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

February 21, 2013 – 2:00 p.m.
February 22, 2013 – 8:30 a.m.

On February 21, 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:

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

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
Leslee Hardy, Director of Actuarial Services
Christine Sweeney, General Counsel
Debbie Munoz, Director of Member Services
Bill Wallace, Director of Communications
Dan Wattles, Director of Governmental Relations
Scott Willrich, Director of Information Resources
Holly Macki, Director of Real Estate
Kristin Qualls, Director of Equities
Dimitry Shishkoff, Director of Risk Management
Stacy White, Executive Assistant
Marcia Beard, R. V. Kuhns & Associates
Jonathan Kowolik, R. V. Kuhns & Associates
Robert Klausner, Klausner Kaufman Jensen & Levinson

Also in attendance:

Sherry Chapman, Investment Accountant
David Crow, Arlington Fire Fighters
Debbie Farahmandi, Investment Operations Specialist
Howell Hollis, Investment Analyst
Chris Jones, Combined Law Enforcement Associations of Texas (CLEAT)
George Kauffman, City of Garland
Scott Kerr, Texas Association of Fire Fighters

Kevin Lawrence, Texas Municipal Police Association
Carol Leung, Investment Analyst
Michelle Mellon-Werch, Associate General Counsel
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
Bob Scott, GFOA/City of Carrollton
Mel Thomas, Editor

Ms. Oakley called the meeting to order at 2:02 p.m. and Jim Parrish gave the invocation.

1. **Investment Program Risk Budgeting Presentation**

Mr. Gavia introduced Mr. Shishkoff to present on risk budgeting as it relates to the active management component of the System's investment portfolio. Mr. Shishkoff reported that as TMRS continues its investment strategy implementation, there will be a growing allocation to actively managed assets. He stated that today's presentation on risk budgeting addresses the incremental risk that active management may contribute; and introduces a framework for setting an active management Risk Budget at the total fund level and the allocation of that risk budget down to the account level that incorporates the Board's risk tolerance as inferred by the TMRS Strategic Target Allocation.

Mr. Shishkoff began by introducing a broad framework for active management decisions which include: (1) well developed rationale; (2) defining return objective; (3) considering risk/return tradeoff; (4) defining a methodology to allocate the expected incremental risk across accounts; and (5) monitoring and reporting of performance. He also highlighted the three basic sources of return: risk free rate; market returns and incremental return from active management. He next discussed market return sources comparing those to active management return sources. Mr. Shishkoff discussed TMRS' current investment strategy, comparing expected return from market sources of 6.4%, and the 0.6% return gap to be achieved from active management sources.

Mr. Shishkoff next discussed five "Risk Budgeting Considerations": (1) risk tolerance; (2) return objective; (3) assumptions to be used; (4) optimal allocation of risk budget, and (5) monitoring and managing. He pointed out that the Board's chosen point on the efficient frontier implies the Board's risk tolerance; he juxtaposed that with the level of returns that must be achieved to make taking additional risks acceptable. For active management strategies, this defined the minimum expected incremental return required to justify incremental risk. Mr. Shishkoff added that risk budgeting is a control method for active management, so that filling the return objective gap remains within the prescribed range and is efficiently allocated across accounts. He also noted that in order for TMRS to manage risk, the System must be able to measure it, and assumptions depend specifically on the sub-asset classes and the particular strategies or managers. Assumptions are made based on a combination of historical performance and assessment of current markets, manager processes and in the managers' investment teams.

Mr. Kowolik then reviewed the manager research and selection process. The objective is to identify managers that provide appropriate exposure to a desired asset class with an increased potential to provide alpha. He highlighted the factors that will go into a manager selection: (1) the firm; (2) the team; (3) philosophy/processes; (4) performance; and (5) product assets. Key considerations include consultant and lead TMRS team members with experience and market knowledge; sufficient resources; and appropriate tools and access to available data. In response to a question from the Board, Mr. Kowolik responded that the steps in selection of a manager would be similar to those the Board has seen used, but that there will be nuances by asset class.

Mr. Shishkoff reported that the allocation objective is to get the highest expected return for a given total portfolio tracking error. The active strategy selection and allocation process was discussed adding that monitoring and management is critical in this process. TMRS' monitoring must include forward-looking risk analysis, analysis of experienced risk (volatility of our historical manager returns over their benchmark), and comparison of results to expectations. Management of the process requires corrective actions when analysis reveals that there are significant departures of results from expectations.

Mr. Kowolik added that risk budgeting provides a disciplined framework for active management decisions to better ensure meeting objectives and provides a tool for active strategy decision-making.

Board discussion centered around whether Investment Policy Statement changes reflecting this process would be necessary before the next active manager selection and it was determined that this was not absolutely necessary given that TMRS is in relatively early stages of considering additional active strategies. The Board then agreed that staff will provide additional information to the Board in a future meeting.

2. **<u>Consider and Act on Authorization to Conduct Search for Investment Program Transition Manager</u>**

Mr. Gavia introduced this agenda item and explained that as TMRS begins implementation of additional asset classes and strategies, the use of Transition Managers (TMs) may prove beneficial to TMRS in certain circumstances. Mr. Kowolik, R.V. Kuhns, reported to the Board that a TM provides a process in moving from a legacy to a target portfolio utilizing strategies designed to reduce overall risks and costs. He stated that this presents an opportunity to hire a third party to transition a portfolio and facilitate clear communication between all parties; and work to minimize market impact, trading costs and opportunity cost. TMs are utilized generally because transitions can be very complex and are subject to a large number of risks. TMs understand this process and are experienced in minimizing costs involved in transitioning assets. Mr. Kowolik stated that TMRS intends to retain TMs on an as needed basis and when economically advantageous to do so, as its portfolios becomes more diversified.

In discussing the costs of a transition, Mr. Kowolik explained that there are both explicit and implicit costs associated with transitions. Explicit costs are those directly measurable and incurred as a result of security transactions; they are more visible, but a less significant cost of a trade. Implicit costs are derived from the price performance achieved and represents the least visible costs, but often the most significant cost of a trade.

Mr. Kowolik stated that creating a "bench" of 2-3 TMs under contract to provide transition management services pursuant to a specific cost-and-risk discovery bidding process has become relatively standard for large institutional investors. The bidding process at the time of engagement is designed to get a best price for services. Mr. Kowolik walked through the general process of selection and use of a TM in a transition. He also discussed the evaluation factors relating to a TM selection. Mr. Kowolik then reviewed an example of TM selection showing expected costs and forecasted range of outcomes. Mr. Klausner suggested the trustees read slides 22 and 23 carefully which describe Principal versus Agency TM providers as well as the pros and cons of fiduciary models. It was generally agreed that an Agency TM acting as a fiduciary would be the focus of the search.

Jim Parrish moved that the Board approve a manager search for 2-3 Transition Managers to assist in the efficient transfer of assets from one investment manager to another. Roy Rodriguez seconded the motion; which passed unanimously by the members of the Board present, 5-0.

3. Manager Reviews

Mr. Gavia introduced Ms. Goerdel to present this item in Mr. Mitra's absence. Ms. Goerdel began the presentation by stating that these reviews were conducted as per the Investment Policy (IPS) which requires an annual comprehensive review of external managers. She reported that the Core Fixed Income allocation target is 30% with the US Core Fixed Income allocation target at 2/3 of that 30% and is currently 40% of the total portfolio. She reminded the Board that this overweight will decline as the BlackRock portfolio continues to fund asset allocation diversification efforts. Ms. Goerdel summarized the manager monitoring process and stated that the manager retention policy includes at least one meeting with the manager, which may be at the manager's offices. R.V. Kuhns, as part of their contract with TMRS, participates in the annual manage review. Memorandums by Mr. Mitra and R.V. Kuhns detailing the scope and outcome of the reviews were provided as attachments.

Ms. Goerdel then reviewed key 2012 market statistics relating to the bond market as a backdrop to the core fixed income portfolio reviews.

3a. <u>Manager Review - BlackRock</u>

Ms. Goerdel noted that due to scheduling conflicts, R.V. Kuhns did not accompany TMRS staff on this site visit. She highlighted the 2012 performance drivers and the current portfolio positioning and activity. She reviewed the annual report card that addressed the primary areas being assessed including People, Process, Portfolio Strategy, Performance, Risk Management, Organization, and Operations all with "excellent" marks. She did discuss an organizational change that occurred after this evaluation was prepared, noting that both Staff and R.V. Kuhns concluded that the change will not negatively impact the management of the TMRS portfolio but further stated that TMRS staff will continue to monitor the situation for any unexpected impact or further changes.

Ms. Goerdel concluded that based on the quantitative and qualitative assessment of the firm, staff recommends that the Board retain BlackRock as the US Cored Fixed Income Manager and she reported that R. V. Kuhns supports this recommendation.

3b. Manager Review - PIMCO

Ms. Goerdel continued the presentation with a review of Pacific Investment Management Company LLC (PIMCO) which serves as TMRS' Core Plus Fixed Income manager. She reported that on January 15, 2010, the Board approved raising the portfolio allocation to 10% which falls within the Core Fixed Income 30% target allocation. Ms. Goerdel then summarized the performance and strategies of PIMCO noting that they have significantly outperformed the benchmark. She reported that PIMCO is overweight in strong performing sectors and underweight in treasuries and their risk management and compliance systems are robust. Following the on-site manager review, PIMCO's report card had "excellent" ratings across all assessment areas (People, Process, Portfolio Strategy, Performance, Risk Management, Organization, and Operations).

Ms. Goerdel concluded that based on the quantitative and qualitative assessment of the firm, staff recommends that the Board retain PIMCO as the Core Plus Fixed Income portfolio manager and reported that R.V. Kuhns supports this recommendation.

Additionally, Ms. Goerdel noted key market observations going forward which currently reflect optimism on the political front in Washington, with evidence of some improvement in the economic picture and a benign inflation outlook. Ms. Goerdel then reviewed a graphic depicting the asymmetric return distribution for the U.S. bond market due to current low yield levels which imposes a cap to rising prices. She concluded that the return outlook for core bonds is somewhat challenged and that TMRS' move to begin implementation of the non-core fixed income allocation is timely in that it should be a good diversifier from the core fixed income allocation and a good risk/return tradeoff, relatively speaking.

4a. Securities Lending Program: Review of Securities Lending Program Transition

Mr. Gavia introduced Mr. Kowolik and Ms. Goerdel to present this item. Mr. Kowolik reported that the TMRS securities lending program began in 2003, and was managed by State Street Bank (SSB) through December 2012 when the Board approved the selection of Deutsche Bank (DB) as TMRS' securities lending agent. Mr. Kowolik reported that the transition from State Street Bank to Deutsche Bank was successfully executed with no issues. He noted that the Deutsche Bank contract and supporting documents were successfully executed after substantial negotiation and there was a successful inbound transition with compliance matters resolved.

Mr. Kowolik stated that a unique aspect of the DB program is that they indemnify TMRS against counterparty insolvency default on repurchase agreements ("indemnified repo")in addition to borrower insolvency default indemnification which is fairly typical in a securities lending program.

Mr. Kowolik provided a summary of State Street's 2012 program experience and Deutsche Bank's program statistics to date. He noted that for January 2013, when DB began serving as securities lending agent, earnings to TMRS was $140,768. Mr. Kowolik highlighted the primary drivers resulting in revenues from the lender confirming that the program is focused on intrinsic value lending.

In summary, Mr. Kowolik stated that during January, with DB as TMRS' securities lending agent, TMRS has generated meaningful earnings for the first month post transition; borrower exposure compliance has been maintained; and legacy duration cash collateral investments withdrawn from the SSB program is being funded by new loans. DB's ongoing strategy on these assets will continue to be monitored.

4b. Securities Lending Program: Consider and Act on Revisions to Investment Policy Statement Concerning Securities Lending Guidelines

Ms. Goerdel reported that policy revisions to the Investment Policy Statement (IPS) are being recommended due in part because existing guidelines did not anticipate a program which exclusively manages cash collateral using indemnified repos. She added that existing cash collateral investment guidelines impose significant limitations on maturity and collateral types that challenge the viability and profitability of the DB securities lending program.

Ms. Goerdel then discussed recommended changes and additions to the IPS securities lending guidelines for reinvestment of cash collateral. These include changing the maximum maturity on tri-party repos to 45 days; reducing the maximum "gap risk" to 10 days if indemnified repurchase agreements are the primary vehicle for investment of cash collateral; and allowing collateral on tri-party repo guidelines to include investment grade corporate bonds, investment grade municipal obligations, and money market instruments with a minimum rating of A2 or P2. Further, the minimum A-rating for counterparties was clarified to allow for split-ratings with at least one A-rating.

In response to a question from Jim Parrish, Ms. Goerdel that these proposed changes do not increase investment risk, rather that it better manages the risk by reducing the gap risk. Mr. Kowolik concurred, adding that this is a controlled risk and the risk exposure is not a direct risk to TMRS.

Frank Simpson cautioned that the IPS guidelines should not be revised reactively. Ms. Goerdel concurred and responded that these revisions reflect a new strategy. Mr. Gavia added that the indemnified feature for repurchase agreements wasn't addressed in the previous IPS. Ms. Beard, R.V. Kuhns, further added that as asset class mandates evolve to a more fully diversified program, changes to the IPS should decrease.

Mr. Frank Simpson moved that the Board adopt the revisions to the IPS as proposed. Mr. Jim Parrish seconded the motion which passed unanimously by the members of the Board present, 5-0.

5. Consider and Act on Ratification of R.V. Kuhns Contract Extension and PIMCO Investment Management Agreement Term

There was no discussion on this item. Roy Rodriguez made a motion that the Board ratify the one year contract extension with R.V. Kuhns, under the same terms and conditions, to expire December 31, 2013; and to ratify the amendment to the PIMCO contract which provides that the Agreements expires on the resignation or removal of the Manager upon 60 day's notice in writing from TMRS or upon 180 days' written notice by PIMCO. Mr. Frank Simpson seconded the motion which carried unanimously by the members of the Board present, 5-0.

6. **Investment Performance Snapshot as of December 31, 2013**
Mr. Gavia introduced Ms. Marcia Beard, R.V. Kuhns, who joined Ms. Goerdel for this item. Ms. Beard presented the comparative performance report as of December 31, 2012. She reported that the year ended much better than expected from the beginning of the year. The total fund performance for the year was 9.99%. She indicated that this number could vary slightly as the real estate numbers have not been finalized noting that Real Estate takes longer to determine as appraisals are involved. Ms. Beard also reported that TMRS outperformed the actual allocation benchmark by 52 bps. She reviewed returns briefly by asset class and manager.

7. **Executive Session**
At 4:44 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 6:05 p.m. All members of the Board who had been present when the Board went into Executive Session were again present.

At 6:05 p.m., the meeting recessed until 8:30 a.m. on Friday, February 22, 2013.

David Gavia
Executive Director

Julie Oakley
Chair, Board of Trustees