

# Investment





## RVKuhns

▶▶▶ & ASSOCIATES, INC.

April 21, 2009

Board of Trustees  
Texas Municipal Retirement System  
c/o Mr. Eric Henry  
Executive Director & Chief Investment Officer  
P.O. Box 149153  
Austin, Texas 78714-9153

Dear Board Members:

The past year has been marked by extreme negative performance of the U.S. economy, with turbulent investment markets and large swings in inflation expectations. U.S. Gross Domestic Product declined in two of the last four quarters as the economy contracted by 3.3% since December 31, 2007.<sup>1</sup> The economy shed approximately 3.1 million jobs from nonfarm payrolls as the unemployment rate rose from 4.9% to 7.2% during the year.<sup>2</sup> Inflation, as measured by the Consumer Price Index, rose 0.1% during the year. The Federal Reserve lowered short-term interest rates from 4.25% to a range of 0.00% – 0.25% over the course of the year, and Treasury yields declined across their range of maturities.

The year 2008 was favorable for only Treasury securities and the highest quality cash and bond instruments. Almost all other market segments posted negative returns with the worst performance in decades for equity markets and other risk oriented asset classes including the traditionally divergent commodities and alternative investments. In the United States, the S&P 500 Index returned -37%. International developed markets fared worse, returning -43% (as measured by the MSCI EAFE Index). Fixed income securities returned 5% (Barclays Capital Aggregate Bond Index). The positive return of the fixed income index is largely due to it being comprised with a majority weight to U.S. Government and Agency securities. All other bond index sectors were negative performers.

The System's primary investment goal is to generate a consistent level of income to support the interest credits required by law. The System is seeking legislation during 2009 that will allow it to move away from an income oriented strategy to a total return approach similar to most pension funds. Within current statutory constraints, the System was able to begin the process of diversification during 2008. The broadest most common asset classes are represented in the current portfolio in a diversified manner. All segments of the U.S. equity market, the developed non-U.S. markets, and the U.S. investment grade fixed income market are represented in the portfolio. We believe these investment allocations are consistent with both investment policy guidelines and the unique legal statutes that govern TMRS.

<sup>1</sup> Based on data provided by the U.S. Department of Commerce, Bureau of Economic Analysis

<sup>2</sup> Based on data provided by the U.S. Department of Labor

Over the last year TMRS has moved in a methodical manner to diversify the portfolio and reduce risk. The equity portfolio was built up to the current allocation levels by regularly planned monthly contributions that proved to diversify the risk of timing the initial transition out of bonds and into equities. We believe that the recent actions taken and the future plans in consideration by the Board to diversify the System's investments into several new asset classes will enhance future portfolio returns while managing the investment risk.

The market value of the Texas Municipal Retirement System (TMRS) investments decreased from \$14.533 billion to \$14.472 billion in the year ended December 31, 2008. The System's current actuarial assumed rate of return is 7.0%, which represents the System's long-term return goal. The System's overall investment return over the past year, calculated using a time-weighted rate of return methodology based upon market values, was -1.3% and the System's three-year annualized return was 2.4%. The five-year annualized return for the System was 6.0% and the System's ten-year annualized return was 6.6%. While these near term return levels are low in absolute amounts, they represent strong performance compared to peers.

The System's investment policies, goals, and objectives, as well as the performance of its assets and transaction costs are regularly monitored by TMRS staff, the Board, and by R.V. Kuhns & Associates. These evaluations include analysis of the investment management firms and the custodial banks that serve the System.

Assets which are directly owned by the System are held in custody at State Street Bank while the underlying assets of commingled funds are custodied by Northern Trust. Returns referenced above are based upon financial statements prepared by State Street. Their statements are, to the best of our knowledge, reliable.

An uncertain market environment demands careful attention and thoughtful treatment of the assets entrusted to the Board's care by the System's employee participants. We expect the Board's continued high standard of care for these assets and commitment to diversification to allow the System to meet its long-term goals and objectives.

Most sincerely,



Russell V. Kuhns  
Chairman



# 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 minimum target rates (presently 5%).
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. Investment decisions shall be made by considering the investment of all of the assets of the System, rather than by considering the prudence of a single investment, and investments shall be made with the degree of judgment and care, under the circumstances 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.

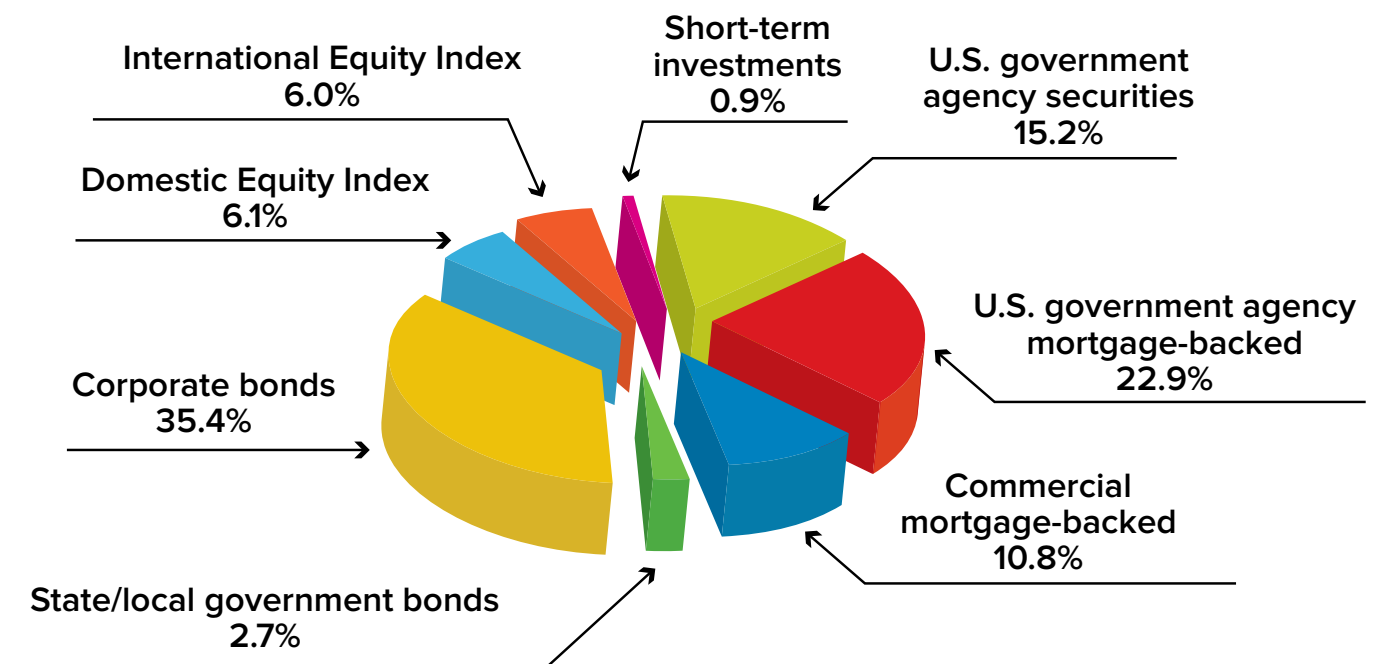
Asset Allocation Table • Interim Targets	
Asset Class	Target %
Domestic Equities	
Passive	6%
International Equities	
Passive - Developed Countries	<u>6%</u>
<b>Total Equities</b>	12%
Fixed Income	
Investment Grade	<u>88%</u>
<b>Total Fixed Income</b>	88%
<b>Unallocated Cash</b>	-
<b>TOTAL</b>	100%



# Summary of Investments

	As of December 31, 2008		As of December 31, 2007	
	Fair Value	Percent of Total Fair Value	Fair Value	Percent of Total Fair Value
<b>Short-term investments</b>	\$129,962,439	0.9 %	\$629,801,737	4.3 %
<b>Fixed-income securities</b>				
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	2,202,622,989	15.2	5,117,830,787	35.2
U.S. government agency mortgage-backed	3,316,586,406	22.9	79,587,088	0.5
Commercial mortgage-backed	1,558,046,237	10.8	-	-
State/local government bonds	397,207,337	2.7	734,485,063	5.1
Corporate bonds	<u>5,128,363,437</u>	<u>35.4</u>	<u>3,949,304,339</u>	<u>27.2</u>
Total fixed-income securities	12,602,826,406	87.0	13,903,614,527	95.7
<b>Equity index funds</b>				
Domestic	876,208,203	6.1	-	-
International	<u>863,179,543</u>	<u>6.0</u>	-	-
Total equity index funds	1,739,387,746	12.1	-	-
<b>TOTAL INVESTMENTS</b>	<b>\$14,472,176,591</b>	<b>100.0 %</b>	<b>\$14,533,416,264</b>	<b>100.0 %</b>

## Asset Allocation





# 2008 Investment Results

	1 Year	3 Years	5 Years	10 Years
TMRS Total Return	-1.3%	2.4%	6.0%	6.6%
All Public Funds > \$1 Billion -Total Fund Median	-26.7%	-2.8%	2.3%	3.6%
TMRS Domestic Fixed Income Return	1.8%	3.4%	6.7%	6.9%
Barclays Capital Government/Credit Long Term Index	8.4%	5.9%	6.3%	6.6%
Barclays Capital US Aggregate Bond Index	5.2%	5.5%	4.7%	5.6%
TMRS Domestic Equity Return <sup>(1)</sup>	-33.4%	-	-	-
Russell 3000 Index <sup>(1)</sup>	-34.6%	-	-	-
TMRS International Equity Return <sup>(1)</sup>	-41.3%	-	-	-
MSCI EAFE Index <sup>(1)</sup>	-42.2%	-	-	-
TMRS Income Return <sup>(2)</sup>	5.9%	5.8%	5.7%	6.4%
State Street Income Return Universe	2.5%	2.4%	2.3%	2.3%
Barclays Capital Government/Credit Long Term Index <sup>(3)</sup>	6.3%	6.2%	6.1%	6.5%
Barclays Capital US Aggregate Bond Index <sup>(3)</sup>	5.4%	5.4%	5.3%	5.8%

<sup>(1)</sup> Returns calculated from inception date of 1/4/2008  
<sup>(2)</sup> Excludes net appreciation/(depreciation)  
<sup>(3)</sup> Coupon income only

**Note:** Rates of return presented were calculated using a time-weighted rate of return methodology based upon market values.

**State Street Income Return Universe** – The State Street Universe is a proprietary comparative universe service developed by State Street Bank containing performance and asset allocation data on over 1,250 funds representing more than 17,200 portfolios with assets in excess of \$1.8 trillion. The Income Return Universe includes Public Funds greater than \$1 billion in assets and is looking only at the total fund income return. This income return includes interest and dividends in the portfolio. There were 47 observations in the universe as of 12/31/08.

**Barclays Capital Government/Credit Long Term Index** – (Previously known as the Lehman Brothers Government/Credit Long Index.) This index represents the long term sector of both the Government and Credit Indices. The Government Index includes U.S. Treasury securities that have remaining maturities of more than one year and U.S. government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. government. The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

**Barclays Capital US Aggregate Bond Index** – (Previously known as the Lehman Brothers U.S. Aggregate Bond Index.) This index covers the U.S. investment grade fixed rate bond market, including government and corporate securities, agency mortgage pass-through securities, and asset-backed securities. To be included in the index, these securities must meet certain criteria. Major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

**All Public Plans > \$1 Billion - Total Fund Median** – As of December 31, 2008, the Total Fund Composite – All Public Plans > \$1B-Total Fund plan sponsor peer group consists of a total of 79 public funds with total assets of greater than \$1 billion, 8 of which include public plan clients of RV Kuhns and Associates. The remaining participants are anonymous plan sponsors whose data is provided quarterly by BNY Mellon and RogersCasey. Total participants may fluctuate each quarter and historical performance and asset allocation is not available for all peer group members.

**Russell 3000 Index** – This index measures the performance of 3,000 publicly held US companies based on total market capitalization, which represents approximately 98% of the investable US market.

**MSCI EAFE Index** – This index is market capitalization weighted and includes a selection of stocks from 21 developed markets, but excludes those from the U.S. and Canada.



This table displays the Risk-Adjusted Return of the TMRS Total Return in comparison to that of the Barclays Capital Government/Credit Long Term Index and Barclays Capital US Aggregate 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.

TMRS	Barclays Capital Government/Credit Long Term Index	Barclays Capital US Aggregate Bond Index
0.31	0.35	0.37

## Largest Holdings (by Fair Value)

Fixed Income Securities • As of December 31, 2008		
Par Value	Description	Fair Value
\$ 655,000,000	Resolution Funding - Principal Strips, due 10-15-2020, Rating AAA	\$ 417,824,500
380,552,500	Illinois State Taxable Pension Bonds - 5.1%, due 6-1-2033, Rating AA3	334,292,538
204,630,000	Tennessee Valley Authority - 7 1/8%, due 5-1-2030, Rating AAA	290,050,747
197,756,185	Federal Home Loan PC Pool G02086 - 5%, due 2-1-2036, Rating AAA	202,368,623
210,090,000	Sysco Corporation - 5.375%, due 9-21-2035, Rating A1	197,207,071
278,000,000	Resolution Funding - Principal Strips, due 7-15-2020, Rating AAA	179,476,522
169,632,455	Federal Home Loan PC Pool G03737 - 6.5%, due 11-1-2037, Rating AAA	176,381,707
137,918,000	General Electric Capital Corp - 7.5%, due 8-21-2035, Rating AAA	165,868,324
153,862,387	GNMA II Pool 004195 - 6%, due 7-20-2038, Rating AAA	158,597,436
161,460,000	United Technologies Corp - 5.4%, due 5-1-2035, Rating A2	152,161,034

Equity Index Funds • As of December 31, 2008		
Shares/Units	Description	Fair Value
3,090,630.960	NTGI - QM Collective Daily EAFE Index Fund - Non Lending	\$ 459,026,714
872,261.850	NTGI - QM Collective Daily Russell 3000 Index Fund - Lending	441,989,036
40,441,386.640	NTGI - QM Collective Daily Russell 3000 Index Fund - Non Lending	434,219,168
1,557,537.050	NTGI - QM Collective Daily EAFE Index Fund - Lending	404,152,829

**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.



# Summary of Investment Operations

For the Years Ended December 31, 2008 and 2007		
	2008	2007
<b>Investment Income</b>		
Interest earned on short-term investments	\$ 14,643,420	\$ 13,025,771
Interest earned on U.S. Treasury securities	85,037,666	198,722,001
Interest earned on U.S. government agencies	199,156,816	250,303,993
Interest earned on U.S. government agency mortgage-backed	83,291,976	–
Interest earned on state/local government bonds	33,187,857	38,882,807
Interest earned on corporate bonds	281,768,234	237,843,439
Interest earned on commercial mortgage-backed	52,411,013	–
Net appreciation/(depreciation) in fair value of investments	(1,008,385,369)	320,332,097
Net securities lending income <sup>(1)</sup>	1,850,967	21,437,372
Other	161,790	15,863
Investment activity expense <sup>(2)</sup>	<u>(4,167,578)</u>	<u>(936,333)</u>
Total	(261,043,208)	1,079,627,010
Less: Unrealized appreciation/(depreciation) in the fair value of securities <sup>(3)</sup>	(1,007,824,880)	316,422,493
Net depreciation in fair value of collateral pool <sup>(3)</sup>	(44,507,068)	–
<b>TOTAL INVESTMENT INCOME AVAILABLE FOR ALLOCATION</b>	<b>\$ 791,288,740</b>	<b>\$ 763,204,517</b>
<b>Investment Income Allocation</b>		
Employees saving fund	\$ 176,235,114	\$ 168,409,023
Municipality accumulation fund	260,271,316	250,881,545
Current service annuity reserve fund	241,554,813	219,997,020
Supplemental disability benefits fund	47,297	50,499
Supplemental death benefits fund	1,229,567	1,168,506
Endowment fund <sup>(2)</sup>	111,950,633	122,697,924
<b>TOTAL ALLOCATION TO FUNDS</b>	<b>\$ 791,288,740</b>	<b>\$ 763,204,517</b>

**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.

<sup>(1)</sup> For purposes of this schedule, securities lending income is presented net of related fees and expenses of \$183,525,961 and \$404,127,814 for 2008 and 2007, respectively.

<sup>(2)</sup> See Schedule of Investment Fees for a detail of these expenses. The Endowment Fund provides an amount to cover administrative expenses during the annual budget process.

<sup>(3)</sup> As defined by the TMRS Act, unrealized appreciation/(depreciation) in the fair value of securities and net depreciation in fair value of the securities lending collateral pool are not considered income available for allocation.



For the Year Ended December 31, 2008	
<b>Personnel services</b>	
Staff salaries	\$ 607,574
Payroll taxes	37,423
Retirement contributions	78,681
Insurance	<u>37,435</u>
Total personnel services	761,113
<b>Professional services</b>	
Investment management	2,688,259
Consulting services	<u>515,000</u>
Total professional services	3,203,259
<b>Communication</b>	
Travel	<u>27,297</u>
Total communication	27,297
<b>Miscellaneous</b>	
Dues, subscriptions, and training	174,512
Other administrative expenses	<u>1,397</u>
Total miscellaneous	175,909
<b>TOTAL INVESTMENT EXPENSES</b>	<b>\$ 4,167,578</b>

Asset Class	External Investment Advisor/Manager	Fees	Assets Under Management at December 31, 2008
Fixed Income Securities	BlackRock Financial Management, Inc.	\$2,608,650	\$12,602,826,406
Equity Index Funds	Northern Trust Global Investments	79,609	1,739,387,746
<b>TOTALS</b>		<b>\$2,688,259</b>	<b>\$14,342,214,152</b>

