

Investment

RVKuhns

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April 15, 2011

Board of Trustees
Texas Municipal Retirement System
c/o Mr. David Gavia
Executive Director
P.O. Box 149153
Austin, Texas 78714-9153

Dear Board Members:

The past year has been marked by generally positive performance of the U.S. economy along with turbulent investment markets and mild price inflation. U.S. Real Gross Domestic Product grew in each of the last four quarters as the economy expanded by 2.8% in 2010.¹ The economy added approximately 940,000 jobs from nonfarm payrolls as the unemployment rate declined from 9.9% to 9.4% during the year.² Inflation, as measured by the Consumer Price Index, rose 1.5% during the year. The Federal Reserve kept target short-term interest rates steady at a range of 0.00% – 0.25% over the course of the fiscal year, and Treasury yields declined across their range of maturities six months and greater, while rising for maturities less than six months.

The trailing year through December 31, 2010 exhibited positive returns for every market segment with the best performance coming from risk oriented asset classes such as REITs, U.S. and non-U.S. small cap equities, and emerging market equities. In the United States, the S&P 500 Index (Cap. Wtd.) returned 15.1%. Broad international equity markets returned 12.7% (as measured by the MSCI ACW ex US Investable Market Index). While positive for the year, international developed markets lagged, returning 7.8% (as measured by the MSCI EAFE Index). Fixed income securities returned 6.5% (Barclays Capital US Aggregate Bond Index). All bond index sectors were positive performers for the year.

The market value of the Texas Municipal Retirement System (TMRS) investments increased from \$16.294 billion to \$17.937 billion in the year ended December 31, 2010³. 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 was 9.0% and the System's three-year annualized return was 5.9%. The five-year annualized return for the System was 5.2% and the System's ten-year annualized return was 7.6%. While the three- and five-year return levels are low in absolute amounts, they represent strong performance compared to peers.

¹ Based on data provided by the U.S. Department of Commerce, Bureau of Economic Analysis. Data for fourth quarter 2010 are preliminary.

² Based on data provided by the U.S. Department of Labor

³ As reported by TMRS' custodian State Street Bank & Trust. Market value includes accruals and is adjusted for open trades.

The System's portfolio is under a process of diversification and has shifted from an income oriented strategy to a total return approach similar to most pension funds. The portfolio is diversified across the global debt and equity markets. We believe these investment allocations are consistent with both Investment Policy guidelines and unique legal statutes that govern TMRS.

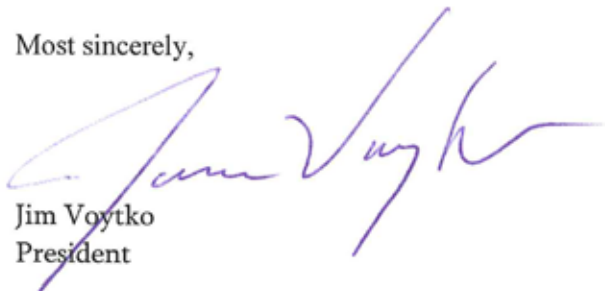
Over the last year, TMRS has continued to move in a methodical manner to diversify the portfolio. The equity portfolio has been built up to the current allocation levels through ongoing, regularly planned monthly contributions that diversify the risk of timing the transition out of bonds and into equities. In addition, the international equity allocation has been broadened to include allocations to emerging markets and non-U.S. small cap equities. The fixed income allocation has been further diversified to include small allocations to non-U.S. and below investment grade debt. 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 with a commensurate, yet moderate increase in risk.

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 R.V. Kuhns & Associates, Inc. These evaluations include analysis of the investment management firms and the custodial bank that serve the System.

The System's assets are held in custody at State Street Bank. Market values and returns referenced above are based upon statements prepared by State Street. Their statements are, to the best of our knowledge, reliable and accurate.

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,



Jim Voytko
President

Outline of Investment Policies

The TMRS Board of Trustees approves the Investment Policy Statement (IPS), which governs the investment of assets for TMRS and is established to provide a framework for the management of those assets. It sets forth the Board's investment objectives and tolerance for investment risk. The IPS outlines objectives, benchmarks, restrictions, and responsibilities so that members of the Board, TMRS staff, investment managers, consultants, and TMRS stakeholders clearly understand the policies, goals and objectives, and risks connected with the TMRS investment program.

Investment Objectives

The overall objective of TMRS' investment program is to ensure that members, retirees, and beneficiaries are provided with the benefits they have been promised by their employers at a reasonable and predictable cost to the employers. Assets will be invested for total return with appropriate consideration for portfolio volatility (risk) and liquidity. Emphasis is on both capital appreciation as well as the production of income in order to satisfy the short-term and long-term funding needs of TMRS. Total return includes dividends, interest, and realized and unrealized capital appreciation.

General Investment Policies

A. Standard of Prudence Applicable. All participants in the investment process will act responsibly. The standard of prudence to be applied by the Board and investment staff is as follows:

1. In satisfying this standard, the Board and staff shall exercise 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 and in consideration of the purposes, terms, distribution requirements, and other circumstances of the trust.
2. Investment and management decisions respecting individual assets will be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

B. Conflict of Interest Prohibited. Members of the Board of Trustees, investment staff, investment managers, and consultants involved in the investment of TMRS assets will refrain from personal business activity that could conflict with the proper execution and management of the TMRS investment program, or that could impair their ability to make impartial recommendations and decisions. These parties are required to reveal all relationships that could create or appear to create a conflict of interest in their unbiased involvement in the investment process.

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's asset allocation policy is intended to reflect, and be consistent with, the return objective and risk tolerance expressed in this IPS. It is designed to provide the highest probability of meeting or exceeding the Board's objectives at a controlled level of risk and liquidity that is acceptable to the Board. In establishing its risk tolerance, the Board considers its ability to withstand short and intermediate-term volatility in investment performance and fluctuations in the financial condition of the fund.

The target asset allocation and acceptable ranges as determined by the Board to facilitate the achievement of long-term investment objectives within acceptable risk parameters are as follows:

Asset Allocation Table • Targets			
Asset Class	Minimum %	Target %	Maximum %
Domestic Equities	12%	20%	25%
International Equities	12%	20%	25%
Fixed Income	30%	35%	70%
Real Estate	5%	10%	15%
Real Return	2%	5%	10%
Absolute Return	0%	5%	10%
Private Equity	0%	5%	10%
Cash Equivalents	0%	0%	10%

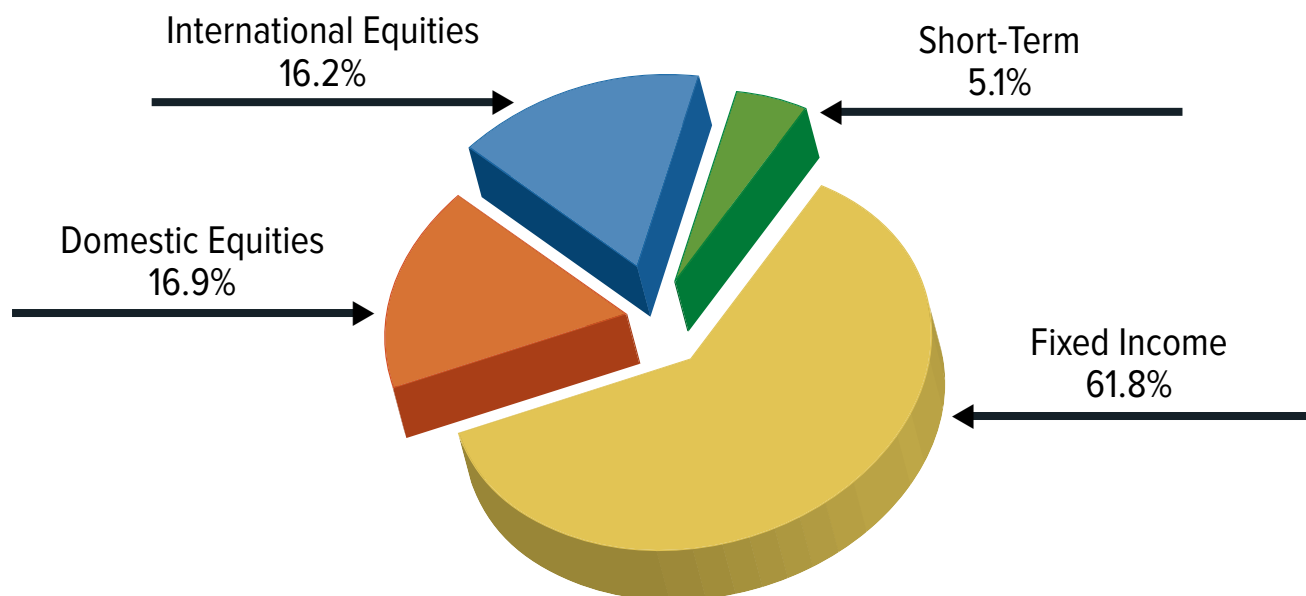
The Board will authorize implementation to these target allocations in stages. The target allocation will be reviewed at least annually for reasonableness relative to significant economic and market changes or to changes in the Board's long-term goals and objectives. A formal asset allocation study will be conducted at least every three years to verify or amend the targets, and an asset-liability study at least every five years.

The Board has chosen to adopt a re-balancing policy that is governed by allocation ranges rather than time periods. The ranges, specified in the table above, are a function of the volatility of each asset class and the proportion of the total fund allocated to the asset class. While the allocation to all asset classes remains within these limits, staff will use cash flow, as available, to maintain the overall allocation as close as possible to the target. When any one of the asset classes hits a trigger point (i.e., falls outside the minimum or maximum limits), the entire fund will be re-balanced back to asset class target allocations as market conditions permit.

Summary of Investments

	As of December 31, 2010		As of December 31, 2009	
	Fair Value	Percent of Total Fair Value	Fair Value	Percent of Total Fair Value
Short-term investments				
Short-term investment funds	\$ 492,180,155	2.7 %	\$ 588,533,277	3.7 %
U.S. Treasury bills	449,449,387	2.4	1,097,488,271	6.9
Total short-term investments	941,629,542	5.1	1,686,021,548	10.6
Fixed Income Securities				
U.S. Treasury bonds/notes	1,998,848,643	10.9	1,440,239,925	9.0
U.S. government agency	336,410,812	1.8	672,287,096	4.2
U.S. government agency mortgage-backed	4,180,744,303	22.8	2,602,446,345	16.3
Municipal	413,857,626	2.3	225,792,991	1.4
Corporate	3,505,758,188	19.2	4,418,430,749	27.7
Commercial mortgage-backed	788,312,220	4.3	996,804,645	6.2
Other asset-backed	30,947,119	0.2	92,741,388	0.6
Foreign government	55,285,985	0.3	74,167,096	0.5
Total fixed income securities	11,310,164,896	61.8	10,522,910,235	65.9
Equity Index Funds				
Domestic	3,096,982,128	16.9	1,887,886,605	11.8
International	2,953,749,758	16.2	1,865,025,351	11.7
Total equity index funds	6,050,731,886	33.1	3,752,911,956	23.5
TOTAL INVESTMENTS	\$ 18,302,526,324	100.0 %	\$ 15,961,843,739	100.0 %

Asset Allocation



Largest Holdings (by Fair Value)

Fixed Income Securities • As of December 31, 2010		
Par Value	Description	Fair Value
\$ 514,100,000	U.S. Treasury Note - 0.5%, due 11/30/12, Rating AAA	\$ 513,436,811
492,180,155	Government STIF (Short Term Investment Fund) - variable rate, NR	492,180,155
384,200,000	FNMA TBA Single Family Mortgage - 4.0%, due 1/25/41, Rating AAA	382,227,312
272,882,571	Federal Home Loan PC Pool A95825 - 4.0%, due 12/01/40, Rating AAA	271,182,513
248,815,545	FNMA Pool AE0061 - 6.0%, due 2/1/40, Rating AAA	270,960,129
195,499,000	U.S. Treasury Bond - 4.375%, due 5/15/40, Rating AAA	196,445,215
193,625,000	U.S. Treasury Note - 2.125%, due 12/31/15, Rating AAA	194,653,149
168,880,000	U.S. Treasury Note - 3%, due 2/28/17, Rating AAA	174,157,500
161,100,000	U.S. Treasury Bill - zero coupon, due 6/9/11, Rating AAA	160,987,584
150,000,000	U.S. Treasury Bill - zero coupon, due 2/3/11, Rating AAA	149,989,020

Equity Index Funds • As of December 31, 2010		
Shares/Units	Description	Fair Value
192,227,802.61	NTGI - QM Collective Daily Russell 3000 Index Fund - Non Lending	\$ 3,096,982,128
9,887,285.94	NTGI - QM Collective Daily EAFE Index Fund - Non Lending	2,092,139,818
7,645,299.30	NTGI - QM Collective Daily All Country World Ex US IMI Index Fund - Non Lending	861,609,940

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.

	1 Year	3 Years	5 Years	10 Years
TMRS Total Return	9.0%	5.9%	5.2%	7.6%
Target Allocation Benchmark	9.4%	5.6%	5.2%	6.8%
TMRS Domestic Fixed Income Return	6.5%	5.0%	4.7%	7.4%
Fixed Income Benchmark	6.5%	5.0%	4.9%	6.6%
TMRS Domestic Equity Return ⁽¹⁾	16.9%	-	-	-
Russell 3000 Index ⁽¹⁾	16.9%	-	-	-
TMRS Non-US Equity Return ⁽²⁾	8.4%	-	-	-
Non-US Equity Benchmark ⁽²⁾	8.0%	-	-	-

(1) The inception date of this portfolio is 1/4/2008, and therefore, three-year returns are not provided. As of 12/31/2010, inception-to-date returns were 0.07% and 0.05% for TMRS' Domestic Equity Return and the Russell 3000 Index, respectively.

(2) The inception date of this portfolio is 1/4/2008, and therefore, three-year returns are not provided. As of 12/31/2010, inception-to-date returns were -3.70% and -3.99% for TMRS' Non-US Equity return and the Non-US Equity Benchmark, respectively.

Note: Rates of return presented are calculated using a time-weighted rate of return methodology based upon market values, and are presented gross of investment management fees.

Target Allocation Benchmark – The Target Allocation Benchmark is calculated monthly using target weights applied to each corresponding benchmark return and reflects the ongoing transition to the final allocation targets as stated in the IPS. Asset classes without current funding mandates are excluded. As of December 31, 2010, the benchmark consisted of:

- 15.5% Russell 3000 Index
- 15.5% Non-US Equity Benchmark
- 69.0% Fixed Income Benchmark

Fixed Income Benchmark – The Fixed Income Benchmark is calculated monthly and consists of 100% Barclays Capital US Aggregate Bond Index beginning July 1, 2009, and 100% Barclays Capital Long Government/Credit Index prior to July 1, 2009.

Barclays Capital US 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.

Barclays Capital US Long Government/Credit Index – This index measures the investment return of all medium and larger public issues of U.S. Treasury, agency, investment-grade corporate, and investment-grade international dollar-denominated bonds with maturities longer than 10 years.

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

Non-US Equity Benchmark – The Non-US Equity Benchmark is calculated monthly using beginning of month investment weights applied to each corresponding benchmark (MSCI EAFE and MSCI All Country World Investable Market Index-ex US IMI) return.

MSCI EAFE Index – This is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

MSCI All Country World Investable Market Index-ex US IMI – This is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets, excluding the U.S.

Presented below is the 5-Year Risk-Adjusted Return of the TMRS Total Return in comparison to that of the Target Allocation Benchmark. 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.

As of December 31, 2010	TMRS	Target Allocation Benchmark
5-Year Risk-Adjusted Return	0.36	0.33

Summary of Investment Operations

For the Years Ended December 31, 2010 and 2009		
	2010	2009
Investment Income		
Interest earned on short-term investments	\$ 798,620	\$ 2,359,122
Interest earned on long-term fixed income securities	465,879,488	610,739,005
Net appreciation/(depreciation) in fair value of investments	1,001,627,620	873,137,944
Net securities lending income ⁽¹⁾	40,366,670	3,326,522
Other	19,490	14,805
Investment activity expense	(12,363,868)	(6,268,446)
TOTAL INVESTMENT INCOME AVAILABLE FOR ALLOCATION	\$ 1,496,328,020	\$ 1,483,308,952
Investment Income Allocation		
Employees Saving Fund	\$ 196,536,034	\$ 186,614,181
Municipality Accumulation Fund	442,776,423	407,352,827
Current Service Annuity Reserve Fund	281,229,892	261,079,841
Supplemental Disability Benefits Fund	41,161	44,216
Supplemental Death Benefits Fund	1,312,293	1,304,784
Endowment Fund ⁽²⁾	574,432,217	626,913,103
TOTAL ALLOCATION TO FUNDS	\$ 1,496,328,020	\$ 1,483,308,952

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) For purposes of this schedule, securities lending income is presented net of related fees and expenses.

(2) The Endowment Fund does not receive a statutory interest allocation; instead, amounts allocated represent funding of the Interest Reserve.

Schedule of Investment Fees

For the Year Ended December 31, 2010	
Personnel services	
Staff salaries	\$ 678,130
Payroll taxes	41,383
Retirement contributions	108,433
Insurance	<u>51,285</u>
Total personnel services	879,231
Professional services	
Investment management	8,188,082
Investment transaction costs	2,420,971
Consulting services	<u>565,767</u>
Total professional services	11,174,820
Communication	
Travel	<u>25,031</u>
Total communication	25,031
Miscellaneous	
Dues, subscriptions, and training	283,003
Other administrative expenses	<u>1,783</u>
Total miscellaneous	284,786
TOTAL INVESTMENT EXPENSES	\$ 12,363,868

Asset Class	External Investment Manager	Fees	Net Assets Under Management at December 31, 2010*	Cost Rate (bps)**
Fixed Income Securities	BlackRock Financial Management, Inc.	\$ 3,619,012	\$ 10,143,019,127	3.42
Fixed Income Securities	Pacific Investment Management Company (PIMCO)	3,362,723	1,718,198,836	19.89
Equity Index Funds	Northern Trust Global Investments	1,206,347	6,050,731,886	2.55
TOTALS		\$ 8,188,082	\$ 17,911,949,849	4.82

* Includes market value of securities, accrued interest, and net receivable/(payable) for open trades.

** Cost rate in basis points (bps) calculated using average monthly net assets under management.

