

**MINUTES OF THE  
TEXAS MUNICIPAL RETIREMENT SYSTEM  
Regular Meeting of the Board of Trustees**

**June 17, 2011**

On June 17, 2011, the Board of Trustees of the Texas Municipal Retirement System (TMRS) convened for a regular meeting at 8:30 a.m. at TMRS Headquarters, located at 1200 North IH 35 in Austin, Texas, with the following members present:

**Board of Trustees**

April Nixon, Chair  
Frank Simpson, Vice Chair  
Ben Gorzell  
Julie Oakley  
Jim Parrish

Absent: Roel ("Roy") Rodriguez

Present also were:

David Gavia, Executive Director  
Ian Allan, Director of Internal Audit  
Rhonda Covarrubias, Director of Finance  
Eric Davis, Deputy Executive Director  
Bernie Eldridge, Director of Human Resources  
Nancy Goerdel, Chief Investment Officer  
Leslee Hardy, Staff Actuary  
Cindy Morse, Executive Assistant  
Christine Sweeney, General Counsel  
Ron Lewis, Ron Lewis & Associates  
Holly Macki, Director of Real Estate  
Michelle Mellon-Werch, Associate General Counsel  
Debbie Munoz, Director of Member Services  
Dev Outlaw, Director of Fixed Income  
Dimitry Shishkoff, Director of Risk Management  
Bill Wallace, Director of Communications  
Dan Wattles, Director of Governmental Relations  
Scott Willrich, Director of Information Resources  
Mark Randall, Gabriel Roeder Smith & Company  
Joe Newton, Gabriel Roeder Smith & Company  
Jeremy Miller, R. V. Kuhns & Associates  
Marcia Beard, R. V. Kuhns & Associates  
Jonathan Kowolik, R. V. Kuhns & Associates  
Ed Schwartz, ORG Portfolio Management LLC  
Lynn Schultz Kehoe, ORG Portfolio Management LLC  
Robert Klausner, Klausner & Kaufman, P. A.

Also in attendance: Sherry Chapman, Investment Accountant  
Debbie Farahmandi, Investment Operations Specialist  
Glenn Johnson, City of Garland Fire Fighters  
George Kauffman, City of Garland  
Randall Meadows, Arlington Police Association  
Rick Menchaca, BOSCO, Inc.  
Anthony Mills, Regional Representative – City Services  
Jim Moore, City of Mesquite Fire Fighters  
Candace Nolte, Controller  
Kate Reed, Investment Risk Analyst  
Katie Reissman, Investment Analyst - Fixed Income  
David Rodriguez, Regional Representative – City Services  
Sean Thompson, Regional Representative – City Services  
Kristin Qualls, Assistant Investment Officer for Equities  
Bob Scott, Government Finance Officers Association of Texas (GFOAT)

The meeting was called to order at 8:31 a.m. and Jim Parrish gave the invocation.

**1. Consider and Act on Consent Agenda**

Mr. Gavia briefly explained the Consent Agenda, stating that it includes the Minutes from the May 19-20 Board meeting, along with quarterly reports on service retirements, disability retirements, death benefits and financial statements. There was no discussion on this item and no revisions to the Minutes. Mr. Parrish moved that the Consent Agenda be adopted as presented. Ms. Oakley seconded the motion, which passed unanimously.

**2. Legislative Update and Overview of 82nd Legislative Session, Including Discussion of TMRS Legislation (SB 350), Other Proposed Legislation and Applicable Federal Legislation**

Mr. Gavia thanked Ron Lewis, Dan Wattles and staff for their diligent work during a grueling Legislative Session. Mr. Lewis agreed that it was a hard session, but said that TMRS came out well and was not adversely affected. He commented that this session included more pension issues than he had ever seen since working with TMRS.

Mr. Wattles updated the Board on the Legislature's activities in the Special Session. He reported that four bills affecting TMRS are currently on the Governor's desk: (1) the TMRS bill (SB 350); two identical return-to-work bills (HB 159 and SB 812); and HB 2460, a bill which strengthens confidentiality measures. He mentioned that the bills that would impose a fee on TMRS in order to fund the Pension Review Board failed to pass. The bill that would impose a fee on TMRS as an employer participating in the insurance pool did pass. He briefly reviewed other bills affecting TMRS.

**3. Consider and Act on Resolutions Honoring Representative Truitt and Senator Williams**

Mr. Gavia stated that Representative Truitt and Senator Williams have been influential and steadfast supporters of the System. Senator Williams has been a key sponsor of important legislation for the System during many sessions of the Texas Legislature. Representative Truitt became our House sponsor upon the death of Representative Edmund Kuempel. Mr. Gavia

commended Representative Truitt on getting quickly up to speed on our bill and recognizing it as an important piece of legislation. In order to show our thanks and appreciation to Representative Truitt and Senator Williams, a Resolution has been prepared for each of them and will be presented at the appropriate time.

Representative Truitt's resolution reads as follows:

### **RESOLUTION**

*WHEREAS, Representative Vicki Truitt has been an influential and steadfast supporter of public pension plans, including the Texas Municipal Retirement System (TMRS), during many sessions of the Texas Legislature; and*

*WHEREAS, in the 82<sup>nd</sup> Regular Legislative Session, Representative Truitt was the House Sponsor of Senate Bill 350, allowing TMRS to restructure the internal accounts that hold employee and city contributions and that pay retirement benefits, which will provide more efficient funding, reduce year-to-year volatility in city contribution rates, and result in lower contribution rates and improved funded ratios for most cities without reducing member or retiree benefits; and*

*WHEREAS, as Chair of the House Pensions, Investments & Financial Services Committee, Representative Truitt's knowledge of TMRS issues and understanding of the importance of balancing the needs of members, retirees, and cities in a challenging economic climate is deeply appreciated by the Board; and*

*WHEREAS, with Representative Truitt's leadership, once SB 350 made passage through the Senate, the legislation was unanimously adopted by the House Pensions, Investments & Financial Services Committee and the full House of Representatives; and*

*WHEREAS, in her leadership role, Representative Truitt's extensive knowledge of pension matters, spirit, warm-hearted presence, steady influence, and integrity helped the members of the Texas House of Representatives understand the importance of the passage of SB 350; now, therefore,*

*BE IT RESOLVED by the Board of Trustees of the Texas Municipal Retirement System that the Board recognize Representative Vicki Truitt's efforts on behalf of TMRS and its participating municipalities, members, and retirees, and express its gratitude to Chairman Truitt for her support; and that a copy of this Resolution be presented to Chairman Truitt as a token of appreciation for her service.*

Senator Williams' resolution reads as follows:

### **RESOLUTION**

*WHEREAS, Senator Tommy Williams has been an influential and steadfast supporter of the Texas Municipal Retirement System (TMRS) and has been especially supportive during recent and critical sessions of the Texas Legislature; and*

*WHEREAS, in the 82<sup>nd</sup> Regular Legislative Session, Senator Williams was the Senate sponsor of Senate Bill 350, allowing TMRS to restructure the internal accounts that hold employee and city contributions and that pay retirement benefits, which will provide more efficient funding, reduce year-to-year volatility in city contribution rates, and result in lower*

*contribution rates and improved funded ratios for most cities without reducing member or retiree benefits; and*

***WHEREAS**, Senator Williams' knowledge of TMRS issues and understanding of the importance of balancing the needs of members, retirees, and cities in a challenging economic climate is deeply appreciated by the Board; and*

***WHEREAS**, in his leadership role, Senator Williams' collegiality, influence, and integrity helped ensure the members of the Texas Senate understand the importance of SB 350; now, therefore,*

***BE IT RESOLVED** by the Board of Trustees of the Texas Municipal Retirement System that the Board recognize Senator Tommy Williams' efforts on behalf of TMRS and its participating municipalities, members, and retirees, and especially his sponsorship of our vital legislation in the 82<sup>nd</sup> Regular Session of the Texas Legislature, and that the Board express its gratitude to Senator Williams for his support; and that a copy of this Resolution be presented to Senator Williams as a token of appreciation for his service.*

Mr. Simpson moved that the Board adopt the Resolutions for Representative Truitt and Senator Williams. Mr. Parrish seconded the motion, which passed unanimously.

#### **4. Annual Economic Outlook Presentation**

Mr. Gavia introduced Dr. Shilling, citing his lengthy and impressive background. Dr. Shilling began his presentation by showing a chart that is reflective of the over-arching economy. He said that what stands out is that the financial and household sectors had leveraged themselves up, but are now deleveraging. He explained that this is a multi-year process; if it happened all at once, we would have a greater depression than that in the 1930s. He anticipated slow growth for the next decade caused by a number of factors that he went on to explain. Dr. Shilling pointed out that the current recession has been followed by a very shallow recovery which is different than in the past. In the engine of growth, the one cylinder that provided the kick for recovery was the normal ending of inventory liquidation as seen in the inventories-to-sales ratios. The other three cylinders for growth, residential construction, jobs, and consumer spending, have not fired. He showed how federal stimulus spending impacted the economy but pointed out that it is basically over now. With slower growth, the unemployment rate is going to stay high and this will put pressure on governments to stimulate the economy. Dr. Shilling said that what is interesting now in Washington is the debate on the deficits. The leaders on deficits are trying to strike while the iron is hot and cut spending, but they are setting up for the longer term debate. Dr. Shilling believes that additional fiscal stimulus is not off the table.

Concerning personal savings, Dr. Shilling reported that personal savings rates have increased; however, if the economy is going to show strong growth, the personal savings rate is going to have to decline to drive the economy. Peoples' confidence in stocks has declined and the decline in homeowner equity and the aging population are indicators that the savings rate may not decline enough to spur the economy. High unemployment is also driving savings. Dr. Shilling indicated that what we are looking at is a two-tier recovery. The people at the top have recovered, but the people at the bottom are still in a recessionary stance. The Fed has tried to reinvigorate the economy, but the impact has been like "pushing on a string," not very effective. M2 has increased \$1 trillion, but reserves have increased by \$1.5 trillion, so in other words, the

money is just sitting there and there have been adverse effects as a result. The Fed has not experienced the success they wanted.

Dr. Shilling then discussed five problem areas that he is monitoring. The first problem area is housing which has excess inventory. Home ownership has declined so it will likely be four to five years before the excess inventory is worked off. He said that we could see another 20% decline in prices. The second problem area is energy, with prices going up and causing more spending. The third problem area is Japan and its tremendous debt. Japan's savings rate and population size have both declined. Japan is going to have to "pay-up" for their debt at some point. Dr. Shilling indicated that the fourth problem is Europe. The Eurozone has not been a good fit for individual members as there is limited monetary policy, but separate fiscal policies. He mentioned that there are two options to deal with this: (1) continue to keep bailing out the weak countries; or (2) don't bail out the countries but bail out their own banks that have large exposures in these countries. The fifth problem is China. China is an export-driven machine, but has been interrupted by the recession. China managed a quick turn around, but their inflation jumped up. They also have a serious property bubble. China is trying to cool off its economy, but Dr. Shilling anticipates a hard landing, which means that commodity prices are likely to come down. Dr. Shilling indicated that the silver lining is it will take a lot of heat off producers in this country. Dr. Shilling concluded by reiterating that he anticipates slow economic growth for the next decade.

#### **5. Securities Lending Annual Review**

Mr. Gavia introduced Dev Outlaw and Jonathan Kowolik of R. V. Kuhns to make the presentation on Securities Lending. Ms. Goerdel stated that this presentation is the culmination of a very in-depth annual review that answers three questions: (1) should TMRS continue lending securities; (2) should TMRS continue with State Street Bank (SSB) as its lending agent; and (3) what changes should be made now and later?

Mr. Outlaw explained that the first step in the review process was a review of TMRS' guidelines compared to our peers, through which we found we were somewhat conservative. Mr. Outlaw reviewed the SSB Quality D fund developments and mentioned the splitting of the fund. Quality D is the commingled pool in which cash collateral from the lending program is invested. He discussed the check that TMRS received from SSB as compensation for being a provider of liquidity in the Quality D pool during a period in which fund withdrawals by other parties did not consistently follow stated guidelines, and as determined through an independent analysis by a forensics accounting firm retained by SSB.

Mr. Outlaw discussed the overall review process and stated that the conclusions and recommendations were reviewed in relation to the three main questions mentioned earlier. Concerning the first question regarding whether TMRS should continue with Securities Lending, it was determined that we should continue. Total income has been advantageous and increased transparency and recommended controls will allow the System to better manage risk. Mr. Outlaw also suggested that we migrate towards "intrinsic value" lending.

Mr. Kowolik began his presentation by reviewing what our peers are doing. He reported that most of our peers are either staying the course or working to reduce risk. He gave a brief overview of the Securities Lending process. He also gave a brief description of “intrinsic value” investing, and said this means only lending those securities the market is willing to pay a premium for. He discussed “reinvestment yield,” and pointed out that total Securities Lending Income is the sum of the Intrinsic Value plus Reinvestment Yield. Mr. Kowolik discussed the risks associated with the Securities Lending program, including discussion of indemnification, and pointed out what is not indemnified. He said the goal is to limit the part of the equation where there is not strong contractual indemnification, that being the reinvestment risk.

Concerning the second question regarding whether TMRS should continue with SSB as its lending agent, Mr. Kowolik said it was determined that we should continue with SSB for now. SSB is one of the top providers in the industry and their performance history comparisons are reasonable; however, it should be noted that SSB believes that if TMRS reduces reinvestment risk, Securities Lending income significant declines, and may significantly affect our current custodial cost which is linked to securities lending. Mr. Kowolik highlighted the advantages and issues related to SSB and mentioned that these concerns are shared with SSB’s peers. He highlighted key statistics in performance.

Concerning the third question regarding what changes should be made now and later, Mr. Outlaw said it was determined that that no changes are needed at this time. Ms. Oakley asked what incentives SSB has for reducing reinvestment risk. Mr. Kowolik answered by discussing the reinvestment guidelines. Mr. Kowolik then discussed changes to be made later. He reviewed several items that will be included in the Custodian and Securities Lending agent search in 2012, and in exploring third party options. Mr. Kowolik compared investment guidelines between a potential separate account versus participation in the State Street Quality D Liquidity Fund. Mr. Kowolik reminded the Board that the risk exposure is reviewed on an on-going basis. He concluded by stating that R. V. Kuhns concurs with the staff recommendation.

## **6. Education Session: Real Estate – Fee Structures**

Mr. Gavia introduced Ed Schwartz to discuss the fee arrangements included in these transactions. Mr. Schwartz introduced Lynn Kehoe, a new member of the ORG team. Mr. Schwartz began by stating that there is no perfect fee structure, as each one has benefits and short-comings. He presented a brief history of fee structures for Real Estate Funds, indicating that scrutiny over existing fee structures and changes in this area came about as a result of the severe market correction of the early 1990's.

Mr. Schwartz then discussed the different types of fees and focused on: Assets Under Management Fees; Incentive fees and Other Fees. He highlighted the pros and cons of these three types of fee structures and outlined approaches to mitigate any structural disadvantages. Regarding fees based on assets under management, he discussed fees tied to asset value, invested equity, committed capital and net operating income or net cash flows. Ms. Macki highlighted that the two Core managers recently approved by the Board operated under the "Assets Under Management" fee structure. Regarding incentive fees, based on performance over a benchmark, he discussed their application in both open-end funds and closed-end funds. With regard to “other” fees, he discussed fees for services of a manager’s affiliate and then reviewed the typical

fee structures by investment strategy (core, value added and opportunistic). A Fee Model Example was presented to the Board for a sample opportunistic fund, assuming a 10 year life, with asset management fees plus an incentive fee based on a hurdle rate. Mr. Schwartz indicated that this type of analysis is done when evaluating and comparing managers during an investment search.

In conclusion, Mr. Schwartz reiterated that there is no perfect fee structure and that fee structures are often dictated by the market. Some fees are negotiable, but structures may not be negotiable. He said the ability to get in early allows more bargaining power. Incentives and alignment are critical; however, net results are most important.

Based on the two real estate managers previously reviewed, Ms. Oakley asked about the firm that was not recommended and how that firm's fee structures were set up. Ms. Goerdel responded that they had an open-ended incentive structure. Ms. Macki stated that staff and ORG felt it was appropriate to have the Board Education Session on Real Estate Fee Structures prior to recommending a manager with this type of structure. Mr. Gavia asked what the time line looks like on the new manager search. Ms. Goerdel and Ms. Macki outlined the current time-line and indicated that the candidates that staff and ORG would recommend to the Board would likely operate under a fee structure with an incentive fee component.

#### **7. Investment Report: March Quarterly Report and May Performance**

Ms. Goerdel stated that this report is a combined effort between staff and R. V. Kuhns. Ms. Goerdel started with comparative performance of our asset allocation benchmarks. She highlighted a chart showing why an investor diversifies and how sector performance has changed over time. She then reviewed the different market sectors. She indicated that yields across the treasury curve were down and the domestic Bond market saw a flight to quality. She said both domestic and international equity markets are seeing corrections and Europe is seeing continued volatility. She briefly reviewed the real estate portfolio and reviewed the one-month and year-to-date performance figures. She outlined the progress being made toward our diversification targets.

Mr. Miller discussed market observations and pointed out that our exposure to fixed income is coming down as we continue to diversify but currently is greater than our peers. He said that a slow and methodical pace into new asset classes and strategies continues to be prudent. It is also important to consider broad investment themes and liquidity when diversifying.

Ms. Beard discussed total fund performance versus benchmarks and reported that the total fund composite returned 6.81% over the trailing five-year period including March 31, 2011. She reported that over time, the System has met its 7% actuarial investment return assumption. She briefly reviewed the Total Fund Risk Return Profile, as well as Composite Performance versus Benchmarks. Ms. Beard then reviewed specific managers versus their benchmarks and the value added. She concluded that R. V. Kuhns is comfortable with where the System is currently relative to its objectives.

**8. Consider and Act on Amendments to Advisory Committee on Retirement Matters**

**Charter**

Mr. Gavia presented this proposed amendment to the Advisory Committee Charter. Mr. Gavia presented an overview of the current Individual and Group class membership requirements and explained that these proposed amendments will limit the Individual Class membership to only TMRS members, retirees and elected officials. This will establish parity between the Individual Class and Group Class.

Mr. Simpson moved that the Board adopt the amended Charter for the Advisory Committee on Retirement Matters as presented. Mr. Parrish seconded the motion, which passed unanimously.

**9. Consider and Act on Appointment to Advisory Committee on Retirement Matters**

Mr. Gavia presented a brief history on the Advisory Committee's Subcommittee that reviews, interviews and recommends applicants for membership on the Advisory Committee. This subcommittee is made up of Mr. Gavia, Ms. Oakley and Mr. Parrish. Mr. Gavia briefly reviewed the process that the Subcommittee uses to recommend applicants to the Board. He explained that there is another vacancy on the Advisory Committee due to Keith Brainard's ineligibility to continue to serve on the Advisory Committee since he is no longer a Councilman for the City of Georgetown.

Ms. Oakley moved that the Board accept the recommendation of the Subcommittee and appoint Charles Windwehen to serve on the Advisory Committee (Individual Class). Mr. Gorzell seconded the motion, which passed unanimously.

**10. Executive Director and Staff Reports**

Mr. Gavia announced that the Valuation is posted on the web site and mentioned that the rate letters will be mailed no later than June 24. He reported that a series of funding workshops are being scheduled around the state. He also said that the impact of SB 350 will be discussed at the annual seminar in August.

**11. Call for Future Agenda Items**

Ms. Nixon asked if there were any future agenda items to be discussed. As there were none, the meeting was adjourned at 12:15 p.m.



David Gavia  
Executive Director



April Nixon  
Chair, Board of Trustees