

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

**February 19, 2010**

On February 19, 2010, 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:

**Board of Trustees**

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

Absent: Roel (“Roy”) Rodriguez

Present also were:

David Gavia, Acting Executive Director  
Ian Allan, Director of Internal Audit  
Rhonda Covarrubias, Director of Finance  
Eric Davis, Deputy Executive Director  
Nancy Goerdel, Acting CIO/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  
Robert Klausner, Klausner & Kaufman  
Mark Randall, Gabriel, Roeder, Smith and Company  
Ryan Cunningham, R. V. Kuhns & Associates, Inc.  
Marcia Beard, R. V. Kuhns & Associates, Inc.  
Russ Kuhns, R. V. Kuhns & Associates, Inc.  
Peter Madsen, R. V. Kuhns & Associates, Inc.

Guests:

David Crow, President, Arlington Professional Fire Fighters  
Debbie Farahmandi, Investment Operations Specialist  
Rick Fulford, PIMCO  
Scott Kerr, Texas State Association of Fire Fighters  
Darlene Lanham, Texas Municipal Police Association  
Randle Meadows, City of Arlington Police Department  
Anthony Mills, Regional Manager, City Services

Jim Moore, City of Mesquite Fire Fighters  
Lorraine Moreno, Regional Manager, City Services  
Joseph Narens, PIMCO  
Candace Nolte, Comptroller  
Jim Parrish, Texas Municipal Human Resources Association  
Mike Perez, Texas City Managers Association  
Kristin Qualls, Assistant Investment Officer  
Katie Reissman, Investment Analyst - Fixed Income  
David Rodriguez, Regional Manager, City Services  
Bob Scott, Director of Finance, City of Carrollton  
Kathy Shields, Farmers Branch  
Susan Smith, TML/IEBP  
Sean Thompson, Regional Representative, City Services  
Greg Vick, Texas City Managers Association

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

1. **Executive Session**

At 8:39 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 9:38 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 Consent Agenda**

Mr. Gorzell presented the Consent Agenda, including the Minutes from the December 4, 2009, January 15, 2010 and January 28-29, 2010 Board meetings. There was no discussion or revisions to the Minutes. Ms. Linér moved that the Minutes be adopted as presented. Ms. Hernandez seconded the motion, which passed unanimously.

3. **Consider and Act on 2009 Interest Credit Allocation to the Municipality Accumulation Fund and Interest Reserve Account**

Mr. Gavia discussed how in past years interest had been credited based on realized income, the statutorily required interest credits to accounts, additional income that could be and was credited to Employee Saving Fund (ESF) and Municipality Accumulation Fund (MAF) accounts and distributive benefit payments. He then discussed the changes made by HB 360; the "hard floor" interest to be credited to the ESF and Current Service Annuity Reserve Fund (CSARF) and the change from realized income to total return calculated in accordance with generally accepted accounting principles (GAAP). And he stated that the estimated investment income that could be used for the MAF was \$1.019 billion.

Mr. Randall began his presentation by discussing that one of the things GRS wanted to help establish was contribution rate stability by use of reserves. The reserves will deal with the volatility created by the fund structure. Mr. Randall also discussed the asset smoothing policy recently adopted by the Board. He stated that because of the 10-year smoothing policy, the

investment return the System experienced last year would not be fully recognized with regard to potential contribution rate reduction if all of the excess net investment income was allocated to the MAF. Actually, only 10% of the excess income would be recognized under the smoothing policy. But the 2009 investment return would allow the actuarially assumed rate of 7.5% to be credited to the MAF and the interest reserve could grow to approximately 4% of the fund.

Mr. Randall showed several charts dealing with the target crediting rate. He pointed out that approximately \$660 million could be reserved to protect against future adverse investment experience. This puts the System in a good position for next year. He indicated that if the System earns approximately 5.8%, the reserves would not need to be touched in order to credit the expected rates. Mr. Randall stated that the recommendation of both GRS and the TMRS staff is to follow the guidelines previously adopted by the Board and to credit 7.5% interest to the MAF with the remainder of the net investment income to be credited to reserves. If the Board did elect to credit more than 7.5% interest to the MAF, the rate reduction would be minimal, but the System would be losing the ability to protect against future adverse investment experience.

Mr. Randall discussed the stratification of cities within TMRS and stated that the largest group was by far the "Group 6" cities – 2 to 1 matching ratio with repeating cost of living adjustments (COLAs). He next showed projected reconciliation of contribution rates and the effect of contribution lag, phase-in lag, and recognition of the next step in the phase-in.

Ms. Nixon moved that the Board set the 2009 MAF interest crediting rate at 7.50% and that the remaining net investment income be transferred to the Interest Reserve account. Ms. Hernandez seconded the motion, which passed unanimously.

#### 4. **Benefit Payments Audit Report**

Mr. Gavia introduced Mr. Allan to discuss the audit of benefit payments. Mr. Allan stated that the purpose of the audit was to assess the adequacy of controls over benefit payments to determine if benefit payments were issued in accordance with state and federal laws, and to assess the accuracy of benefit payment calculations. He stated that the key take-away from the audit should be that the controls over issuance of benefit payments are strong. He reported that testing revealed few exceptions. Payments were substantially in compliance with applicable state and federal law. There were no member eligibility issues and applications for benefits were timely processed and all benefit calculations were accurate.

Mr. Allan then paraphrased the recommendations made in the report, item by item, and discussed the rationale, based on the findings, for the recommendations. The report includes the department's response to these recommendations. He reiterated that the controls were strong and that the recommendations were peripheral in nature. Mr. Allan pointed out that the next step is a 60-day action plan, then a 6 month action update.

Mr. Simpson moved that the Board accept the Benefit Payments Audit Report. Ms. Linér seconded the motion, which passed unanimously.

5. **Consider and Act on Revisions to Investment Policy Statement**

Ms. Goerdel presented the revisions to the Investment Policy and walked the Board through the summary of revisions. She stated that these revisions had been presented to the Board in December 2009. She highlighted the revisions that expand authority under the Policy, as well as the areas where policy revisions restricted authority. Ms. Goerdel explained that there were no changes from the recommendations made in December.

Mr. Simpson asked about separation of the Executive Director and Chief Investment Officer positions.

Mr. Simpson moved that the Board adopt changes to the Investment Policy to be effective March 1, 2010, with conforming changes to paragraph C on page 3 of the policy to reflect the separation of the Executive Director and Chief Investment Officer positions (striking the language before “Chief Investment Officer,” or as staff deems necessary to meet this intent). Ms. Nixon seconded the motion, which passed unanimously.

6. **Investment Program: 2009 Review/2010 Next Steps and Discussion**

Mr. Madsen began by introducing Russ Kuhns, who announced that he will be retiring on June 30, 2010, and that the firm had previously undergone an organizational change naming Becky Gratzinger as Chief Executive Officer of R. V. Kuhns.

Mr. Madsen began the 2009 review by highlighting the accomplishments TMRS staff has made: total return orientation, Investment Policy revision, asset allocation study, portfolio diversification, and risk vendor search – highlighting the achievements under each category. He next discussed the fixed income asset class: Blackrock’s core fixed income mandate and PIMCO’s core plus mandate. He reported that the interest rate risk of the fixed income portfolio has been reduced significantly as evidenced by the duration having been reduced from approximately 14 to 4. Regarding equities, Mr. Madsen indicated that progress has been made in methodically increasing exposure to passively managed equities.

Looking forward, Mr. Madsen said we will maintain the current structure for fixed income for 2010. Core fixed income will continue to be used to fund investment in other asset classes. Regarding equities, a conversion to a new international index was discussed. Mr. Cunningham discussed how the ACW ex US IMI index differs from the MSCI EAFE, highlighting the added diversification through expansion of both capitalization across the index and the expansion of countries represented in the index. They showed that the ACW ex US IMI index has higher volatility while also carrying a premium on returns over time, such that the “Sharpe Ratio” shows a more favorable unit of return per unit of risk under the ACW ex US IMI index. The ACW ex US IMI maintains the same correlation with regard to U.S. equities as does the MSCI EAFE, so it is not giving up any diversification benefits.

Although the ACW ex US IMI does potentially enhance returns, it does introduce an incremental increase in risk. This is something that was considered originally, when international equities were added to the portfolio. This recommendation will be coming to the Board for action later in the year.

Mr. Madsen then gave an overview of the Real Return asset class which is primarily inflation-linked bonds. The two approaches are investment in U.S. TIPS and Global linked bonds which are almost always sovereign issued debt. One third of the global linked bond market is U.S. TIPS and approximately 25% is UK. The principal of a bond is adjusted for inflation and paid at maturity. The coupon rate is fixed and the payment is variable due to inflation adjustments to principal. These bonds are of slightly longer duration so they are slightly more volatile due to interest rate risk. Mr. Madsen stated that this is a compelling opportunity both from risk/return and diversification perspectives, while also hedging against inflation. This is a fairly new asset class and there are not a tremendous number of managers with sufficient experience and track records.

In summary, RVK finds that the advantages of inflation-linked bonds are diversification, attractive risk/return properties and inflation orientation. Disadvantages are relatively less liquidity than bonds without an inflation adjustment and limited selection by duration and issuer. RVK's recommendation is to consider an actively managed global mandate.

7. **Investment Program: 2009 Performance Review**

Mr. Madsen introduced the December full quarterly report. Although 2009 was a good year for investments, it was moderated by the System's allocation to equities compared to our peers. Mr. Cunningham highlighted the quarterly and annual returns. He pointed out the comparative performance, both on the whole and by sector. The risk/return statistics over 5 year and 7 year periods were also reviewed.

Mr. Cunningham then moved to the January 31, 2010, performance analysis. He showed the portfolio characteristics for both domestic and international equities. He likewise showed portfolio characteristics for the fixed income managers.

8. **Educational Session: Use of Derivatives with the Core Plus Mandate**

Mr. Gavia began with a background discussion on potential staff recommendations regarding the use of derivatives within the Core Plus mandate. He indicated that both legal counsel and staff have determined that "Treasury futures" can be used within TMRS' mandate as well as "currency forwards" for managing currency risk. Rick Fulford and Joseph Narens made the presentation for PIMCO. Mr. Narens stated that derivatives have both positive and negative perceptions of risk. PIMCO explained that derivatives are instruments that derive their value from another instrument. PIMCO's focus will be on Treasury futures and currency forwards. Bond ownership is compensated for assuming certain risks including interest rate risk, volatility risk, credit risk, liquidity risk, and currency risk. He indicated that one reason for using derivatives as a substitute for bonds is that you can get the same exposure with more liquidity. Mr. Fulford defined futures contracts and pointed out that these are exchange traded instruments that carry no counter-party risk. He indicated that the futures market has grown since 2001 and he said there are now many types of futures available. Mr. Fulford said that the three reasons for use are: (1) substitution (bringing the cheapest asset to gain exposure); (2) hedging; and (3) managing duration. Mr. Fulford then went through examples of the use of these instruments in relation to the three reasons listed above.

Mr. Fulford then discussed the definitions of accounting leverage and economic leverage and stressed the importance of correctly defining leverage and controlling appropriate risk. He then briefly discussed currency forwards, saying that the currency market is the largest in the world. The types of transactions include: (1) spot transaction (like converting cash at the airport); and (2) forward transactions and futures. He stated that currency is much more volatile than interest rates so it is appropriate to hedge this away. In summary, he stated that it makes sense to buy the most appropriate vehicle that will meet the System's needs. The goal is to achieve an appropriate balance of risk and returns regardless of the instrument employed.

9. **Call For Future Agenda Items**

As there was no further business, the meeting adjourned at 1:00 p.m.



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David Gavia  
Executive Director



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Ben Gorzell, Chair  
TMRS Board of Trustees