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

February 20, 2009

On February 20, 2009, the Board of Trustees of the Texas Municipal Retirement System (TMRS) convened for a special meeting at 8:37 a.m. at TMRS Headquarters, located at 1200 North IH 35 in Austin, Texas, with the following members present:

Board of Trustees
Carolyn Linér, Chair
Ben Gorzell, Jr., Vice Chair
Pat Hernandez
April Nixon
H. Frank Simpson

Mr. Roel ("Roy") Rodriguez arrived at the meeting at 9:37 a.m.

Present also were:
Eric Henry, Executive Director and CIO
Ian Allan, Director of Internal Audit
Rhonda Covarrubias, Director of Finance
Eric Davis, Deputy Executive Director
Bernie Eldridge, Director of Human Resources
David Gavia, General Counsel
Nancy Goerdel, Director of Public Investments and Asset Allocation
Leslee Hardy, Staff Actuary
Holly Macki, Director of Fixed Income
Michelle Mellon-Werch, Associate General Counsel
Cindy Morse, Executive Assistant
Debbie Munoz, Director of Member Services
Eddie Solis, Director of Government Relations
Bill Wallace, Director of Communications
Scott Willrich, Director of Information Resources
Ron Lewis, Ron Lewis & Associates
Susan Warren, KPMG
Sandra Traub, KPMG
Joe Newton, Gabriel, Roeder, Smith and Company
Mark Randall, Gabriel, Roeder, Smith and Company
Russ Kuhns, R. V. Kuhns & Associates, Inc.
Dan Krivinskas, R. V. Kuhns & Associates, Inc.
Jonathan Kowolick, R. V. Kuhns & Associates, Inc.
Todd Shupp, R. V. Kuhns & Associates, Inc.

Guests:
David Crow, President, Arlington Professional Fire Fighters
Darlene Lanham, TMPA
Jim Moore, Assistant Fire Chief, City of Mesquite
Bob Scott, Director of Finance, City of Carrollton

Colin Davidson, TMRS Travel Team
Shannon Lucero, TMRS Travel Team
Maryann Malave-Jaini, TMRS Travel Team
Anthony Mills, Regional Manager – City Services
Lorraine Moreno, TMRS Travel Team
Candace Nolte, Controller
Kate Reed, Investment Analyst

The meeting was called to order by Ms. Linér at 8:37 a.m., and Ms. Hernandez gave the invocation.

1. Executive Session

At 8:37 a.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 9:20 a.m. All members of the Board who had been present when the Board went into Executive Session were again present.

2. Consider and Act on Adoption of Minutes from the December 2008 Regular Meeting of the Board of Trustees

Mr. Henry introduced this item and pointed out that one late change to the Minutes being presented to the Board for adoption was made in order to clarify that two (2) votes occurred regarding adoption of the 2009 budget. A revised page was presented to the Board for their consideration. Mr. Simpson moved that the Minutes be adopted, as revised to reflect the two votes on the 2009 budget. Mr. Gorzell seconded the motion, which passed unanimously.

3. Discussion of 2008 External Audit

Ms. Warren, with KPMG, walked the Board through their responsibilities under Generally Accepted Auditing Standards and presented an overview of the scope of the audit. The Board asked whether the auditor provides a statement on the sufficiency of the System's internal controls. Ms. Warren responded that there is not a standard that permits KPMG to make such a statement. She said that such an action would have to be considered as a separate engagement.

Ms. Warren reintroduced the members of the audit team. She next discussed "materiality" as it relates to an audit. She outlined KPMG's audit methodology and timeline and summarized the audit process for TMRS. Next, she outlined general areas of the audit and accounting matters that could have a material impact on TMRS. Ms. Warren then posed several questions to the Board. Mr. Henry asked that Mr. Allan be added to the TMRS Audit Contacts. Ms. Warren mentioned that at the conclusion of the audit KPMG will come back and make a presentation at the June Board meeting.

Mr. Gorzell asked if this was a normal timeline for a public retirement and Ms. Warren answered in the affirmative.

4. Consider and Act on Ad Hoc Updated Service Credit and Annuity Increase Amortization Policy

Mr. Randall began discussing this issue by citing the Actuarial Standard of Practice (ASOP) that provides that these benefits should be financed as a stand-alone arrangement and that sufficient contributions should be received before benefits are paid out. Mr. Randall graphically explained these points as they relate to TMRS' current policy versus GRS' recommendation. Mr. Randall explained GRS' recommendation of using a 15-year, level dollar arrangement. Mr. Randall next showed the impact that this recommendation would have on several sample cities. Discussion ensued at this point about one-time ad hoc adoptions versus regular ad-hoc adoptions, the 15 versus 20 year level dollar period, and funding impact.

In order to allow the Board to fully assess the impact of legislation passed during the legislative session and its impact on TMRS, Ms. Nixon moved that the ad-hoc benefit adoption recommendation be tabled until the summer. Ms. Hernandez seconded the motion, which passed with Mr. Rodriguez opposing.

5. Consider and Act on Closed Plan Amortization Policy

Mr. Randall discussed GRS' recommendation regarding closed plans. He discussed the Actuarial Standard of Practice and GASB requirements regarding closed plans. He graphically showed the amortization payouts between level dollar and level percent of pay. Based on the pattern of payments and expectations of when benefits become due, GRS recommended that a closed 20-year period be established as the standard maximum amortization period, with the actuary having discretion to lower that period, if necessary. Mr. Randall showed the impact of this policy under various periods and methods.

GRS recommended: (a) level dollar amortization; (b) standard 20-year closed amortization period, unless the actuary, with approval by the Board, discerns a shorter period is necessary; cities can request a longer period in writing, subject to Board approval; (c) elimination of phase-in contribution rate schedule; (d) new rate becomes effective on the same date that plan is closed; (e) removal of statutory maximum; and (f) more stringent funding requirements for benefit enhancements granted after the plan closing.

Mr. Rodriguez moved that the closed plan amortization policy be tabled until the summer. Mr. Simpson seconded the motion, which passed unanimously.

6. Discussion of Rate Expectations for 2010 and Beyond

Mr. Randall presented this as a prelude to the actuarial valuation presentation. He explained that there are three major influences on the rate expectations for 2010 and beyond. The first issue is the lag time involved and he explained that the lag time is the time between when the rates are calculated and when they are implemented. This one year period between the valuation and when the rates are implemented can cause a drag on funding. He indicated that this lag is typically not significant; however, because of the actuarial funding method change, it is exacerbated in this valuation. Mr. Randall stated that the second influence is the difference in the interest credit assumption and the actual interest credit granted to cities. The third influence is the recent actuarial assumption changes.

Mr. Randall then discussed the impact of the lag on the valuation process; he explained how this is a function of timing between the valuation and rate implementation. He discussed the interest credit impact and the actuarial assumption changes.

Mr. Newton then introduced six groupings of cities that were used to illustrate the impact on the valuation of the above mentioned changes. He walked the Board through these six groups and explained how these changes will affect rates. Mr. Newton then discussed what could be expected in the December 31, 2009 valuation producing the 2011 rates. He emphasized the point that the issue of the lag will be greatly diminished at that point because we will be past the change from Unit Credit (UC) to Projected Unit Credit (PUC). Mr. Newton then moved to longer term expectations, and where rates should trend over the long term.

7. <u>Legislative Update and Overview of 81st Legislative Session, including Discussion on Status of TMRS Legislation (House Bill 360), Interim Committee Reports, Proposed Legislation and Federal Legislation</u>

This item was taken out of order. Mr. Solis and Mr. Lewis discussed the current legislative session. Mr. Solis pointed out that the TMRS bill has been filed by Representative Kuempel (HB360) and Senator Williams (SB908), and that the intent is to keep this bill clean. He reported that the Senate interim report did not include any items regarding TMRS. The House interim report recommended passing the TMRS bill and adding a "return to work" feature for returning to the same city, as long as adding such a provision does not have any negative tax qualification issues.

Mr. Solis then discussed other bills relating to TMRS that have been filed. First, regarding the "alternate COLA" bill that was filed by Senator Seliger, he indicated TMRS has only provided technical support on that bill. He reported that TMRS has not supported any issues other than the TMRS bill; however, Mr. Solis noted that TMRS' technical support may have been misinterpreted by some as support for the provision. Mr. Solis then briefly discussed draft language regarding Other Post Employment Benefits (OPEB) trust funds. Another bill that has been filed relates to codifying the Advisory Committee into the TMRS Act. This item is very similar to the current Advisory Committee Charter. Mr. Solis indicated that we will continue to monitor this bill.

Mr. Solis discussed committee assignments in the House. Mr. Lewis added that TMRS is lucky to have the same Committee Chair who has worked with us in the past. He indicated that TMRS will have to educate the new Committee members who do not have a Pension Committee background. Mr. Henry stated, and Mr. Simpson agreed, that the Board's position has been to support the TMRS legislation only, and remain neutral on all other proposed provisions and bills.

Mr. Rodriguez asked about a comment in Mr. Solis' report regarding the City of San Antonio's desire to look at possible options regarding closing their TMRS plan. Mr. Solis explained the background of the situation. Mr. Rodriguez also asked about "non-TMRS" members being able to be added to the Group class of members on the TMRS Advisory Committee. Mr. Henry reiterated that it is the consensus of the Board, and the Board members agreed, to support the TMRS bill, and remain neutral on all other issues. Mr. Solis gave a brief Federal update, stating that we did get relief with regard to potential age discrimination issues associated with interest crediting.

8. Consider and Act on Appointments to the Advisory Committee on Retirement Matters

Mr. Henry introduced the Group member nominees and the respective groups that submitted the nominations, which included Scott Kerr (Plano Firefighters Association), Suzanne Levan (City of San Antonio), Mike Staff (Corpus Christi Police Officers Association) and Monty Wynn (Texas Municipal League). Mr. Simpson moved that these four Group member nominees be approved. Mr. Gorzell seconded the motion, which passed with Mr. Rodriguez absent from the vote.

9. Consider and Act on Ennis Knupp's Contract Renewal

Mr. Henry gave a brief history of this contract and pointed out that this contract includes two educational sessions that the Board may attend, along with one client conference. Mr. Rodriguez moved that the contract with Ennis Knupp be renewed as presented. Ms. Nixon seconded the motion, which passed unanimously.

10. Year-End Investment Performance Report and Securities Lending Program Review

Mr. Kuhns gave an overview of the System's performance. Mr. Kuhns stated that the median public fund with assets over one billion dollars, had an annual return of -27% and reported that TMRS has held its value. He indicated that while the System's performance over the last ten years has been spectacular, the System must diversify, because we will not see these same market conditions in the next ten years.

Mr. Kowolick then began his review of the securities lending program. The discussion began with a definition of securities lending and the reasons why a plan participates in securities lending. Mr. Kowolick graphically explained the securities lending process and outlined what needs to be monitored in the process. He indicated that both of the lending agents, State Street and Northern Trust, were evaluated and he reviewed several of the monitoring factors for each firm. Mr. Kowolick concluded his presentation by stating that securities lending is adding value and the program is being prudently managed, although it is not without risk.

11. Educational Session: Real Estate as an Asset Class

Mr. Krivinskas presented this educational session. He defined the different commercial Real Estate Sectors and the cyclicality of these sectors and mentioned there are also non-traditional commercial sectors including senior housing, health care and infrastructure. He discussed the two mechanisms for investing in private real estate investments: open-ended funds and closed-ended funds. He stated that real estate produces returns through both income and appreciation and he went on to discuss the two types of real estate investments; equity interest (REITs) and debt interest (mortgages or commercial mortgage-backed securities).

Mr. Krivinskas next discussed three investment strategies (core, value-added and opportunistic), defining each one and pointing out their strengths, weaknesses and potential risks compared to returns. He discussed several reasons to invest in real estate, including as an inflationary hedge, for increased liquidity and liability matching. He also discussed ways to invest in private real estate, as well as public real estate investments and Real Estate Investment Trusts (REITs). The keys to an effective Real Estate investment strategy were discussed. He said that the key thing to remember is that if you can generate income from a real estate investment, you will be better off in the long run. Issues to consider, including calculation issues, liquidity, the valuation process and higher fees than traditional asset classes, were discussed. Leverage risks as well as strategy risks were also discussed. Mr. Krivinskas stressed that real estate is an illiquid asset class rather than a short-term trading vehicle.

12. Educational Session: High Yield as an Asset Class

Mr. Kuhns introduced Mr. Shupp to present this educational session, and mentioned that Mr. Shupp specializes in below investment grade bonds. Mr. Shupp began his presentation by defining "high yield" or below investment grade rated securities. He indicated that the goal of adding high yield is to add diversification with non-correlated assets. He said that high yield has a slightly higher correlation to small cap stocks. Mr. Henry pointed out that the lower the correlation, the more benefit on risk diversification.

Mr. Shupp discussed the role of these securities with regard to yield. He then spent some time discussing the risk and volatility associated with this class, explaining default risk by saying that the higher the default risk, the higher the spread over Treasuries. He said in a conservative high yield portfolio, it is unlikely to see an actual default. He then discussed the approaches to adding high yield: core plus versus a dedicated high yield mandate. With core plus, he said that the percentage of high yield within a core portfolio is lessened. A mandate is a strategic move into this asset class. Mr. Shupp indicated that high yield performance is cyclical, but it can provide enhanced returns due to higher risks, lower correlation with other asset classes, current opportunity, and it aligns well with staff and resources. Mr. Shupp indicated that the key is finding the right fit.

13. Report from Internal Auditor: Fixed Income Review and Finance Department risk Assessment

Mr. Allan presented a summary of issues and analyses related to Duration Reduction and Portfolio Diversification. Mr. Allan went through the Executive Summary, concluding that the Duration Reduction project was successfully implemented. Mr. Allan also concluded that TMRS has traded one set of risks for another, but said TMRS is well-suited to manage the new risks. The second item that was discussed was the completion of the risk assessment of the Finance Department. He indicated that the gaps which were identified were primarily related to policies and procedures related to procurement and accounts receivable, and creation of a finance risk management policy with emphasis on quality.

14. Call for Future Agenda Items

Ms. Linér announced a call for future agenda items. As there were none, Mr. Gorzell moved that the meeting be adjourned. Ms. Nixon seconded the motion, which passed unanimously and the meeting was adjourned at 2:55 p.m.

Eric Henry
Executive Director and CIO

Carolyn Linér, Chair
TMRS Board of Trustees