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

August 23, 2013 – 8:00 a.m.

On August 23, 2013, the Board of Trustees of the Texas Municipal Retirement System (TMRS) convened for a meeting of the Board at 8:00 a.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
Kristi O'Hara, Director of Human Resources
Nancy Goerdel, Chief Investment Officer
Leslee Hardy, Director of Actuarial Services
Christine Sweeney, General Counsel
Bill Wallace, Director of Communications
Dan Wattles, Director of Governmental Relations
Scott Willrich, Director of Information Resources
Debbie Munoz, Director Member Services
Holly Macki, Director of Real Estate
Bonnie Mitra, Director of Fixed Income
Kristin Qualls, Director of Equities
Dimitry Shishkoff, Director of Risk Management
Karen Jackson, Executive Assistant
Robert Klausner, Klausner, Kaufman, Jensen & Levinson
Mark Randall, Gabriel, Roeder, Smith & Company
Marcia Beard, R. V. Kuhns & Associates
Jonathan Kowolick, R. V. Kuhns & Associates

Also in attendance:
Randle Meadows, Arlington Police Association
David Crow, Arlington Fire Fighters
Michael Dane, City of San Angelo
Scott Kerr, Texas State Assoc. of Firefighters (TSAFF)

Jerry Gonzales, Service Employees Int'l Union – San Antonio (SEIU)
Charles Windwehen, TMRS Retiree
Sherry Chapman, Investment Accountant
Juan Garcia, Governor's Office
George Kauffman, City of Garland
Barbara Whitehorn, City of Arlington
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
Peter Jeske, Support Services Analyst
Eddie Schultz, Real Estate Analyst
Debbie Farahmandi, Investment Operations Specialist
David Rodriquez, Regional Manager – City Services
Jesse Pittman, Project Manager
Bob Scott, GFOA/City of Carrollton
Mel Thomas, Editor

Mr. Rodriguez called the meeting to order at 8:00 a.m. and gave the invocation.

1. **Consider and Act on Adoption of Minutes from the June 19-20, 2013 Meeting of the Board of Trustees**
   Mr. Parrish noted Agenda Item #6 required a correction. Agenda Item #6 stated that Ms. Nixon made and seconded the motion. The item should read "Ms. Nixon made a motion; Mr. Parrish seconded". The item was corrected to show Mr. Parrish as the second.

   Mr. Parrish made a motion that the Board adopt the minutes from the June 19-20, 2013 meeting of the Board of Trustees as corrected. Ms. Nixon seconded the motion; which passed unanimously by the members of the Board present, 4-0.
2. **Consider and Act on Risk Budgeting Framework Recommendation**
   Mr. Gavia introduced Dimitry Shishkoff to discuss the Risk Budgeting Framework recommendation. Mr. Shishkoff stated that in June of 2009 the Board adopted a Strategic Target Allocation and Policy Index to be implemented over a multi-year period. He described the asset class and benchmark components of the Policy Index, which is the total fund benchmark, and the expected evolution of active portfolio strategies through the implementation process. The number and diversity of active strategies is expected to significantly increase in the next several years. Mr. Shishkoff then discussed expected benchmark returns and active return targets by Asset Class.

   The objectives of the presentation are to recommend a Risk Budgeting Framework for active management decisions and to ask the Board to adopt the Risk Budgeting Framework. Active management risk is defined as any departure from the Policy Index; risk due to any departure can be measured separately. Mr. Shishkoff discussed framework development considerations which included: excess return objective; marginal risk tolerance;

assumptions for active management excess return performance; optimal allocation of the Risk Budget; and the need for monitoring, managing and reporting. The Excess Return Objective equals the gap between the Total Return Objective and the expected return from the Policy Index. Currently the total return objective is 7%; expected return from the Policy Index is 6.4%; and the return objective gap is 0.6%. He graphically presented the implied marginal risk tolerance suggesting that TMRS requires at least 0.2% expected return to accept 1% of additional risk. Mr. Shishkoff discussed the basis for developing active management excess return performance assumptions and allocation of the risk budget, including a combination of historical performance and assessment of current markets, manager process and quality of team. He discussed optimal allocation of the tracking error risk budget. The objective is to calculate the combination of manager allocations that give the highest expected excess return (net of fees) for a given total portfolio tracking error. Manager performance will be monitored against assumptions based on forward looking and experienced volatility. Mr. Shishkoff discussed further the monitoring, management and reporting on the portfolio results. He emphasized the importance of identifying differences between actual manager performance and our assumptions, and making appropriate changes to either assumptions and/or manager allocations when actual results are significantly different. He then explained two charts showing the expected evolution of portfolio excess return vs. excess risk and asset allocation over the next several years as the implementation of the investment policy is completed.

The conclusions from the presentation observed that: the tracking error of the current portfolio is primarily due to the difference in asset class allocation between it and the Policy Index due to TMRS' deliberate implementation timeframe such that the tracking error should decrease as we progress with Investment Policy implementation; and the targeted Active Management Allocations satisfy the implied Marginal Risk Tolerance. The conclusion also observed that Risk Budgeting benefits the portfolio by: providing a disciplined framework for making and monitoring active management decisions to better ensure meeting our objectives.

Mr. Shishkoff stated the Staff's recommendation as: 1) adopting the risk budgeting framework; 2) adopting an initial active management risk budge of 2%; 3) regular review of continuing appropriateness of risk budget, and 4) that staff will develop risk budgeting language to be included in the IPS.

Mr. Parrish initiated a discussion about how common this type of framework is among other large retirement systems. Mr. Shishkoff stated that this is not a new concept, and that most plans of our size claim to have risk budgeting, but it is hard to tell exactly what that entails. Marcia Beard (RV Kuhns) agreed and added that we are ahead of the curve on how TMRS has structured this framework. Ms. Nixon inquired about how often reporting would be on this framework. The current goal is for quarterly reporting to the Board, and that reporting for internal monitoring will evolve into a monthly frequency as needed.

Ms. Nixon made a motion that the Board approves Staff's recommendation to: 1) adopt a Risk Budgeting Framework as defined in the presentation; 2) adopt an initial Active Management Risk Budget of 2%; measured as tracking error; and 3) require regular reviews of the continuing appropriateness of Risk Budget, coincident with Asset Allocation reviews. Mr. Parrish seconded the motion; which passed unanimously by the members of the Board present, 4-0.

3. **Consider and Act on Investment Program Transition Manager(s) Recommendation and Related Amendments to the Investment Policy Statement**

Ms. Goerdel and Mr. Kowolik of R. V. Kuhns began by introducing the Transition Manager Recommendation and the related amendments to the Investment Policy Statement. Mr. Kowolik gave a brief summary of the Transition Management search process and the guidelines governing Transition Managers. Transition Management is the movement of assets from a "legacy" portfolio to a "target" portfolio with the objective to reduce overall risks and costs in a transition. Transitions can be complex and subject to a large number of risk factors. With a Transition Manager, fees are potentially more competitive and provide increased transparency. Costs will be incurred with all transitions; this is trying to do so in the most efficient way which can ultimately lower the cost of the transition.

Mr. Rodriguez inquired about the fees paid to Transition Managers. Mr. Kowolik discussed the fee caps by asset type and that the fees quoted are competitive or better than what the legacy or target managers themselves could achieve. A legacy manager is not incentivized to get TMRS the best outcome. He also clarified that there are no retainer fees incurred with selection of a pool of Transition Managers. The All-Cap Equity Manager will be the first transition event where use of a transaction manager would be considered.

Ms. Goerdel discussed the TMRS IPS guidelines and the decision on how to transition assets. Decisions regarding transitioning assets are delegated to the Executive Director and Chief Investment Officer with advice from the Investment Consultant. She discussed the following requirements of investment managers: Board approved pool of Transition Managers; post transition reporting to the Board and periodic analysis; and reporting to the Board on the quality and status of the pool of managers. Mr. Goerdel reviewed the transition manager search process and timeline. Mr. Kowolik discussed the manager screening process and criteria, reviewed the due diligence ranking factors and the quantitative metrics. He next discussed the final ranking and the three highest ranking managers.

Mr. Kowolik provided a list of pros and cons of key descriptions for each of the top three candidates. K. V. Kuhns and Staff have undergone a rigorous and well-defined process to determine the selection and recommendation for a "pool" of Transition Managers. Ms. Goerdel presented the recommendations for the pool of Transition Managers to include Russell, Citi and BlackRock.

Mr. Parrish made a motion to: 1) approve the top (3) ranked Transition Managers to serve as a "bench" contingent on successful negotiation of the contracts at management fees substantially comparable to those proposed; and 2) approve the proposed amendments to the IPS guidelines. Ms. Nixon seconded the motion; which passed unanimously by the members of the Board present, 4-0.

4. **Consider and Act on Amendment to the Strategic Plan Delaying the General Investment Consultant Search by One Year**
Mr. Gavia stated that the Strategic Plan calls for a search for an investment consultant to occur during 2013. Due to Ms. Goerdel's retirement and the desire for the new Chief Investment Officer to be a part of the selection process, the recommendation is for the search to be delayed by either one or two years. Since TMRS is satisfied with the current relationship with R.V. Kuhns, Ms. Goerdel stated the current contract should be extended.

Mr. Rodrigues stated he would recommend a one year delay and then re-evaluate if another year is necessary.

Mr. Parrish made a motion to adopt an amendment to Goal 2, Objective (g) to provide that the RFP for an investment consultant is due by 12/31/2014 and to authorize the Executive Director to negotiate a one year extension to the general investment consultant's contract on substantially the same terms and conditions as the current agreement. Ms. Nixon seconded the motion; which passed unanimously by the members of the Board present, 4-0.

5. **Consider and Act on Ratification of Termination of Real Estate Contract Negotiations and Allocation of Core Debt Fund Allocation**
Mr. Gavia discussed that candidates for real estate managers are pre-screened to ensure that TMRS can successfully negotiate the necessary legal documents with a manager. Considerable time and effort was spent in negotiations with Mesa West and being unable to successfully reach an agreement, a decision was made that continuing to expend resources on negotiations was not in our best interest and a decision was made to cease negotiations. Mesa West was notified by Letter on July 29, 2013. The $100 million previously allocated to Mesa West will be reallocated to one of the managers that will be recommended for selection at the September Board meeting.

Ms. Nixon made a motion to ratify the decision to cease negotiations with Mesa West and reallocate the $100 million previously allocated to Mesa West to one of the managers that will be recommended for selection at the September Board Meeting. Mr. Parrish seconded the motion; which passed unanimously by the members of the Board present, 4-0.

6. **Investment Report: Performance Updates**
Ms. Beard began her report by stating that June started off well, but Federal Reserve Chairman Ben Bernanke's comments on the slowing quantitative easing caused market reactions to be negative.

Ms. Beard provided a broad overview of the portfolio, noting that assets are at $20.77 billion, while TMRS is continuing diversification towards the long-term strategic target. Ms. Goerdel reminded the Board that the over allocation to equity is a place holder for the private equity allocation.

Ms. Beard reviewed monthly returns and Ms. Goerdel stated that year-to-date return is about 3%.

7. **<u>Call for Future Agenda Items</u>**
Mr. Gavia stated that a preliminary budget will be presented at October's Board meeting. No other requests were made.

The meeting was adjourned at 10:20 a.m.

David Gavia
Executive Director

Roel "Roy" Rodriguez
Chair, Board of Trustees