

Investment





April 30, 2008

To: The Participants and Employers of the Texas Municipal Retirement System
and the Readers of the *Comprehensive Annual Financial Report*

The year 2007 was the beginning of a period of transition for the Texas Municipal Retirement System investment program. During 2007, the TMRS Board of Trustees began considering a change in the actuarial cost method used to measure liabilities and determine required contribution rates of employer cities. The Board of Trustees also recognized that, given the current low level of yields following a 20-year bond bull market (i.e. decline in yields), an all fixed income portfolio, as TMRS has had through much of its history, will find it difficult to deliver satisfactory returns going forward. These factors led to consideration of a change in the objectives of the investment program. The goal will be to generate better returns to protect the level of benefits currently provided by supporting higher interest credits to mitigate potentially increasing required contribution rates. Pending legislative authority, this will require a total return focus and a diversified asset allocation policy designed to deliver the desired level of both risk and reward.

Also in 2007, the TMRS Board of Trustees retained its first general investment consultant, R.V. Kuhns & Associates, Inc., to assist the Board in exercising its fiduciary responsibility as it prepares for this change in direction. R.V. Kuhns has been and will continue to conduct educational sessions with the Board, and has assisted the Board through an asset allocation study to begin diversifying the portfolio. As a result, the Board of Trustees approved an initial allocation of 6% to a domestic equity index fund and 6% to an international equity index fund, while the overall portfolio continues to provide the 5% yield objective during this interim period. To achieve the initial target allocations, funds are being invested systematically on a monthly basis throughout 2008 to avoid the risk of market timing. The Board of Trustees also made the decision to begin using the advisory services of an external fixed income manager to assist the board during the potential transition toward a diversified total return approach, as well as manage the interest rate risk attributable to the bond portfolio's long duration.

The objective of the TMRS investment program has been to generate a consistent level of income to support the interest credits required by law. Most accounts currently require a 5% interest credit, while the member and municipality accounts target a minimum 5% credit if the income earned will support it. TMRS has historically achieved this objective through a strategy that focuses on highly rated bonds with long maturities intended to lock in yields exceeding 5%. This focus on income ignores market value fluctuations, which are irrelevant when bonds are held to maturity and are redeemed at their face value. TMRS' income return in 2007 of 5.49% supported the 5% interest credit to all accounts while the long Treasury bond yield averaged 4.8% for the year.

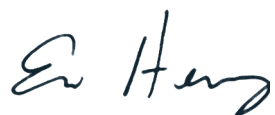
The main issue affecting the markets during 2007 was that of subprime defaults that led to a credit crisis, which made a serious impact on the financial markets. Flight to quality by investors benefited the Treasury market, while the relative value of corporate issues declined. In an effort to help stem the deterioration of the economy, the FOMC lowered rates by 50 basis points from 5.25% to 4.75% in September, another 25 basis points in October to 4.50%, and yet another 25 basis points in December ending the year at 4.25%.

The TMRS portfolio performance for 2007 was calculated by State Street Analytics, a division of State Street Corporation. Rates of return presented were calculated using a time-weighted rate of return methodology based upon market values. Comparisons were made to other pension plans in the State Street Universe (SSU), without regard for the investment objectives of the individual plans in the universe. The State Street Universe is a proprietary comparative universe service developed by State Street Corporation, representing more than \$1 trillion in assets and containing over 5,000 portfolios. Additional comparisons were made to a relevant nationally recognized bond index, the Lehman Government/Credit Long Bond Index (LG/C Long Bond Index).

Given the long-term nature of the TMRS fund objectives, performance for longer periods is most relevant. The performance measurement reveals that the TMRS income rate of return, a measure that is appropriate for the current investment program objectives, remains consistent and was 6.6% over the past ten years. TMRS ranked in the top 1% of SSU's Total Fund income returns whose Median Total Fund return was 2.5% and also exceeded the LG/C Long Bond Index income return of 6.5%. For the past ten years the total rate of return was 7.7%, consistent with the return of the SSU's Median Public Fund, which represents ownership of all classes of security investments. In addition, TMRS exceeded the LG/C Long Bond Index total return of 7.0%. The portfolio's ability to achieve a total rate of return comparable to that of well-diversified public funds is a result of the portfolio's long maturity structure and higher concentration in zero coupon securities in a period of generally declining interest rates. The investment results were achieved within the investment policies established by the TMRS Board of Trustees.

The TMRS investment program continues to be prudently managed and is at an important crossroad. TMRS will be seeking legislation in 2009 during the 81st Regular Session of the Texas Legislature that will, in essence, allow for a total return objective for the investment program. Our goal is to manage the move toward a well-diversified approach in a very deliberate, thoughtful, and cautious manner to the benefit of our active members and employer cities.

Respectfully submitted,



Eric Henry
Executive Director & Chief Investment Officer

Outline of Investment Policies

Investment Objectives

The basic objectives of investment and reinvestment of system assets are:

1. To assure preservation of (and return of) principal.
2. To earn income sufficient to:
 - a) allow annual interest credit on the reserve funds at the statutory rate;
 - b) pay annual administrative costs of the System; and
 - c) allow annual interest credit on the member and municipality accumulation accounts at the statutory rates.
3. To consistently earn additional income, if feasible, to maintain and continue an “interest reserve” to better ensure continued credits at the statutory minimum target rate during low yielding market periods.
4. To maintain sufficient liquidity to pay benefits.

General Investment Policies

1. Funds of the System shall be invested, without distinction as to source, only in securities as that term is defined in the TMRS Act, and as authorized by the TMRS Board of Trustees’ investment policies. Board policy limits on amounts of any security or class of securities shall be observed.
2. Investments shall be made with the degree of judgment and care, under the circumstances then prevailing, that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, considering the probable income from the securities and probable safety of their capital.

Portfolio Management

The Board of Trustees recognizes that the most important determinant of long-term return and volatility is the asset allocation decision. The Board will set long-term asset allocation targets or ranges that will best meet the needs of the System, the plans, and their members. The Board expects to adopt a series of interim asset allocation targets as the System approaches a long-term fully diversified investment portfolio.

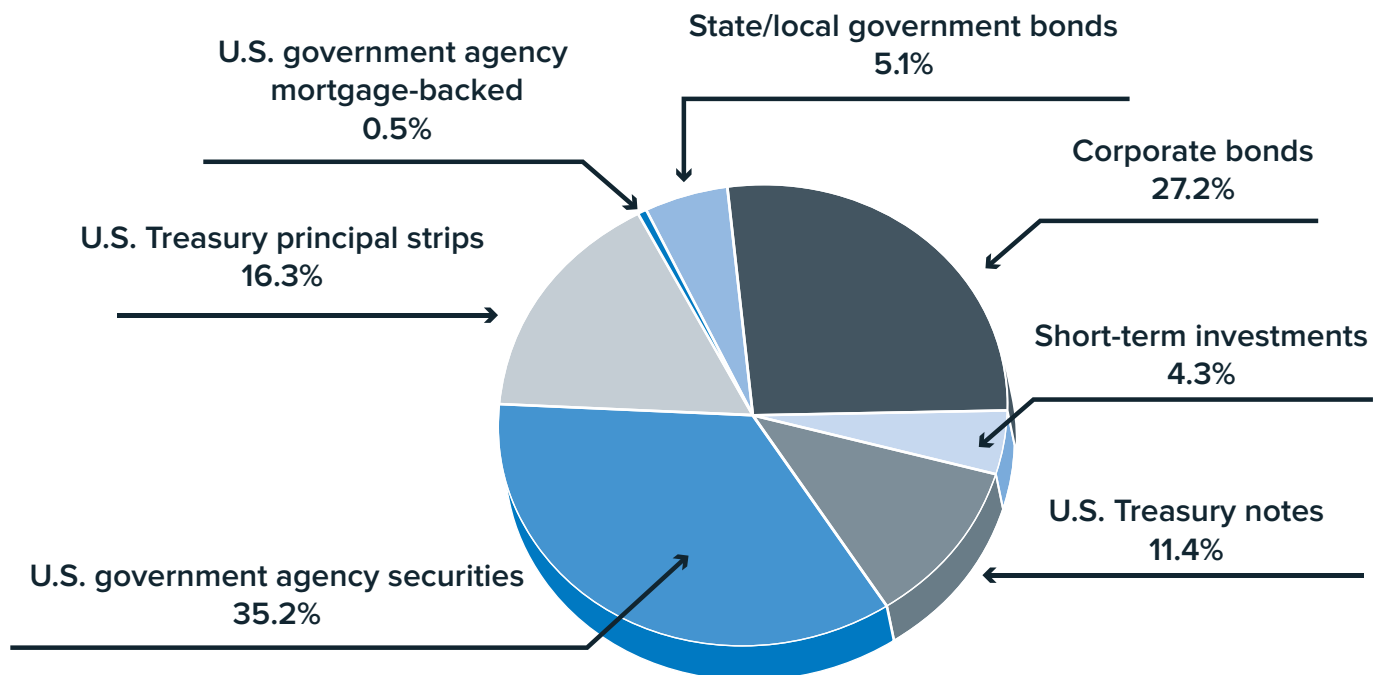
Asset Allocation Table • Interim Targets	
Asset Class	Target %
Domestic Equities	
Passive	6%
International Equities	
Passive-Developed Countries	<u>6%</u>
Total Equities	12%
Fixed Income	
Investment Grade	<u>88%</u>
Total Fixed Income	88%
Unallocated Cash	-
TOTAL	100%

Summary of Investments

As of December 31, 2007		
	Fair Value	Percent of Total Fair Value
Short-term investments	\$ 629,801,737	4.3 %
Fixed income securities		
U.S. Treasury notes	1,652,554,300	11.4
U.S. Treasury principal strips	2,369,852,950	16.3
U.S. government agency securities	5,117,830,787	35.2
U.S. government agency mortgage-backed	79,587,088	0.5
State/local government bonds	734,485,063	5.1
Corporate bonds	<u>3,949,304,339</u>	<u>27.2</u>
Total fixed-income securities	13,903,614,527	95.7
TOTAL INVESTMENTS	\$ 14,533,416,264	100.0 %

Note: The summary above includes assets of both the Pension Trust Fund and Supplemental Death Benefits Fund.

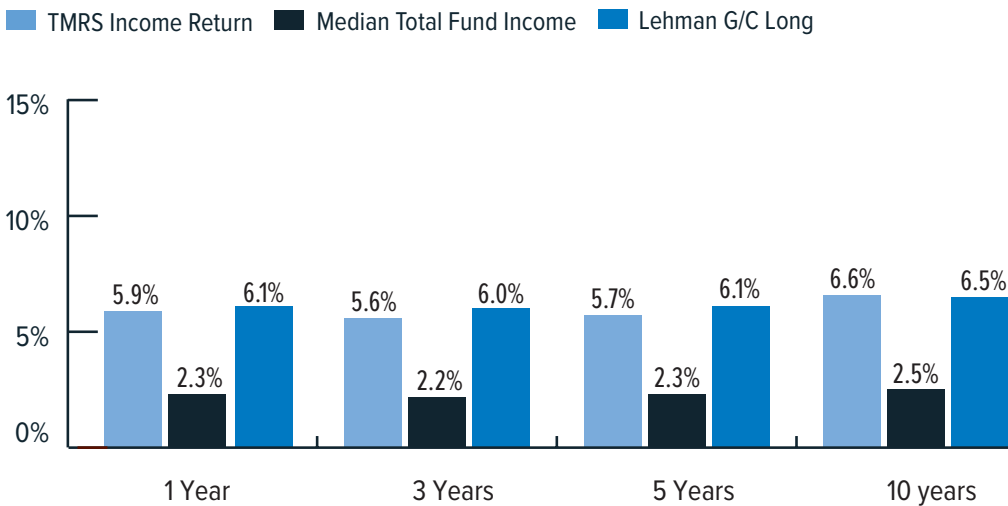
Asset Allocation



2007 Investment Results

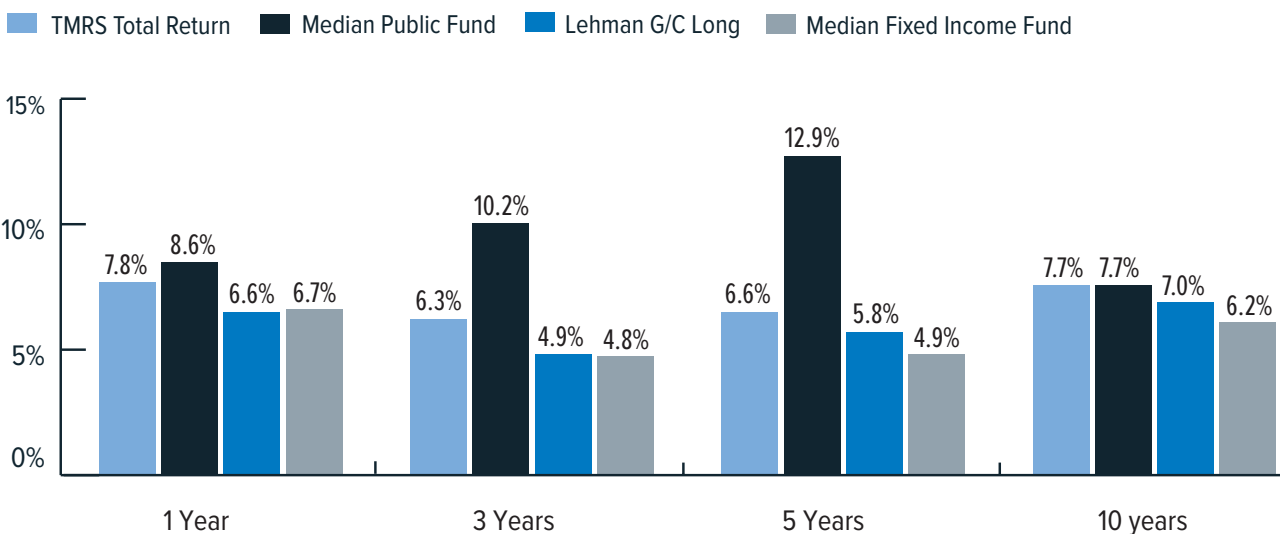
TMRS Income Rate of Return

This graph compares the ordinary annual income of TMRS on a current yield and time-weighted basis with the Median Total Fund Income of the universe measured and the Lehman Brothers Government/Credit Long Bond Index. This income stream is an important part of guaranteeing retirement annuities. Quality income and preservation of capital are the main TMRS investment objectives.



TMRS Total Fund Rate of Return

This graph compares TMRS' total rate of return, which includes income and appreciation of assets (realized and unrealized gains), to the Median Public Fund of all public funds measured, which includes all asset classes, the Lehman Brothers Government/Credit Long Bond Index, and the Median Fixed Income Fund, which includes bonds only.



This table displays the Risk-Adjusted Return of the TMRS Total Fund Rate of Return in comparison to that of the Lehman Brothers Government/Credit Long Bond Index. The Sharpe Ratio is used, which measures excess return per unit of total risk. It is calculated by taking the excess return over the risk-free rate, divided by the standard deviation of the excess return. The higher the value, the better the historical risk-adjusted performance. The longer duration of the TMRS portfolio relative to the index generally means higher volatility (risk) of the returns.

As of December 31, 2007	TMRS	Lehman G/C Long
5-Year Risk-Adjusted Return	0.30	0.33

This table displays the statistical characteristics of the TMRS bond portfolio as of December 31, 2007, in comparison with a relevant market index, the Lehman Brothers Government/Credit Long Bond Index.

Bond Portfolio Characteristics	TMRS December 31, 2007	Lehman G/C Long December 31, 2007
Total number of securities	184	1,083
Current coupon	3.70%	6.80%
Yield to maturity	5.20%	5.40%
Average maturity (years)	20.9	21.0
Adjusted duration (years)	14.5	11.0
Average quality	Aaa	Aa3

Summary of Investment Operations

For the Years Ended December 31, 2007 and 2006		
	2007	2006
Investment Income		
Interest earned on short-term investments ⁽¹⁾	\$ 13,025,771	\$ 11,938,211
Interest earned on U.S. Treasury securities	198,722,001	213,330,578
Interest earned on U.S. government agencies	250,303,993	219,769,780
Interest earned on state/local government bonds	38,882,807	37,056,841
Interest earned on corporate bonds	237,843,439	210,284,778
Net appreciation/(depreciation) in fair value of investments	320,332,097	(566,569,835)
Net securities lending income ⁽²⁾	21,437,372	5,680,876
Other	15,863	13,158
Investment activity expense ⁽³⁾	<u>(936,333)</u>	<u>(1,012,050)</u>
Total	1,079,627,010	130,492,337
Less: Unrealized appreciation/(depreciation) in the fair value of securities ⁽⁴⁾	316,422,493	(584,128,460)
TOTAL INVESTMENT INCOME	\$ 763,204,517	\$ 714,620,797
Investment Income Allocation		
Employees saving fund	\$ 168,409,023	\$ 184,553,278
Municipality accumulation fund	250,881,545	276,628,954
Current service annuity reserve fund	219,997,020	198,958,763
Supplemental disability benefits fund	50,499	53,960
Supplemental death benefits fund	1,168,506	1,062,425
Endowment fund ⁽³⁾	122,697,924	42,226,419
Distributive benefit	–	11,136,998
TOTAL ALLOCATION TO FUNDS	\$ 763,204,517	\$ 714,620,797

Note: This schedule represents the allocation of interest income, as defined by the TMRS Act, to the various funds. A description of each fund can be found in Note 1-D and fund allocations, as defined by the TMRS Act, in Note 5 in the Financial Section.

(1) Includes interest earned in both the Pension Trust Fund and Supplemental Death Benefits Fund.

(2) For purposes of this schedule, securities lending income is presented net of related fees of \$404,127,814 and \$352,988,354 for 2007 and 2006, respectively.

(3) See Schedule of Investment Fees for a detail of these expenses. The Endowment Fund provides funding for administrative expenses during the annual budget process.

(4) As defined by the TMRS Act, unrealized appreciation/(depreciation) in the fair value of securities is not considered income available for allocation.

Largest Holdings (by Fair Value)

As of December 31, 2007		
Par Value	Description	Fair Value
\$ 1,362,800,000	U.S. Treasury - 5 1/2%, due 8-15-2028, Rating AAA	\$ 1,543,098,440
3,200,000,000	Resolution Funding - Zero bonds, due 1-15-2030, Rating AAA	1,148,800,000
685,552,500	Illinois State Taxable Pension Bonds - 5.1%, due 6-1-2033, Rating AA	665,877,143
1,660,000,000	Resolution Funding - Zero bonds, due 4-15-2030, Rating AAA	590,296,000
1,262,000,000	U.S. Treasury Principal Strips - due 2-15-2027, Rating AAA	521,963,200
975,000,000	U.S. Treasury Principal Strips - due 11-15-2026, Rating AAA	407,257,500
1,000,000,000	U.S. Treasury Principal Strips - due 8-15-2027, Rating AAA	404,200,000
950,000,000	U.S. Treasury Principal Strips - due 8-15-2026, Rating AAA	400,710,000
655,000,000	Resolution Funding - Zero bonds, due 10-15-2020, Rating AAA	360,577,500
254,630,000	Tennessee Valley Authority - 7 1/8%, due 5-1-2030, Rating AAA	331,324,556

Note: Space and cost restrictions make it impractical to print a detailed listing of the investment portfolio in this report; however, a portfolio listing is available and will be mailed upon request.

Schedule of Investment Fees

For the Year Ended December 31, 2007	
Personnel services	
Staff salaries	\$ 470,120
Payroll taxes	25,404
Retirement contributions	60,081
Insurance	<u>28,545</u>
Total personnel services	584,150
Professional services	
Consulting services	<u>177,917</u>
Total professional services	177,917
Communication	
Travel	<u>32,069</u>
Total communication	32,069
Miscellaneous	
Dues, subscriptions, and training	141,388
Other administrative expenses	<u>809</u>
Total miscellaneous	142,197
TOTAL INVESTMENT EXPENSES	\$ 936,333

Note: All investment fees incurred during 2007 are related to the System's internally managed portfolio of fixed income securities.