved that the Board grant a 3% merit increase for the General Counsel. Mr. Parrish seconded the motion. Mr. Simpson opposed the motion stating that he wanted to be mindful of other cities we serve and also the fact that other employees were given a 2.5% increase or nothing and is no reflection on Ms. Sweeney. The motion carried with a 4-1 vote.

3. <u>Consider and Act on Consent Agenda *(taken out of order)*</u>

Mr. Gavia presented the items contained in the consent agenda which included the minutes from the May 3-4, 2012 Joint Meeting of the Board and the Advisory Committee on Retirement Matters, along with quarterly reports on service retirement, disability retirements, death benefits and financial statements. There was no discussion on this item and no revisions to the minutes. Ms. Nixon moved that the Board adopt the Consent Agenda as presented. Ms. Oakley seconded the motion, which passed unanimously by all Board members who were present, 4-0. Mr. Rodriguez was not present for the vote.

4. **<u>Consider and Act on 2011 External Audit Results (SAS 114) and Auditor Report to the Board of Trustees *(taken out of order)*</u>**
Mr. Gavia introduced Ms. Susan Warren, Partner with KPMG, to present the audit results for the year ended December 31, 2011. Mr. Gavia also mentioned that this is the last year of the audit contract with KPMG. Ms. Warren then introduced Diana Mayes, the Audit Manager. Ms. Warren began with a discussion of management's responsibilities with regard to the audit and the auditor. She also reviewed KPMG's responsibilities with regard to forming an opinion, planning and conducting the audit, and communicating all required information to management and the Board.

Ms. Warren then presented the results of the audit, reporting that it is an unqualified (clean) opinion. In response to a question from Mr. Simpson, Ms. Warren stated that no management letter was issued. She noted that there were two "best practice" items observed and discussed with staff/management, but they did not rise to the level of a letter. She indicated that there were no material weaknesses or significant deficiencies identified during the 2011 audit nor were there significant corrected or uncorrected adjustments identified.

Ms. Warren then discussed management's estimates in the financial statements which include the actuarial information. These estimates were evaluated and determined to be reasonable in relation to the financial statements taken as a whole. She concluded by stating that there were no other matters to note, and reiterated that the opinion for 2011 was unqualified or clean.

Mr. Jim Parrish moved to accept the audit results for the year ended December 31, 2011, and adopt the *Report to the Board of Trustees.* April Nixon seconded the motion; which passed unanimously by all Board members who were present, 5-0.

5. **<u>Consider and Act on 2011 Comprehensive Annual Financial Report (CAFR) *(taken out of order)*</u>**
Mr. Gavia introduced Ms. Rhonda Covarrubias to review the 2011 Comprehensive Annual Financial Report (CAFR). Ms. Covarrubias stated that special recognition should be given to the Communications, the Information Technology and Actuarial staff for their assistance in producing the CAFR. She also stated that Candace Nolte should be recognized for her assistance in coordinating the CAFR in her absence. She began by discussing the five sections of the CAFR, stating that there are no significant changes to the CAFR format. The Introduction section includes the Letter of Transmittal, which includes the changes brought about by SB 350, as well as a brief investment overview. The Letter of Transmittal also includes a funding and actuarial overview. Other items in this section include listing of the Board and Executive Director, Advisory Committee, professional advisors and a summary of plan provisions.

The second section, the Financial section, includes the Independent Auditor's Report, Management's Discussion and Analysis (MD&A), and the financial statements. She highlighted certain financial results of 2011 and key points in the footnotes and Required

Supplementary Information (RSI). She highlighted the “Roll-forward” of activity for each city’s account in the Benefit Accumulation Fund (BAF).

Ms. Covarrubias then highlighted the key points within the Investments section.

Next she discussed the Actuarial section, which separates out the pension trust and Supplemental Death Benefit Fund, and includes the actuaries’ certification letter for each fund. She pointed out key takeaways from the valuation results for each city.

Regarding the statistical section, Ms. Covarrubias highlighted the schedule of changes in Plan Net Assets, average benefit payments, retired members by type, and other schedules showing statistics regarding the System.

She concluded noting the CAFR would be distributed electronically, posted on the TMRS website, and it will be submitted to GFOA for its certification program. She also mentioned that the Popular Annual Financial Report (PAFR) will be distributed in the coming weeks.

April Nixon commended staff on the quality of this year’s CAFR; Julie Oakley concurred.

Ms. Oakley moved that the Board approved the CAFR and its distribution. Ms. Nixon seconded the motion, which passed unanimously by all members who were present, 5-0.

At the conclusion of this agenda item, the Board reconvened into Executive Session at 9:03 a.m. pursuant to Texas Government Code Section 551.071 and 551.074 to consult with Legal Counsel and discuss personnel matters. No action was taken during the Executive Session and the meeting was opened to the public again at 9:40 a.m. All members of the Board who had been present when the Board went into Executive Session were again present.

6. **<u>Consider and Act on Appointment to the Advisory Committee on Retirement Matters</u>**
Mr. Gavia reported that the Board Subcommittee, comprised of Julie Oakley and Jim Parrish, were appointed to assist in reviewing applications for vacant or expired positions on the Advisory Committee and to develop recommendations for the Board’s consideration being mindful of geographical diversity and type of member. The recommendation of the Committee is that Neil Resnik, Councilman for the City of Addison, be considered for the Advisory Committee. He gave a brief description of Mr. Resnik’s relationship with TMRS and the City of Addison.

Mr. Parrish moved that the Board approve Neil Resnik, of the City of Addison, to serve in the Individual Class of membership. Ms. Oakley seconded the motion, which passed unanimously by all Board members who were present, 5-0.

7. **<u>Consider and Act on Acceptance of Internal Audit Report Entitled: Payroll Reporting and Contribution Payment Processes</u>**
Mr. Allan began the discussion of the payroll reporting and contributions payment processes audit by highlighting the purpose of this audit. He briefly discussed the objectives of the audit, which were determined at the beginning of the audit. He stated that controls over the

receipt and processing of municipal payroll reports and contributions are strong. Municipal payroll reports and employee contributions payments were processed in compliance with applicable laws and regulations with few exceptions and gross earnings were found to be reliable. He noted two items that were identified that warrant further action: identifying members who exceed the federal annual compensation limit; and memorializing current payroll reporting practices in the Board rules. Staff has already taken action on addressing the federal annual compensation limit concerns.

Mr. Allan then moved into the separate recommendations. These recommendations included: (1) periodically measure the timeliness of contribution payments and develop a benchmark based on the results of this measurement; (2) drafting a rule to limit the "grace period" to a period reflective of the U.S. Postal Service's delivery standard with regard to monthly report submission; (3) developing a process to ensure the consistent application of interest due on late contribution payments; (4) evaluating the feasibility of and authority for establishing a threshold amount, above which the collection of interest due on late contribution payments would be pursued; (5) evaluating the feasibility of and the authority to charge an administrative fee to cover the cost of processing late contribution payments and to encourage their timely submission; (6) developing a policy clarifying the method to be used in the calculation of interest on late payrolls for the Executive Director's review and approval; (7) assessing the feasibility of developing a program that evaluates the reliability of payroll information reported to TMRS by participating cities and their compliance with key requirements of the TMRS Act; (8) determining the best approach to improve guidance to TMRS' participating cities regarding the practical application of the TMRS Act in those cities; (9) revising the methodology used in identifying members with gross earnings above the federal annual compensation limit to ensure compliance with Federal law; (10) drafting a rule covering the solicitation of certain payroll information from participating cities; and (11) developing written policies covering the use of TMRS-2 and TMRS-3 report forms in soliciting certain payroll information from TMRS' participating cities. Mr. Allan also recommended developing written policies regarding the use of monthly payroll reporting forms. The last recommendation is to develop performance information related to the processing of payroll reports and contribution payments. Bob Scott stated that GFOA would be happy to sponsor an informational session for cities to better inform them of reporting requirements. Mr. Allan reported that Debbie Munoz will follow-up with an action plan within 60 days and an update will be provided at the September meeting.

Roy Rodriguez moved that the Board accept the Payroll Reporting and Contribution Payment Processes Audit Report. April Nixon seconded the motion, which passed unanimously by all Board members who were present, 5-0.

8. <u>Consider and Act on Contract Renewal with Ron Lewis & Associates</u>

Mr. Gavia presented the proposed contract extension for governmental relations consulting services with Ron Lewis of Ron Lewis and Associates in the amount of $75,000 per year. Roy Rodriguez moved that the contract be extended for a term to expire on May 31, 2014. Jim Parrish seconded the motion; which carried unanimously by all Board members who were present, 5-0.

9. **<u>Consider and Act on Ratification and Termination of Real Estate Manager Contract Negotiations and Allocation of Core Real Estate Commitment</u>**

Mr. Gavia reminded the Board that they previously authorized staff to negotiate a contract satisfactory to the System with H/2 Capital Partners, a real estate manager, for an investment of $100 million. Mr. Gavia reviewed staff's procedural process in negotiating the limited partnership agreements with real estate investment managers. He explained that in the course of negotiations, staff began developing basic legal and business guidelines to incorporate in the contract. Most of TMRS' legal guidelines are due to its status as a governmental entity which means that, with certain exceptions, our investments are generally subject to the Public information Act (PIA). In this instance, contract terms around the PIA proved to be an obstacle that TMRS and H/2 could not overcome, so both parties decided to cease negotiations.

April Nixon moved that the Board ratify staff's decision to cease negotiations with H/2 and to authorize staff to include the $100 million previously allocated to H/2 in its current search for real estate core managers. Julie Oakley seconded the motion; which passed unanimously by all Board members who were present, 4-0. (Roy Rodriguez was not present for the vote).

10. **<u>Asset Allocation Philosophy Discussion</u>**

Ms. Goerdel and Mr. Shishkoff began this discussion of TMRS' Asset Allocation Philosophy by highlighting the goals of the presentation: to review the Board's approach to governance and decision making; and to provide a framework for defining the Strategic Target Allocation and making changes to it when necessary, as well as providing a framework for defining and changing Asset Class Structures. Mr. Shishkoff reviewed how the TMRS Board governs the investment program and summarized the Board's key policy decisions. He reviewed the Board's strategic target allocation decisions that need to be made, and provided a flow chart of the TMRS Asset Management Decision Flow Process.

Mr. Shishkoff then covered the development of the framework. The first discussion point covered was the Strategic Target Allocation (STA) deliverables. These included the STA being representative of the board's long-term objective and risk tolerance, providing sufficient confidence for the Board to "stay the course" in volatile markets, and a benchmark against which to measure performance. He also discussed the requirements for setting the STA. Mr. Shishkoff added that asset classes should be chosen if they add unique, significant and compensated market risk factors to the asset mix. He noted that taken together, the asset classes considered, should represent all appropriate opportunities for a pension system.

Mr. Shishkoff discussed the framework used to choose one asset allocation over another in Modern Portfolio Theory (MPT). The assumptions used in this framework must be long-term assumptions. Current market fundamentals and valuations are not factored in. Shortcomings of MPT as a decision framework were also presented. The key shortcomings are that it is a single period model and cannot incorporate a dynamic view of capital markets that would recognize current market valuations and fundamentals and that it cannot be used to evaluate hedging decisions. It was pointed out that currently we are not faced with these decisions but if the need arises, more powerful, albeit more complicated, decision frameworks are available and will be introduced by the Investment Department.

Mr. Shishkoff next discussed the Asset Class Structure deliverables and touched on key points. The prerequisite for setting the asset class structure requires the same information as the STA, but their focus is recognition of current relative opportunities within the Asset Class and the development of an allocation structure to capture those opportunities. It was pointed out that Asset Class Structure decisions have an evolving nature, reflecting the evolving nature of capital market opportunities.

Due to time constraints the Chairman then requested that the balance of the presentation be included as an introduction to the Asset Allocation Study, the presentation of which is planned for the August board meeting.

11. <u>Absolute Return Education Session: Risks and Risk Mitigators *(taken out of order)*</u>
Marcia Beard and Todd Shupp, R.V. Kuhns & Associates, began their presentation by reviewing the current allocation and the final target asset allocation which includes a 5% allocation to Absolute Return. Ms. Beard also reviewed the reasons why investors generally utilize an absolute return allocation and added that absolute return can increase the potential return without increasing volatility.

Mr. Shupp reviewed the highlights of previous educational presentations on absolute return that focused on the basic characteristics of absolute return, and pointed out that the reason for investing in absolute return is the attractive risk adjusted returns over the long-term with attractive correlations. He emphasized that absolute return strategies are typically less transparent (although this is improving), less liquid and more expensive than traditional equities, though costs are decreasing. He reviewed three broad categories of hedge fund strategies: Directional (managers invest in both long and short positions designed to gain from advances or declines in equity or bond markets), Non-Directional (managers attempt to identify arbitrage opportunities in mispricing of related securities); and Event Driven (managers trade in securities that are or may become involved in mergers, bankruptcy or other corporate events). He illustrated the Risk/Return Profiles of these three categories of strategies, stating that the Non-Directional strategies have lower to moderate expected return and volatility, while the Directional strategy has moderate expected return and moderate volatility. He showed that a distribution of monthly Absolute Return Strategy returns over the last seven years is slightly wider than that of fixed income while narrower than equity.

Mr. Shupp then discussed, in detail, potential risks and corresponding risk mitigators including operational risks, investment risks and other risks such as fraud and regulatory issues. Mr. Simpson inquired about the loss experience and incidence of fraud in absolute return, and Mr. Shupp responded that he would provide this information.

Mr. Shupp concluded that Hedge Fund investing can be very complicated and involves a variety of risks, but a thorough due diligence process, as well as imposition of certain investment restrictions and fund terms can substantially reduce the associated risks. He added that while unique risks do exist, Absolute Return Strategies can have a positive impact on the risk/return profile of the portfolio. Mr. Shupp added that the next educational presentation on Absolute Return would address implementation approaches.

12. **Investment Report: March Quarterly Report**

Ms. Beard began by reviewing the economic news during the first quarter, which included moderate growth and positive news for equities. However, she reported that circumstances have changed since the first quarter. She then reviewed the target allocations relative to the actual allocations. Mr. Simpson asked what the trigger points were for rebalancing. Ms. Goerdel responded that the trigger points are reflected in the strategic target allocation ranges as found in the Investment Policy Statement (IPS) with U.S. equities, for example, ranging from 12% to 25%. Ms. Beard then reviewed the asset allocation by theme and liquidity and reported on performance according to the objectives laid out in the IPS. Total fund performance outperformed its policy index benchmark over the five-year period ending March 31, 2012.

Ms. Beard then reviewed performance by asset class and reported that fixed income, U.S. equities, and non-U.S. equities outperformed their benchmarks over the three years ended March 31, 2012. Ms. Beard added that the real return asset class does not yet have a three-year performance history, but outperformed its benchmark for the quarter ended March 31, 2012.

Ms. Goerdel reviewed the May 2012 and year-to-date performance. She reported that some of the first quarter's performance was lost in the second quarter due to difficult markets, but that June's performance has been positive, bringing the year-to-date performance to over 3%. She pointed out that the risk report addressing compliance and relative market exposures reflects no risk concerns, and there were no significant change from the last report. She did note that there was one exception to guideline compliance by BlackRock, but that this exception was not material and was cured very quickly.

Ms. Goerdel updated the Board on the BlackRock Annual Review Watch list status, reporting that they had satisfied all of the criteria for removal from watch list status and had been so notified in April. Ms. Goerdel mentioned that the Annual Securities Lending Review Report was provided to the Board in the March 2012 meeting materials, but was not formally presented at that time as a quorum of the Board was not present. She reported that the recommendation of staff and R.V. Kuhns was to continue to participate in a securities lending program, but to consider any changes to the program in conjunction with the custody/securities lending search currently in progress.

13. **Executive Director and Staff Reports, including Reports from Administration, Communications, Staff Actuary, Finance, Governmental Relations, Human Resources, Information Resources, Internal Audit, Legal and Member Services**

Mr. Gavia presented the staff reports and the Board had no questions or comments.

14. <u>Call for Future Agenda Items</u>

Mr. Simpson asked the Board if there were any future agenda items to be discussed. As there was no further business, the meeting adjourned at 12:27 p.m.

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David Gavia Executive Director	Frank Simpson Chair, Board of Trustees