TEXAS MUNICIPAL RETIREMENT SYSTEM

JOINT MEETING OF THE BOARD OF TRUSTEES
AND THE
ADVISORY COMMITTEE ON RETIREMENT MATTERS

TMRS Headquarters
1200 North IH 35
Austin, Texas

May 4, 2012

On May 4, 2012, the Board of Trustees of the Texas Municipal Retirement System (TMRS) convened for a joint meeting of the Board and the Advisory Committee on Retirement Matters at 9:00 a.m. at the Texas Municipal Retirement System Headquarters, 1200 North IH 35 in Austin, Texas, with the following members present:

Board of Trustees
Frank Simpson, Chair
Julie Oakley, Vice Chair
Ben Gorzell, Jr.
Jim Parrish
Roel (“Roy”) Rodriguez

Absent: April Nixon

Advisory Committee on Retirement Matters
Allen Bogard, City of Sugar Land
Randle Meadows, Arlington Police Association
David Crow, Arlington Fire Fighters
Michael Dane, City of San Angelo
Scott Kerr, Texas State Assoc. of Fire Fighters (TSAFF)
Jerry Gonzalez, Service Employees Int’l Union – San Antonio (SEIU)
Don Byrne, Texas Municipal Human Resources Assoc. (TMHRA)
Mayor Wayne Riddle, City of Deer Park
Charles Windwehen, TMRS Retiree
Bob Scott, Government Finance Officers Association of Texas (GFOAT)

Absent:
Flor Garcia, City of San Antonio
Dean Frigo, City of Amarillo
Mike Perez, Texas City Management Association (TCMA)
Kevin Lawrence, Texas Municipal Police Association
Victor Hernandez, City of Lubbock
Ron Cox, City of Friendswood
Monty Wynn, Texas Municipal League
Mike Staff, Corpus Christi Police Officers’ Association
Present also were:

David Gavia, Executive Director
Eric Davis, Deputy Executive Director
Ian Allan, Director of Internal Audit
Rhonda Covarrubias, Director of Finance
Bernie Eldridge, Director of Human Resources
Christine Sweeney, General Counsel
Nancy Goerdel, Chief Investment Officer
Leslee Hardy, Staff Actuary
Debbie Munoz, Director of Member Services
Bill Wallace, Director of Communications
Dan Wattles, Director of Governmental Relations
Scott Willrich, Director of Information Resources
Stacy White, Executive Assistant
Cindy Morse, Investment Support Analyst
Gary Shilling, A. Gary Shilling & Company, Inc.
Mark Randall, Gabriel Roeder Smith & Company
Joe Newton, Gabriel Roeder Smith & Company
Robert Klausner, Klausner, Kaufman, Jensen & Levinson
Marcia Beard, R. V. Kuhns & Associates, Inc.

Guests:

George Kaufman, City of Garland
Juan Garcia, Governor’s Office
Michelle Mellon-Werch, Associate General Counsel
Lorraine Moreno, Regional Manager, City Services
Glenn Johnson, Garland Fire Fighters Association
Jim Moore, Mesquite Fire Department
Keith Hopkins, Mesquite Fire Department
Nick Ballard, Pension Review Board
Jeff Kersten, College Station
Rick Menchaca, BOSC, Inc.
Alex Harlan, J.P. Morgan
Michael Smith, J.P. Morgan
Holly Macki, Director of Real Estate
Dimitry Shishkoff, Director of Risk Management
Candace Nolte, Controller
Kristin Qualls, Director of Equities
Anthony Mills, TMRS Regional Manager
Chris Jones, Combined Law Enforcement Association of Texas (CLEAT)
Melanie Thomas, Editor
Kate Reed, Investment Risk Analyst
Katie Reissman, Investment Analyst – Fixed Income
Debbie Farahmandi, Investment Operations Specialist
Sherry Chapman, Investment Accountant

The meeting was called to order at 9:00 a.m.
1. **Consider and Act on Adoption of Minutes from the March 28-30, 2012 Regular Meeting of the Board of Trustees**

Mr. Simpson presented this item and asked if there were any changes or questions to the minutes. Mr. Gavia noted one revision to the minutes. On page 1 of the minutes of the March 30, 2012 meeting, the starting time was stated as 3:31 p.m., rather than 2:01 p.m. Mr. Simpson asked the Board if there were any questions or any further revisions to the minutes. As there were none, Mr. Parrish moved that the minutes be adopted as revised. Ms. Oakley seconded the motion, which passed unanimously, 5-0.

2. **Annual Economic Outlook Presentation**

Mr. Gavia introduced Dr. Shilling and reviewed Dr. Shilling’s consulting role with TMRS and highlighted his credentials. Dr. Shilling began his presentation by noting the cumulative debt and equity issuance to GDP for the five financing sectors of the U.S. economy noting the increased leverage in the financial and household sectors and that they are starting a long process of reversing back to the norm. Dr. Shilling anticipates that slow growth will likely continue due in part to U.S. personal savings rate starting a move back to double digit levels. The U.S. has had a very slow recovery from the recession’s end in the second quarter of 2009. The economic slowdown affected central bank rates, driving these rates very low and, with a decline in lending activity, ultimately increasing the reserves held by depository institutions compared to required reserves.

Dr. Shilling stated that at one time, state and local spending was a stable and significant component of GDP. Income and sales tax collections declined on the state level due to the Great Recession, but have recently resumed growth while those of local governments have leveled off. State governments still have budget problems and are under pressure as federal stimulus programs are winding down. Depressed housing valuations have resulted in lower local government property tax revenues. He noted that as a result of shortfalls, municipal governments have been forced to cut back spending resulting in layoffs, decreased salaries, and increased employee and retiree shares of healthcare costs. Underfunded pension plans have caused government employers to consider converting their defined benefit plans to defined contribution plans. Union membership has declined in the private sector to the point that union membership as a percentage of the workforce is significantly higher in the public sector. Employment has not increased significantly following the end of the recession. Dr. Shilling noted that the U.S. is bringing manufacturing back into this country, but it is highly-automated production that requires limited labor. He added that energy-using manufacturers in the U.S. have an advantage over other countries due to lower energy costs. Real household income has been declining since 1998. Profitability is now at an all-time peak, but is not sustainable, as there is limited ability to continue to cut costs and productivity gains are slowing down.

Dr. Shilling reported that the consumer is the key to the economic outlook and that personal spending is still outpacing personal income thereby increasing debt to finance spending growth. However, with the need to increase personal savings, this spending gap should narrow and should send debt levels back to historic norms. Retail sales and used merchandise store sales have been increasing at a fast pace.
It is expected that based on average demand for housing, it will take about 4 years to absorb excess inventory in the housing market. Housing prices are continuing to decline due to excess inventories, although at a slower pace, and prices are now 34% off the peak of the housing boom. Lending standards have tightened up and it is no longer believed that one can’t lose by buying a house. This decline will continue to negatively affect small banks and financial institutions as they see a drop in mortgage loans and increased loan write offs. The Great Recession did not affect apartment rental or medical office construction, as these remain positive investment options as we begin returning towards normal rate of homeownership and aging demographics.

Dr. Shilling reminded the Board that the Euro zone and U.S. suffered similar declines in real GDP during 2008; the U.S. saw GDP restored through 2010 and 2011 while the Eurozone saw a much weaker recovery and continues in a financial crisis due in part to two different cultures under the Euro. According to Dr. Shilling, the Euro zone debt crisis initially came about after several European countries lost control of their finances following the global recession. The North continues to have to support the South. The issues in the Euro zone could cause tremendous chaos and could spill over to global GDP.

Regarding China, Dr. Shilling stated that China’s GDP growth was hit hard by the Great Recession. China experienced double digit growth until the recession when their export-driven economy collapsed. China then embarked on a massive government stimulus program which resulted in double digit inflation and a near top in their housing market. China seems to be heading to a hard landing as Chinese exports are down due to slowed global economies. Given the size of the Chinese economy, one of the big effects is on supply of copper and other commodities if China is not able to support them. Dr. Shilling predicted hard times ahead for China which will result in a slowdown worldwide.

Dr. Shilling noted that the world is working its way out of excess leverage as many other countries continue in recession.

*Mr. Windwehen left the meeting at this point.*

*The Board took a break from 10:00 a.m. to 10:10 a.m.*

3. **Consider and Act on Results of 2011 Actuarial Valuation and Approval of 2013 Retirement Contribution Rates and Supplemental Death Benefit Contribution Rates**

Mr. Gavia introduced Mark Randall and Joe Newton from Gabriel, Roeder, Smith & Company (GRS) and stated that GRS’ presentation will cover the valuation results and proposed 2013 contribution rates for municipalities.

Mr. Gavia provided a historical review of the changes in the actuarial funding method and amortization policies which resulted in increased rates and reduced funded ratios, which resulted in some cities electing to reduce benefits, thereby reducing liabilities. He reported that recent legislative changes have reversed the trend in funded ratios and have caused contribution rates to decline.
Mr. Randall began his presentation on the valuation by highlighting trends in actual to expected experience stating that there has been a 6% increase in the number of retirements; payroll remains flat, and the number of contributing cities has increased. He also reported that the system-wide funded ratio has increased to 85.1% and that system-wide unfunded liabilities declined by over $250 million.

Mr. Newton stated that the results are positive, and long term prospects are good. He began with the summary of system-wide results, noting that the Unfunded Actuarial Accrued Liability (UAAL) actually declined. He continued his presentation explaining the difference between straight average, payroll-weighted average and payroll-weighted average full rate. Overall rates are very stable. This is in light of the Projected Unit Cost (PUC) bias to higher normal cost rates.

Mr. Newton noted that the actual return on the asset side has been 6.95% for the past decade, compared to GRS’ 7% assumption. He noted that utilizing actuarial smoothing is working and is doing what it was supposed to do: smooth out contribution rate volatility to ensure that contribution rates rise and fall gradually--leveling out spikes. Currently, there are about $250 million in deferred gains remaining.

With regard to cash flow, he reviewed how contributions and outflows are merging. At some point in the near future, TMRS should see a negative outflow, but this is expected, and in fact the reason for having a pension trust. He noted that TMRS should be able to manage a 3-4% negative cash flow without immediate concern for liquidity.

Mr. Newton noted that active and retired member counts are relatively flat and a 3% increase in payroll is assumed. If cities’ payrolls do not increase at this pace, contribution rates could increase.

Mr. Newton reported that the system-wide funded ratio has increased four years in a row, and is currently at 85.1%. He noted that the actual funding ratio is not as important as the trend. The funded ratio, assuming all assumptions are met, is projected to increase over time, reaching full funding over the next 25 years. Using stochastic projections over the next 30 years, he noted that TMRS’ funding policy limits potential downside risks. In response to a question from Frank Simpson, Mr. Newton stated that changing to an open amortization policy from our current closed amortization policy is not appropriate at the current time, but may be appropriate later.

Mr. Newton then summarized the contribution rate changes noting that the vast majority of cities’ rate changes varied less than 0.50% plus or minus from last year. He then reviewed aggregate reconciliations for groups without repeating COLAs. The “lag” due to fund restructuring was more pronounced than it should be going forward. He also reviewed the groups with repeating COLAs and the phase-in minimum rates in the aggregate. In GRS’ projections to 2012, the UAAL should remain stable, and the funded ratio should rise.

With regard to demographic assumptions, Mr. Newton reported that salary increases and COLA increases were less than expected resulting in a liability gain. Due to the increased average age of participants, current service costs have increased.
Mr. Newton briefly reviewed the Summary of Benefit changes and then discussed the demographic experience highlighting the low turnover rate and reduced number of people retiring when eligible.

In conclusion, Mr. Randall stated that the system-wide funded ratio continues to increase, with most cities paying their full rate beginning in 2012. The expectation is for increasing funded ratios and stable rates.

Ms. Oakley moved that the Board accept the December 31, 2011 actuarial valuation prepared by its consulting actuary and certify contribution rates and Supplemental Death Benefit rates for municipalities for 2013. Mr. Parrish seconded the motion; which passed unanimously, 5-0.

4. Educational Session: Investment Risk Reporting
Mr. Gavia introduced Mr. Shishkoff, Director of Risk Management for TMRS. Ms. Goerdel commented that the risk reporting system TMRS utilizes, and that Mr. Shishkoff’s presentation covers, is robust and will be an asset to the System.

Mr. Shishkoff reviewed the agenda for the presentation, and began an analysis of investment risk reporting and what it should achieve. He pointed out the key questions that risk reporting should answer for the Board, indicating that these can be summarized in methodology, compliance and exposure.

He delivered a brief review of TMRS’ risk policies. He stated that the Investment Policy Statement (IPS) sets forth the Board’s investment objectives and tolerance for investment risk, establishes the time horizons and risk measures, and the Strategic Target Allocation (STA) which reflects the Board’s risk tolerance. The investment risk management tools, defined in the IPS, are the investment guidelines and risk and compliance reporting.

Mr. Shishkoff then discussed capital market and portfolio risk measurement. In a diversified portfolio, virtually all risk is due to capital market risk factors. He added that, in a diversified portfolio, very little risk is due to risk specific or unique to a single security. He explained how TMRS’ system models investment risk beginning at the individual security level. He then explained the process for building a one year estimate of capital market risk. Ms. Goerdel added that as TMRS moves to its benchmark target allocations, the portfolio’s risk will approach that of the benchmark; noting that the key in any investment is to understand the risk and to be paid for the risk taken.

Mr. Simpson asked what the acceptable level of risk is in a diversified portfolio. Ms. Goerdel responded that the level of risk tolerance has been defined by the Board’s strategic asset allocation and that although a well-diversified portfolio should not be subject to great surprises, excess risk can creep into the portfolio but will be recognized through regular monitoring, allowing staff to evaluate and respond to it. Mr. Shishkoff stated that there should be no surprises in this report, as the guideline compliance and risk exposures are reviewed regularly and corrective action is taken immediately if it is necessary.
5. **Investment Update**
Mr. Gavia introduced Nancy Goerdel and Marcia Beard, R. V. Kuhns, to provide the Investment update. Ms. Goerdel and Ms. Beard presented a snapshot investment report. As of the end of March, the total fund composite was 5.36%, 0.11 ahead of the asset allocation benchmark's return of 5.25%. The public market managers are at, or beating, their benchmark expectations. According to Ms. Beard, 2012 has been positive for performance year to date.

6. **Call For Future Agenda Items**
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 12:10 p.m.

David Gavia
Executive Director

Frank Simpson
Chair, Board of Trustees