Public Plan Sponsor of the Year: Texas Municipal Retirement System

Measured against most public funds' investment returns, the Texas Municipal Retirement System (TMRS) had a great year in tumultuous 2008. The fund lost only 1.3%, recalls David Gavia, Acting Executive Director at the Austin-based fund. "Compared to our peers," he says, "it was a phenomenal result." Many public funds dropped in the 20% to 30% range that year.

What was its secret? TMRS had long used an all-fixed-income strategy, which paid off in 2008, but fund officials knew the approach had to change for the fund to succeed in the long run. "We were the top-performing public fund in the country in 2008. We got lucky in 2008, is what happened," says Eric Henry, the TMRS Executive Director at the time, who left in August 2009. "For the long run, we still needed to diversify." While a valid investing approach, a long-duration fixed-income strategy is also an expensive strategy, he says. "With 5% expected returns, we were looking at employer contribution rates more than doubling immediately. It just was not sustainable."

So, despite results at the time that made the investing strategy look enlightened, at least in the short run, in May 2009, TMRS officials convinced the state legislature to pass HB 360. The legislation allowed it to diversify investments, because it changed the rules for crediting and charging the fund's investment gains and losses. That allowed the plan—which, at year-end 2009, had $15.9 billion in assets, with 139,488 contributing member accounts and 34,123 retired members—to move into equity at an ideal time. "We emerged in 2009 buying at bargain-basement prices," Gavia says.

In 2007, the TMRS board also had changed its actuarial method for recording the cost of benefits. "They are making a more-complete recognition of the true cost of the benefits, and allocating the cost of those benefits more evenly among taxpayers who are receiving the services," says Keith Brainard, Austin-based Research Director at the National Association of State Retirement Administrators (NASRA). "The board and the leadership recognized that the circumstances had changed, and they embraced the changes that needed to be made accordingly."

The investment strategy made sense when TMRS launched in 1948 as a pioneering public cash balance plan. "A bond portfolio fit nicely with that plan design," Brainard says. "The accrual of benefits was steady and predictable, so they could purchase a fixed-income security to match the accrual of benefits."

The plan design began to resemble a final-average-pay setup more starting in the 1970s, when the plan gave its employer-members the option to switch from determining an employee's benefits based on his or her careerlong average salary to an "updated service credit" that bases the calculation on the highest-three salary years. Over the next 20 years, many cities added this plan feature.

Still, the all-fixed-income allocation "worked for a long time," says Henry, now Ann Arbor, Michigan-based Chief Investment Officer at the UAW Retiree Medical Benefits Trust. "Long-term interest rates declined steadily from the early '80s. For a 20-year period, the wind was at their back." Returns typically ran in the high single digits, he says, and the fund had a 7% assumed rate of return. Adds Gavia, "We were able to credit double-digit returns to our members for many years."

Employer-members withhold 5%, 6%, or 7% of an employee's pay, then submit it to TMRS to manage. All employers do a match at a rate they choose, either 1:1, 1.5:1, or 2:1. Most of Texas' larger cities choose to match at 2:1.

Then, in 2006, the TMRS board hired consultant Ennis, Knupp & Associates, Inc., to do an investment review. The resulting message: "Because rates for fixed income were coming back to where they would normally be, that investment strategy would no longer deliver exceptional returns," Gavia says.

"Everyone had convinced themselves that a fixed-income strategy was risk-free," Henry says, and TMRS had "bet the farm" on long-term rates staying low. "The total duration on the fixed-income portfolio was 15 years, so, for every one percentage point move up in long-term rates, that portfolio would have lost 15% of its value."

Legislation had passed several years earlier that allowed the fund to invest in all types of securities, Gavia says, but to see the benefits of diversifying further, the TMRS law had to change more. The fund required the ability to shift from just recognizing realized gains (income return) in calculating the annual credit to employers and participants, to also recognizing unrealized gains on securities still held—known as a total return strategy.

TMRS needed to convince state legislators to permit the change at a volatile time, when it looked as if the prevailing investment approach worked very well. That meant stressing the long-term argument.

Among its benefits, going toward a diversified portfolio "allowed us a higher annual rate of return, which would translate into a little rate relief for cities," says Eddie Solis, TMRS Government Relations Director. In tough economic times, that had clear appeal. "If we stayed with fixed income, we would have to go to a 5% rate of return. If we began diversifying and maintained a steady migration, a 7% annual rate of return was very acceptable. The course we were taking was not going to fill our bucket the way it had been."

After the legislation passed, in July 2009, TMRS began using dollar-cost-averaging to shift fixed-income money into equities. "By dollar-cost-averaging, we get rid of the cyclicality risk," Henry says. To lessen interest-rate vulnerability, he adds, "We also shortened the duration on fixed income, from 15 years to just over four years."

The system had 76.7% of assets in fixed income as of December 31, 2009, with 23% in equities.

In late 2007, the TMRS board also decided to make an actuarial change from a unit credit to a projected unit credit. That means recognizing and pre-funding the future cost of the updated service credit as well as cost-of-living adjustments (COLAs) for those cities that had chosen to adopt those provisions on an annually repeating basis. “Under our old actuarial cost method, we would only recognize the updated service credit a year at a time. Future increases were not pre-funded,” Gavia says.

The change increased employer contributions, which Henry acknowledges was “a controversial move” initially. “We wanted to work with stakeholders, so everybody could walk away with something,” Solis says. “We placed a floor, but no ceiling, on the interest credit to members, and allowed for potential increased credited rates for cities. We went toward a 7.5% ‘soft target’ credited rate to the cities’ accounts because, in the future, they were going to be on the hook for the down years.”

Previously, the system had a “soft target” 5% floor on annual interest credits for employee participants, as well as 5% for the discount rate used in calculating the annuity-purchase rate. Those became hard-target guarantees for participants.

“If we are doing anything better, it is communication and outreach—to the board, to participants, and to employers,” Gavia says. “In the past couple of years, we have done an about-face, and we are providing them with a lot of information. We like to think that we became much more transparent.”

By Judy Ward, editors@plansponsor.com
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