MINUTES OF THE
TEXAS MUNICIPAL RETIREMENT SYSTEM
Joint Meeting of the Board of Trustees and the
Advisory Committee on Retirement Matters

May 15, 2014 – 2:00 p.m.
May 16, 2014 – 8:30 a.m.

On May 15, 2014 the Board of Trustees of the Texas Municipal Retirement System (TMRS) and the Advisory Committee on Retirement Matters convened for a joint meeting at 2:00 p.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
Jule Oakley, Vice Chair
Jim Parrish
Bill Philibert
David Landis
Jim Jeffers

Advisory Committee Members
Joe Angelo, City of San Antonio
David Crow, Arlington Professional Fire Fighters Association
Scott Kerr, Texas State Association of Fire Fighters
Greg Shipley, Combined Law Enforcement Associations of Texas
Dean Frigo, Retiree
Victor Hernandez, City Councilmember, City of Lubbock
Jerry Gonzales, Service Employees International Union
Tadd Phillips, Texas Municipal Human Resources Association
Mitch Landry, alternate Texas Municipal Police Association
Greg Vick, alternate, Texas City Management Association
Bob Scott, Government Finance Officers Association of Texas
Michael Dane, City of San Angelo
Monty Wynn, Texas Municipal League
Allen Bogard, City of Sugar Land
Ron Crabtree, Retiree
Bryan Langley, City of Denton
Charles Windwehen, Retiree

Present also were:
David Gavia, Executive Director
Ian Allan, Director of Internal Audit
Rhonda Covarrubias, Director of Finance
Eric Davis, Deputy Executive Director
Kristie O'Hara, Director of Human Resources
TJ Carlson, Chief Investment Officer

Leslee Hardy, Director of Actuarial Services
Debbie Munoz, Director of Member Services
Christine Sweeney, General Counsel
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
Jesse Pittman, Project Manager
Karen Jackson, Executive Assistant
Robert Klausner, Klausner, Kaufman, Jensen & Levinson
Marcia Beard, RVK
Amy Hsiang, RVK
Ed Schultz, ORG
Nancy Williams, Hewitt EnnisKnupp
Amy McDuffee, Hewitt EnnisKnupp
Mark Randall, Gabriel, Roeder, Smith & Company
Joe Newton, Gabriel, Roeder, Smith & Company
Brad Stewart, Gabriel, Roeder, Smith & Company

Also in attendance:

Sherry Chapman, Investment Accountant
Debbie Farahmandi, Investment Operations Specialist
Howell Hollis, Investment Analyst
Peter Jeske, Project Specialist
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
Melissa Jerkins, Quantitative Analyst
Pete Krnavek, Information Systems Manager
David Rodriquez, Regional Manager – City Services
Eddie Schultz, Real Estate Analyst
Chris Jones, Combined Law Enforcement Associations of Texas
George Kauffman, City of Garland
Keith Hopkins, Mesquite Fire Department
Mel Thomas, Editor
Jon Scolnik, Unite Here

Mr. Rodriguez called the meeting to order at 2:01 p.m. and Mr. Landis gave the invocation.

1. **<u>Consider and Act on Adoption of Minutes from the March 20-21, 2014 Meeting of the Board of Trustees.</u>**
Mr. Gavia stated that Staff had nothing to add to the minutes as presented. There were no changes suggested by the Board.

Mr. Parrish made a motion the Board adopt the minutes from the March 20-21, 2014 Meeting of the Board of Trustees. Mr. Jeffers seconded the motion, which passed 6-0.

2. **<u>Consider and Act on Filing Proposed Amendments to TMRS Rule 34 TAC §123.1 to Clarify Actuarial Tables Used to Calculate Service and Disability Retirement Benefits with the Texas Register.</u>**
Mr. Gavia discussed the changes implemented to the mortality tables and Annuity Purchase Rates and the reason this rule should be clarified. Ms. Sweeney indicated by implementing the tables that discussed the 70/30 male/female split, it could have been misconstrued to apply to beneficiaries. The amendment will clarify that, when the new mortality tables go into effect January 1, 2015, the actuarial calculations of benefits for retired members and disabled annuitants will be based on a 70%/30% male/female blend of the mortality tables named in amended Rule §123.1, and the actuarial calculation of benefits for beneficiaries of retired members and for beneficiaries of disabled annuitants will be based on a 30%/70% male/ female blend of the mortality tables.

Ms. Oakley made a motion that the Board authorize the Executive Director (i) to file the proposed amendments to TMRS Rule §123.1 with the *Texas Register* with any permanent adoption of the amended rule to take place at a later Board meeting, and (ii) to make non-substantive changes to the attached proposed rule amendments as necessary or desirable to conform the rule amendments to *Texas Register* requirements. Mr. Philibert seconded the motion, which passed 6-0.

3. **<u>Consider and Act on Modifying the Manner in Which the New Annuity Purchase Rate Factors Used in Determining Retirement and Disability Annuities are to be Implemented Throughout the Calendar Year</u>**
Mr. Gavia reviewed the changes to the Annuity Purchase Rates (APRs) which were put into production on January 1, 2014. Shortly thereafter, an anomaly in the month to month benefit accrual was found with some December and January retirement estimates. In a limited number of cases, the January estimate was less than the December estimate because the benefit accrual from December to January was less than the change in the APR from December to January. Staff reviewed the anomaly with Gabriel, Roeder, Smith and Company (GRS), and GRS recommended an approach to implement the APRs on a monthly basis versus the annual implementation. Using a monthly implementation results in a gradual increase in the monthly benefit accrual and eliminates the December to January anomaly.

Mr. Newton pointed out that this new approach does not change the annual APRs that were adopted by the Board in December 2013. Under this proposed methodology, smaller adjustments in the APRs would be made monthly throughout the calendar year versus one adjustment made annually in January of a given year. The APR for each successive month of a calendar year would reflect an additional $1/12^{th}$ of the change in the December APRs from one year to the next. The monthly implementation of the APRs increases the system-wide Unfunded Actuarial Accrued Liability (UAAL) and decreases the overall savings obtained by adopting the new APRs by approximately $54 million. Mr. Newton discussed the important point here is that no one has been impacted by this anomaly since the factors do not change until 2015.

Ms. Philibert made a motion that the proposed 2015-2074 Monthly APR Factor files be adopted by the Board in accordance with their statutory authority, that these monthly APR factor files replace the annual APR factor file adopted by the Board in December 2013, be reflected in the December 31, 2013 actuarial valuation, and that the monthly APR factors be effective for January 31, 2015 and later retirement dates. Mr. Landis seconded the motion, which passed 6-0.

4. **Consider and Act on Results of 2013 Actuarial Valuation and Approval of 2015 Retirement Contribution Rates and Supplemental Death Benefit Contribution Rates.**
Mr. Newton and Mr. Stewart presented the valuation based on monthly APR implementation. Mr. Newton pointed out that compared to our peers, TMRS has already dealt with issues that most systems will have to deal with in the future.

Mr. Newton reviewed the valuation results as if the mortality and actuarial cost method changes had not been adopted. The results overall were favorable. Investment returns were better than expected and liability growth was less than expected. Demographic experience indicated lower salary increases than expected, COLA increases were less than expected and turnover was greater than expected. Mr. Newton summarized benefit changes adopted by cities.

Mr. Newton reviewed investment performance for the past ten years and showed the market value compared to actuarial value of assets. TMRS has historically had positive cash flows, but the 2013 net cash flow is approximately zero with this valuation. TMRS should see a small percentage of negative cash flow in future years, meaning investments are helping pay for the benefits. The growth of active members and retirees was about as expected. The funded ratio before the changes was 89.1%. The market value of assets is higher than the actuarial value of assets resulting in a deferred gain of $1.2 billion which will offset future investment underperformance. The historical dollar weighted contribution rates for TMRS are relatively stable, slightly decreasing from last year.

After the actuarial changes were taken into account, the System's funded ratio declined to a still healthy 84.1%. Mr. Newton showed several graphs representing the distribution of contribution rates. He discussed the phase-in authorized by the Board due to mortality table and actuarial cost method changes. 256 cities will have a phase-in due to a contribution rate increase of 0.50% or more. These cities can phase-in at 0.50% per year until the full rate is achieved.

In summary, overall the system's health continues to improve and the expectation is for an increasing funded ratio over the next few valuations. Ms. Oakley stated she is concerned about the negative cash flow projected in the future. Mr. Newton responded that as long as that negative amount remains at a manageable level, the resulting cash flow can be planned for. Mr. Carlson added that as long as diversification continues at a judicious rate, this negative cash flow is manageable.

Mr. Langley asked if there were any changes anticipated in the amortization periods for laddered gains and losses. He also asked about the trend in salary increases being less than expected. Mr. Newton replied that both of these areas will be reviewed in the next experience investigation in 2015.

Mr. Gavia pointed out that one exhibit regarding the Supplemental Death Benefit Trust has been amended to show reporting based on Entry Age Normal as opposed to Projected Unit Credit.

Ms. Oakley made a motion that the Board accept the December 31, 2013 actuarial valuation based on a monthly implementation of the APRs with the change to the exhibit regarding the Supplemental Death Benefit Trust involving the use of EAN instead of PUC and certify contribution rates for municipalities. Mr. Parrish seconded the motion, which passed 6-0.

5. **Consider and Act on Residential Mortgage Backed Securities and Commercial Mortgage Backed Securities (RMBS/CMBS) Manager Recommendation(s).**

Mr. Carlson introduced Amy Hsiang, RVK, and Howell Hollis, TMRS Investment Analyst. Mr. Carlson reviewed the Board's previous actions on this diversification of the non-core fixed income allocation. He discussed the due diligence in the manager search and stated that the recommendation, due to market conditions and portfolio considerations, will be to increase the allocation for the RMBS/CMBS strategy from $550 million to $750 million.

Ms. Hsiang reviewed the manager search process stating that this was similar to the other search processes. 28 managers were selected to receive a Request for Information (RFI) with 23 managers responding and submitting data to RVK. TMRS Investment Staff and RVK reviewed and analyzed each of the 23 submitted responses and they were scored independently. Manager calls were held with the top ten ranking managers and this resulted in reducing the group to seven managers. Due diligence visits were conducted with the seven finalists and each meeting included multiple presentations and interactions. Three managers were selected for Board recommendation. Ms. Hsiang discussed the minimum qualifications for a manager and pointed out that they wanted firms with at least a three-year performance track record investing in RMBS/CMBS. The initial scoring criteria were reviewed and the manager evaluation steps were shown.

Mr. Hollis next reviewed the three finalists, Ellington Management Group, LLC, ING U.S. Investment Management (now Voya Financial) and Marathon Asset Management LP. Ellington has a heavy quantitative and statistical approach to mortgage loan security analysis driven by proprietary interest rate, prepayment and credit models. They are a strong risk manager with compliance systems, policies and procedures in places. Ellington has outstanding risk adjusted returns with the highest Sharpe Ratio of the three finalists. ING U.S. Investment Management has a strong and balanced team approach with deep surveillance of residential and commercial real estate values and trends. They have a clear and dedicated focus on risk management and compliance. Marathon Asset Management LP is one of the largest and most active alternative managers focused on opportunistic investing in global corporate, emerging markets, and structured credit with significant experience and expertise in credit dislocations through multiple cycles. They have a highly sophisticated proprietary credit model and the ability to move quickly should the window of opportunity be short.

Mr. Carlson discussed the risk budget impact. These three managers shorten the duration (interest rate risk) of the overall fixed income portfolio and should add approximately 18 basis points to the total return at the total plan level. The recommendation is to allocate $250 million to each manager. Ms. Oakley asked how the amount per manager was determined. Mr. Carlson explained the process behind the decision and how the fee structure is reviewed and has been negotiated on these managers. The fees are significantly reduced from what the normal fee structure should be. Normally, the fee structure is 2/20 (for 2 of the 3 managers) and it has been negotiated down to approximately a 38 basis point management fee with 13% performance fee, in the aggregate.

Ms. Oakley made a motion the Board approve the following:

- increase the sector allocation limit for the RMBS/CMBS allocation to 40% of the Non-Core Fixed Income asset class; and
- Ellington Management Group, Voya Financial (formerly ING Investment Management), and Marathon Asset Management for the RMBS/CMBS mandate as presented, at fees no greater than proposed, and authorize the Executive Director to decide on the final legal structures (including, without limitation, fund of one limited partnership structures and separately managed account structures) for investment in non-core fixed income structures of the managers or their affiliates and to negotiate and execute contracts satisfactory to the System for such investments.

Mr. Parrish seconded the motion, which passed 6-0.

6. <u>Consider and Act on Appointment(s) to the Advisory Committee on Retirement Matters</u>

Mr. Gavia stated at the time of the agenda there were two vacancies. There was a vacancy for the Texas City Management Association (TCMA) and one for an elected official. Greg Vick was nominated for TCMA with Paulette Harman as the alternate. Regarding the elected position, Julie Masters, Mayor of Dickinson was nominated. Due to Neil Resnik being defeated in his bid for reelection, an additional position will now need to be filled.

Mr. Parrish made a motion to recommend that the Board approve the nomination of Greg Vick to be appointed to a six year term to expire on December 31, 2019 to represent the Texas City Management Association with Paulette Hartman as the alternate. Ms. Masters is nominated for a three year term to expire on December 31, 2017 representing an elected official in the Individual Class. Ms. Oakley seconded the motion, which passed 6-0.

Public Comments

Mr. Rodriguez opened the floor to public comments. John Scolnik from Unite Here made a public statement regarding ORG's recommendation of Walton Street. He also made comments regarding potential conflict of interest issues relating to ORG and a timber manager ORG has previously worked with. Mr. Scolnik outlined his concerns relating to that manager's fees and ORG. In Mr. Scolnik's opinion, relying on ORG's recommendations could subject the Board to potential headline risk, and he recommended that TMRS terminate its contract with ORG.

7. **Executive Session**

At 4:48 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.

The Board returned from Executive Session at 5:34 p.m. All members of the Board who had been present when the Board went into Executive Session were again present. No action was taken in the Executive Session. Mr. Landis made a motion to adjust the Executive Director's salary by 4% effective July 1, 2014. Mr. Philibert seconded the motion, which passed, 6-0.

At 5:37 p.m. the meeting was recessed until 8:30 a.m. on Friday, May 16, 2014.

David Gavia
Executive Director

Roel "Roy" Rodriguez
Chair, Board of Trustees