

Investment



May 8, 2012

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 was marked by generally positive performance of the U.S. economy, but also by turbulent investment markets and elevated price inflation. In 2011, U.S. Real Gross Domestic Product grew in each quarter as the economy expanded by 1.6%.¹ The economy added approximately 1,840,000 jobs from nonfarm payrolls as the unemployment rate declined from 9.4% to 8.5% during the year.² Inflation, as measured by the Consumer Price Index, rose 3.0% during the year.³ 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 all maturities.

The trailing year through December 31, 2011 exhibited volatile equity markets with U.S. equities ending the year slightly positive and international equities negative. In the United States, the Russell 3000 Index returned 1.0%. Broad international equity markets declined -14.3% (as measured by the MSCI ACW excluding U.S. Investable Market Index). The best performance came from income oriented asset classes such as fixed income and real estate. Fixed income securities returned 7.8% (Barclays Capital U.S. 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 \$17.937 billion to \$18.515 billion in the year ended December 31, 2011.⁴ 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 2.4% and the System's three-year annualized return was 7.2%. The five-year annualized return for the System was 5.5% and the System's ten-year annualized return was 7.0%. While the one- and five-year return levels are low in absolute amounts, they demonstrate strong performance compared to peers.

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 all segments of the

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

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

³ Ibid.

⁴ As reported by TMRS' custodian State Street Bank & Trust. Market value includes accruals and is adjusted for open trades.

U.S. and international equity markets (both developed and emerging). The fixed income portfolio primarily consists of U.S. investment grade investments with small allocations to non-U.S. and below investment grade debt. The System also invests in real return assets (currently global inflation-linked bonds) and real estate. 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, systematically planned monthly contributions that diversify the risk of timing the transition out of bonds and into equities. The target allocation to equities was reached at the end of 2011. The System also funded the real return allocation at the beginning of 2011 by investing in global inflation-linked bonds. Two initial real estate investments were made towards the end of the year as the current allocation to real estate will continue to increase toward its target in a methodical manner over time. 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.

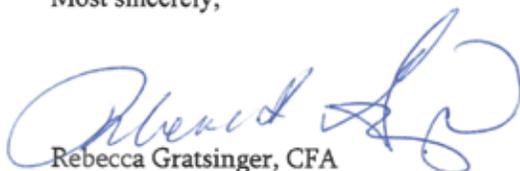
During the year, R.V. Kuhns & Associates, Inc. was engaged to conduct an Asset/Liability ("A/L") study for the System. The A/L study showed that TMRS is currently comparatively well-funded, but can improve its most likely outcomes, as well as its best and worst case outcomes, by continuing with a measured degree of additional diversification from its current asset allocation to its strategic or final target allocation. Investments into assets with higher expected return that provide additional diversification will allow the System to better reach its full funding goals without negatively affecting projected worst case scenarios or System liquidity.

The System's investment policies, goals, and objectives, as well as the performance of its assets and transaction costs are regularly monitored and evaluated 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, with equity investments held at Northern Trust through commingled funds and real estate fund assets held by their respective general partners. Market values and returns referenced above are based upon statements prepared by State Street Bank. Their statements are, to the best of our knowledge, reliable and accurate. Investment performance is calculated using a time-weighted rate of return methodology (gross of fees) based upon market values and cash flows.

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,



Rebecca Gratsinger, CFA
Chief Executive Officer

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 risk is the asset allocation decision. The Board's strategic target allocation is intended to reflect, and be consistent with, the return objective and risk tolerance expressed in the 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 strategic target 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 • Strategic Targets			
Asset Class	Minimum %	Target %	Maximum %
U.S. 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%

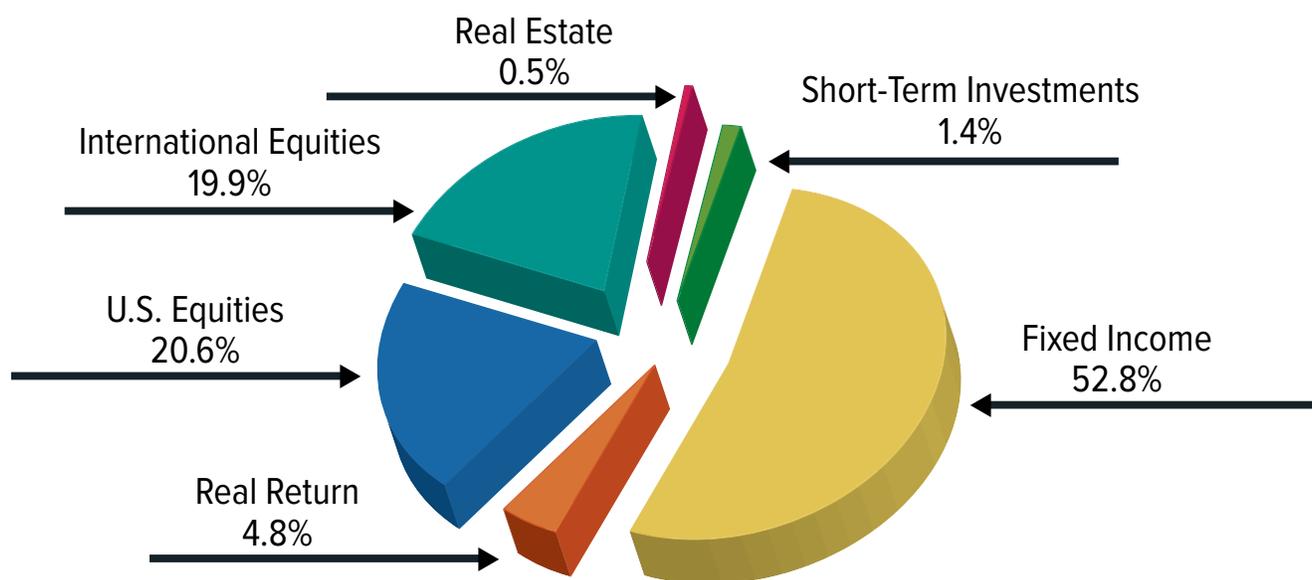
The Board will authorize implementation to this strategic target allocation in stages. To ensure that the risk tolerance remains appropriate, the target allocation will be reviewed at least annually for reasonableness relative to significant economic and market changes or to changes in the Board's long-term goals and objectives. A formal asset allocation study will be conducted at least every three years to verify or amend the targets, and a formal pension financial (asset-liability) study will be conducted 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, 2011		As of December 31, 2010	
	Fair Value	Percent of Total Fair Value	Fair Value	Percent of Total Fair Value
Short-term Investments				
Short-term investment funds	\$ 99,028,620	0.5 %	\$ 492,180,155	2.7 %
U.S. Treasury bills	96,399,434	0.5	449,449,387	2.4
Repurchase agreements	72,600,000	0.4	-	-
Total short-term investments	268,028,054	1.4	941,629,542	5.1
Fixed Income				
U.S. Treasury bonds/notes	2,315,305,301	12.5	1,822,896,469	10.0
U.S. Treasury inflation-protected	274,185,120	1.5	175,952,174	1.0
U.S. government agency	647,345,452	3.5	336,410,812	1.8
Municipal	166,201,697	0.9	413,857,626	2.3
Corporate	2,819,745,766	15.2	3,505,758,188	19.2
Residential mortgage-backed	2,917,382,493	15.8	4,180,744,303	22.8
Commercial mortgage-backed	419,552,522	2.3	788,312,220	4.3
Other asset-backed	67,866,413	0.4	30,947,119	0.2
Foreign government	123,467,833	0.7	55,285,985	0.3
Total fixed income	9,751,052,597	52.8	11,310,164,896	61.9
Real Return - Global Inflation-linked Bonds				
U.S. Treasury bonds/notes	9,714,072	0.1	-	-
U.S. Treasury inflation-protected	222,942,048	1.2	-	-
Foreign government inflation-linked	471,776,587	2.5	-	-
Foreign government	176,841,495	1.0	-	-
Foreign exchange contracts	1,856,537	0.0	-	-
Total real return	883,130,739	4.8	-	-
U.S Equities	3,796,989,718	20.6	3,096,982,128	16.9
International Equities	3,668,624,466	19.9	2,953,749,758	16.1
Real Estate	97,000,000	0.5	-	-
TOTAL INVESTMENTS	\$ 18,464,825,574	100.0 %	\$ 18,302,526,324	100.0 %

NOTE: The above table reflects investment assets in categories consistent with the strategic target allocation, and therefore may differ from the presentation within the Notes to the Financial Statements.



Largest Holdings (by Fair Value)

Fixed Income Securities • As of December 31, 2011		
Par Value	Description	Fair Value
\$ 299,700,000	U.S. Treasury Note: 0.875%, due 12/31/2016, Rating AAA	\$ 300,239,460
291,065,000	U.S. Treasury Note: 0.375%, due 11/15/2014, Rating AAA	291,248,371
253,303,451	Federal Home Loan PC Pool A95825: 4.000%, due 12/01/2040, Rating AAA	266,054,747
264,700,000	U.S. Treasury Note: 0.875%, due 11/30/2016, Rating AAA	265,507,335
213,235,000	U.S. Treasury Note: 1.500%, due 7/31/2016, Rating AAA	220,448,740
211,055,000	Federal Home Loan Mortgage Corporation: 3.525%, due 9/30/2019, Rating AAA	212,570,375
167,260,000	U.S. Treasury Note: 2.000%, due 11/15/2021, Rating AAA	169,168,437
163,300,000	U.S. Treasury Note: 0.250%, due 11/30/2013, Rating AAA	163,319,596
136,006,000	U.S. Treasury Note: 1.750%, due 10/31/2018, Rating AAA	139,980,095
119,265,321	U.S. Treasury Inflation Index Note: 0.125%, due 4/15/2016, Rating AAA	124,334,097

Equity Index Funds • As of December 31, 2011		
Shares/Units	Description	Fair Value
233,273,313.12	NTGI - QM Collective Daily Russell 3000 Index Fund - Non Lending	\$ 3,796,989,718
37,924,478.90	NTGI - QM Collective Daily All Country World Ex US IMI Index Fund - Non Lending	3,668,624,466

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.

2011 Investment Results

	1 Year	3 Years	5 Years	10 Years
TMRS Total Return	2.41%	7.17%	5.54%	6.99%
Total Fund Active Weighted Benchmark	2.21%	5.08%	5.25%	6.31%
TMRS Fixed Income Return	7.99%	7.06%	6.14%	7.29%
Fixed Income Benchmark	7.84%	4.83%	5.90%	6.64%
TMRS Real Return ⁽¹⁾	6.43%	-	-	-
Barclay's World Government Inflation-Linked Index ⁽¹⁾	9.99%	-	-	-
CPI + 4% ⁽¹⁾	6.22%	-	-	-
TMRS Domestic Equity Return ⁽²⁾	1.03%	14.90%	-	-
Russell 3000 Index ⁽²⁾	1.03%	14.88%	-	-
TMRS Non-US Equity Return ⁽³⁾	-13.35%	7.45%	-	-
Non-US Equity Benchmark ⁽³⁾	-13.48%	7.23%	-	-
TMRS Real Estate Return ⁽⁴⁾	-	-	-	-
NCREIF-ODCE ⁽⁴⁾	-	-	-	-

(1) The one-year return presented is calculated from the inception date of 2/1/2011. The policy benchmark for the Real Return asset class is the CPI + 4%; however, until further diversification within the asset class occurs, the portfolio benchmark for global inflation-linked bonds is used.

(2) The inception date of this portfolio is 1/4/2008, and therefore five-year and ten-year returns are not provided. As of 12/31/2011, inception-to-date returns were -0.22% and -0.23% for TMRS' Domestic Equity return and the Russell 3000 Index, respectively.

(3) The inception date of this portfolio is 1/4/2008, and therefore five-year and ten-year returns are not provided. As of 12/31/2011, inception-to-date returns were -7.91% and -8.14% for TMRS' Non-U.S. Equity return and the Non-U.S. Equity Benchmark, respectively.

(4) The inception date of this portfolio is 11/1/2011, and therefore returns are not provided. Performance is reported on a quarterly-lagged basis.

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.

Total Fund Active Weighted Benchmark – The Total Fund Active Weighted Benchmark is weighted by the average balance of all funds and is comprised of all benchmarks associated with each fund/composite.

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 U.S. 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.

Barclay's World Government Inflation-Linked Index – This index includes only government issuers of inflation-linked bonds in the following major markets: Australia, Canada, France, Germany, Italy, Japan, Sweden, U.K., and the U.S.

CPI – The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

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

NCREIF-ODCE – The National Council of Real Estate Investment Fiduciaries - Open End Diversified Core Equity (NCREIF-ODCE) is a capitalization-weighted index of investment returns reporting on both a historical and current basis the results of 28 open-end commingled funds pursuing a core investment strategy, some of which have performance histories dating back to the 1970s.

Presented below is the 5-Year Risk-Adjusted Return of the TMRS Total Return in comparison to that of the Total Fund Active Weighted 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, 2011	TMRS	Total Fund Active Weighted Benchmark
5-Year Risk-Adjusted Return	0.55	0.44

Schedule of Investment Expenses

For the Year Ended December 31, 2011	
Internal operating expenses	
Staff salaries	\$ 924,356
Payroll taxes	55,298
Retirement contributions	154,183
Insurance	69,761
Electronic investment services	333,420
Travel	24,642
Dues, subscriptions, and training	40,377
Other administrative expenses	<u>2,450</u>
Total	1,604,487
Investment management and other external expenses	
Investment management	10,040,384
Equity index funds transaction costs	3,683,398
Consulting services	745,580
Legal	<u>147,018</u>
Total	14,616,380
TOTAL INVESTMENT EXPENSES	\$ 16,220,867

Asset Class	External Investment Manager	Fees	Net Assets Under Management at December 31, 2011*	Cost Rate (bps)**
Fixed Income	BlackRock Financial Management, Inc.	\$ 3,154,015	\$ 8,176,574,214	3.46
Fixed Income	Pacific Investment Management Company (PIMCO)	3,633,971	1,854,581,085	20.31
Real Return	Colchester Global Investors	1,275,271	896,313,006	16.77
Equity Index Funds - U.S.	Northern Trust Global Investments	694,944	3,796,989,718	2.00
Equity Index Funds - International	Northern Trust Global Investments	1,282,183	3,668,624,466	3.85
TOTALS		\$ 10,040,384	\$ 18,393,082,489	5.58

* 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.