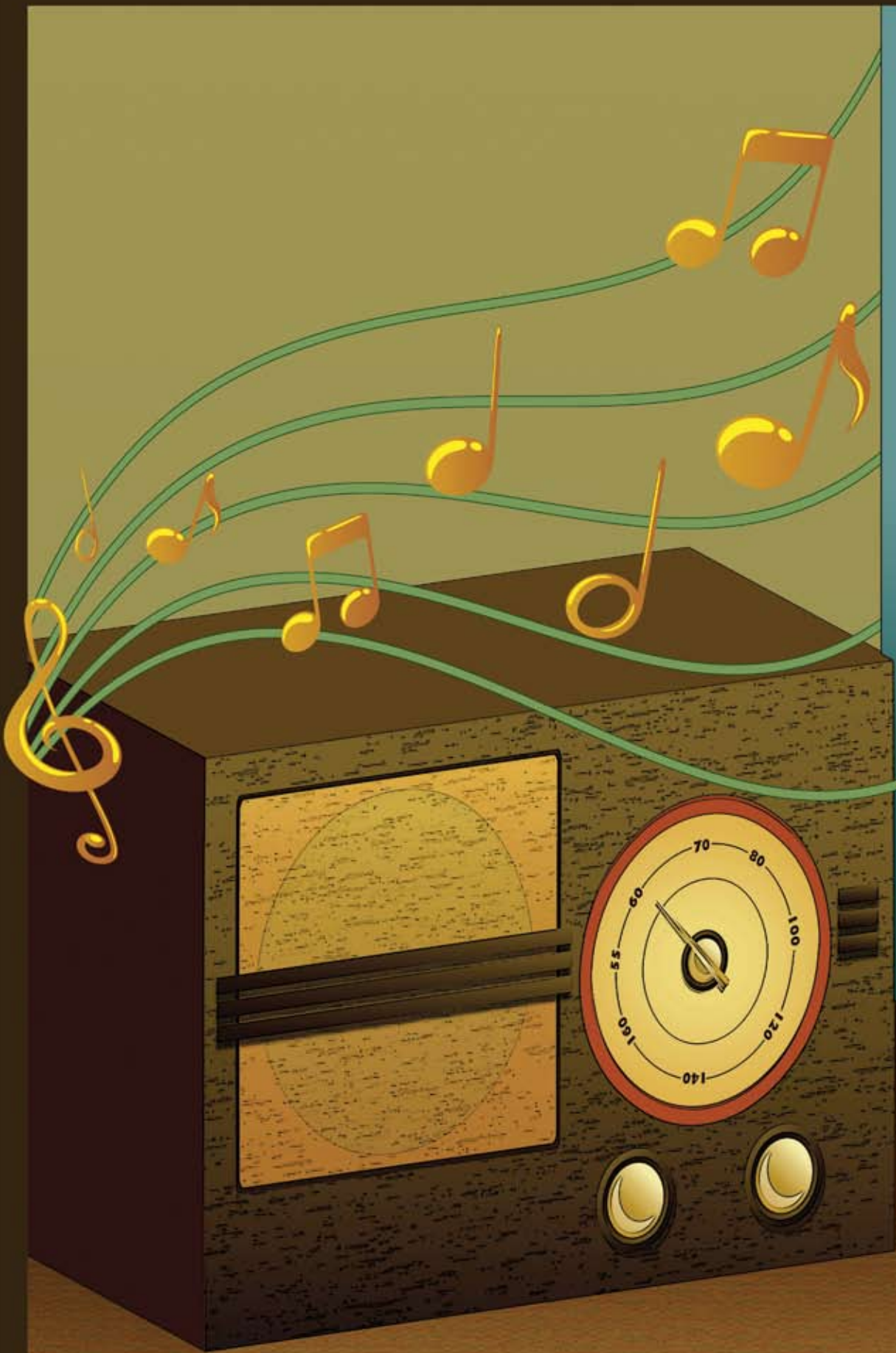


# Investment



# Report on Investment Activity

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April 30, 2007

To: The Board of Trustees and  
Participants of the Texas Municipal Retirement System

The objective of the TMRS investment program is to generate consistent income to meet statutory requirements and credit supplemental interest, when available, to member and municipality accounts. TMRS achieves this by investing in quality bonds with long maturities and with an emphasis on protection from the likelihood of a bond being retired prematurely. As a result, the investment program objectives focus on income rates of return rather than total rates of return that are affected by volatile valuations in a changing interest rate environment. Depending on the interest rate environment, the total rate of return of the TMRS investment portfolio can fluctuate significantly, while the income rate of return is relatively stable. The focus on income return and a consistent strategy of holding quality long-term bonds has allowed the TMRS Board to credit 5.75% interest to member and municipality accounts for 2006. This was above the general market environment and above the statutory target rate of 5%. In addition, TMRS paid an “extra payment” to annuitants equivalent to 30% of one month’s retirement benefit.

The interest rate environment stabilized in 2006, with short-term interest rates increasing from 4.25% to 5.25% as of year-end. Higher rates usually result in lower bond prices, which enables TMRS to purchase securities at lower prices while earning more income for the portfolio. Even though short-term rates increased slightly during 2006, TMRS’ economic advisors, A. Gary Shilling and Co., Inc. and Hillswick Asset Management, LLC, continue to project an environment of lower long-term interest rates. During 2006, long Treasury yields ranged from a low of 4.48% to a high of 5.31%. We continue to focus on maintaining the overall quality of the portfolio while facing ongoing challenges of finding high-quality investments at relatively attractive yields.

The TMRS portfolio performance 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 \$1.4 trillion in assets and containing over 4,000 portfolios. Additional comparisons are 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 investment program objectives, remains consistent and was 6.8% over the past ten years. TMRS ranked in the top 1% of SSU's Total Fund income returns whose Median Total Fund return was 2.7% and also exceeded the LG/C Long Bond Index income return of 6.6%. For the past ten years the total rate of return was 8.6%, 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 7.7%. The portfolio's high relative total rate of return is a result of the portfolio's long-term maturity structure and higher concentration in zero coupon securities. The investment results were achieved within the investment policies established by the TMRS Board of Trustees.

Respectfully submitted,



Preston G. Craig  
Director of Investments

# Outline of Investment Policies

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**B**ecause the plan design depends on a relatively consistent level of credited interest across all plan years, and because compound interest credited annually at the highest feasible rate best assures the highest amount of accumulated deposits of the member at retirement, TMRS' goals are best achieved by an income-producing portfolio management strategy, rather than a total return strategy that may result in credits below the 5% statutory minimum target level.

As such, neither market value declines nor rises of its fixed-income portfolio are of material significance to the System's investment objectives. Periods of rising interest rates, which, by definition, will result in erosion of bond market values, should be regarded as opportunities to increase the yield on the total portfolio, and fixed income market volatility should be regarded as opportunities to realize gains.

## 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 minimum 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 minimum statutory rate.
3. To consistently earn additional income, if feasible, to:
  - a) maintain and continue an "interest reserve" to better ensure continued credits at the statutory minimum target rate during low yielding market periods;
  - b) pay a distributive benefit to annuitants on December 31st of each year; and
  - c) credit additional annual interest to the individual accounts of members and to the accumulation accounts of municipalities.
4. To maintain sufficient liquidity to pay benefits.

## General Investment Policies

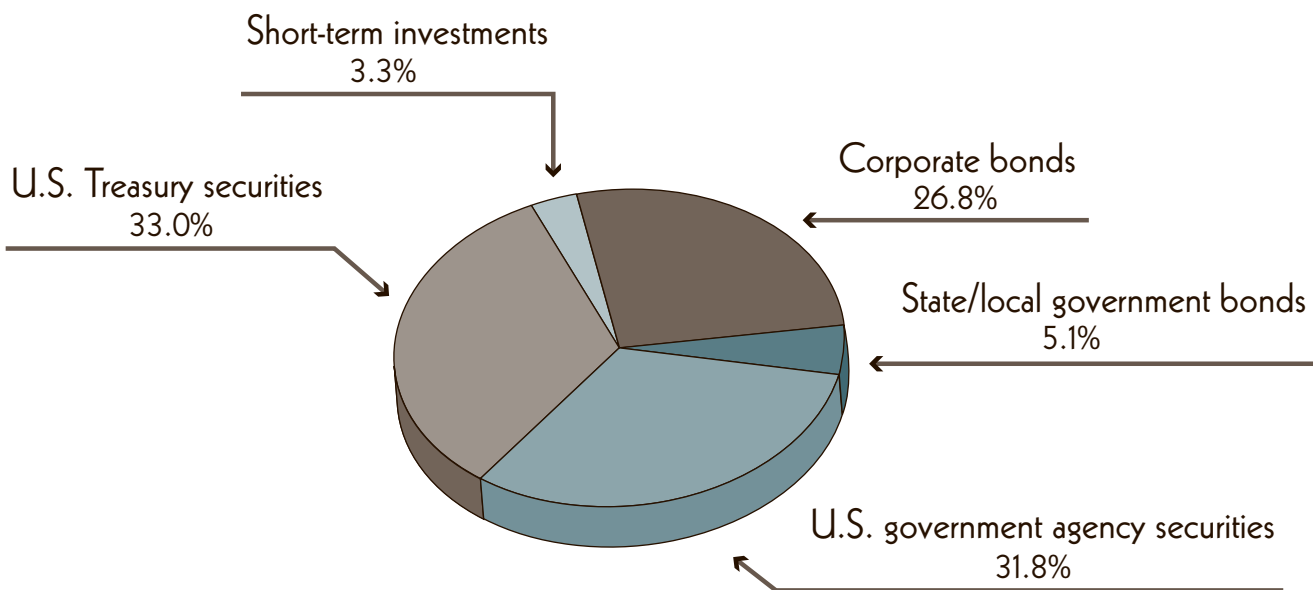
1. Funds of the System shall be invested, without distinction as to source, only in securities as that term is defined in the TMRS Act, and as authorized by the TMRS Board of Trustees' investment policies. Board policy limits on amounts of any security or class of securities shall be observed.
2. Investments 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.

# Summary of Investments

As of December 31, 2006		
	Fair Value	Percent of Total Fair Value
<b>Short-term investments</b>	\$ 455,199,860	3.3 %
<b>Fixed-income securities</b>		
U.S. Treasury securities	4,491,997,610	33.0
U.S. government agency securities	4,326,277,977	31.8
State/local government bonds	700,217,383	5.1
Corporate bonds	<u>3,642,066,729</u>	<u>26.8</u>
Total fixed-income securities	13,160,559,699	96.7
<b>TOTAL INVESTMENTS</b>	<b>\$ 13,615,759,559</b>	<b>100.0 %</b>

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

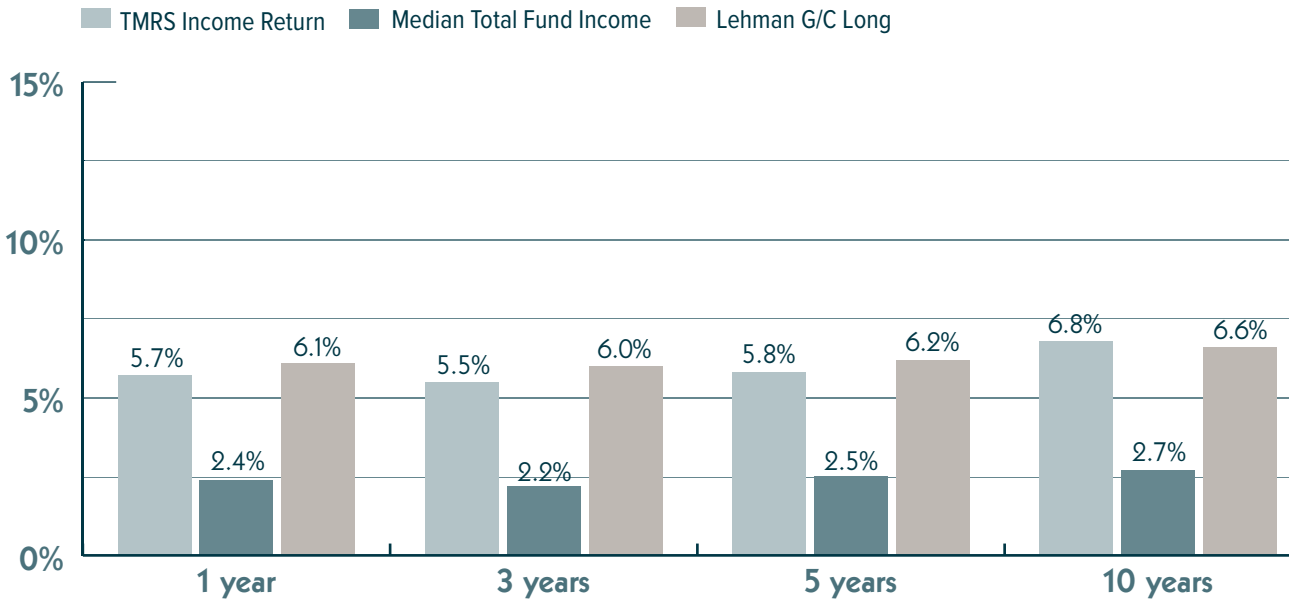
## Asset Allocation



# 2006 Investment Results

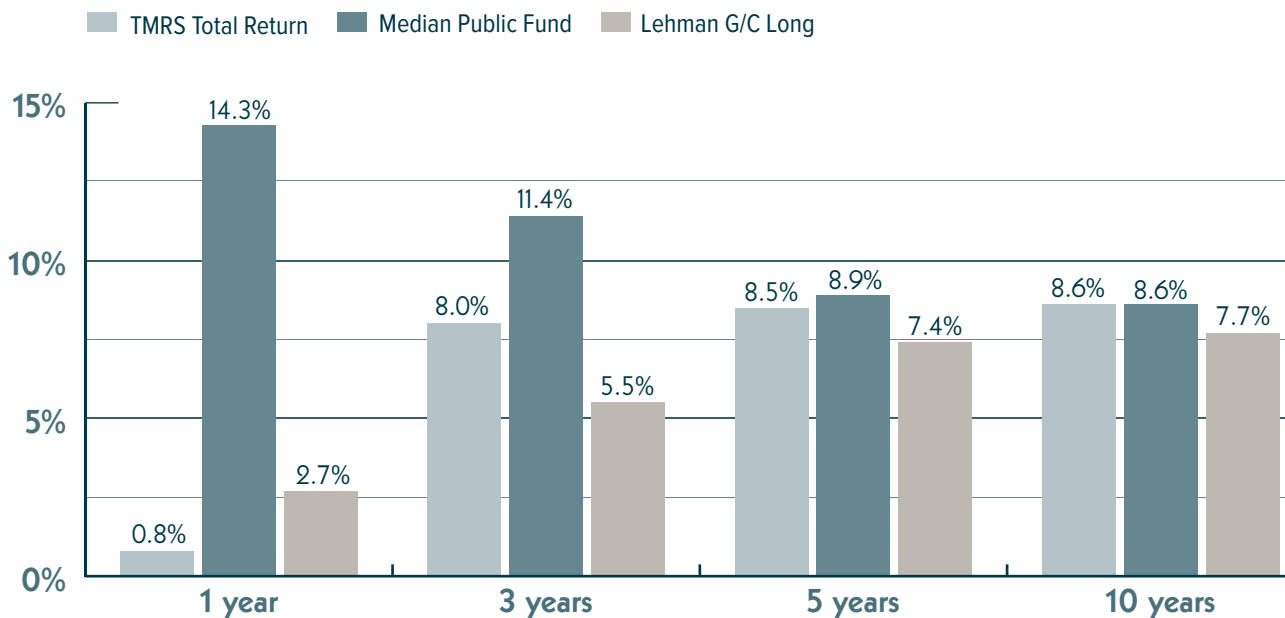
## TMRS Income Rate of Return

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.



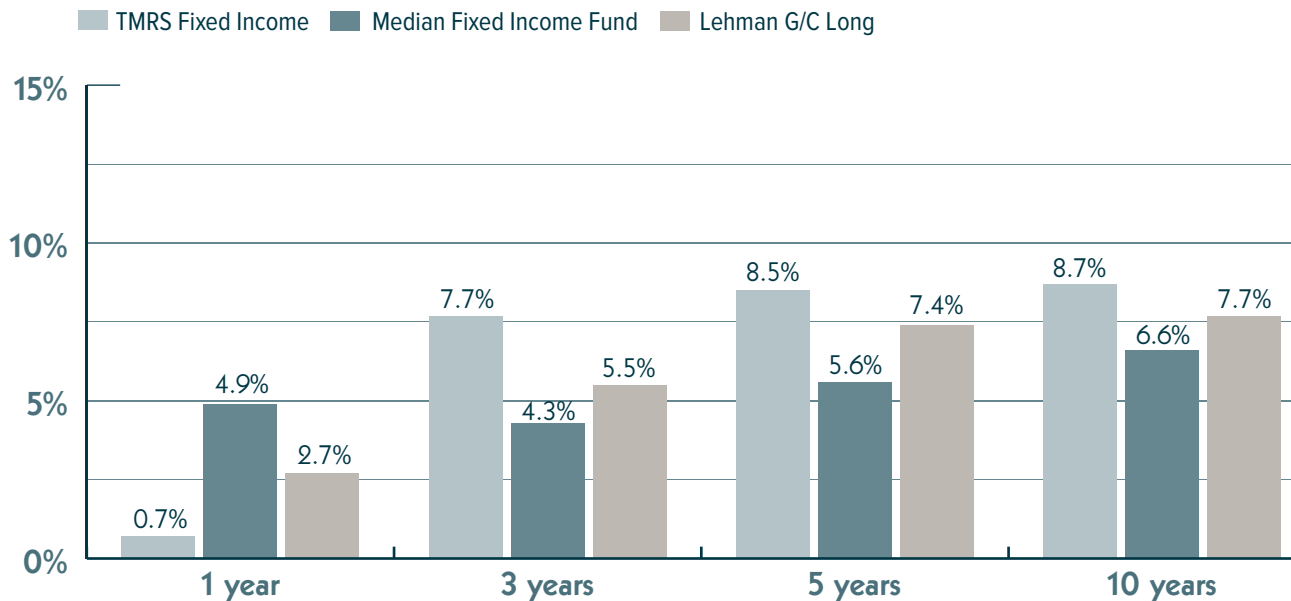
## TMRS Total Fund Rate of Return

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, and the Lehman Brothers Government/Credit Long Bond Index.



## TMRS Bonds Only • Total Rate of Return

This graph compares TMRS' fixed income total rate of return with the Median of the Bonds Only Universe and the Lehman Brothers Government/Credit Long Bond Index. The TMRS policy, with its long-term nature, emphasizes income rate of return in lieu of market performance.



This table displays the statistical characteristics of the TMRS bond portfolio as of December 31, 2006, in comparison with a relevant market index, the Lehman Brothers Government/Credit Long Bond Index.

Bond Portfolio Characteristics	TMRS DECEMBER 31, 2006	LB G/C LONG DECEMBER 31, 2006
Total number of securities	172	976
Current coupon	3.70%	6.90%
Yield to maturity	5.30%	5.50%
Average maturity (years)	21.8	20.4
Adjusted duration (years)	14.8	11.0
Average quality	Aa1	Aa2

# Summary of Investment Operations

For the Years Ended December 31, 2006 and 2005		
	2006	2005
<b>Investment Income</b>		
Interest earned on short-term investments*	\$ 11,938,211	\$ 19,240,539
Interest earned on U.S. Treasury securities	213,330,578	208,317,426
Interest earned on U.S. government agencies	219,769,780	190,372,798
Interest earned on state/local government bonds	37,056,841	33,827,549
Interest earned on corporate bonds	210,284,778	187,638,901
Gains on sale of fixed-income securities	17,558,625	109,631,476
Net securities lending income**	5,680,876	4,962,091
Other	13,158	13,974
<b>TOTAL INVESTMENT INCOME</b>	<b>\$ 715,632,847</b>	<b>\$ 754,004,754</b>
<b>Investment Income Allocation</b>		
Employees saving fund	\$ 184,553,278	\$ 183,427,760
Municipality accumulation fund	276,628,954	277,220,775
Current service annuity reserve fund	198,958,763	177,931,709
Supplemental disability benefits fund	53,960	57,476
Supplemental death benefits fund	1,062,425	972,686
Endowment fund	43,238,469	100,930,961
Distributive benefit	11,136,998	13,463,387
<b>TOTAL DISTRIBUTION TO FUNDS</b>	<b>\$ 715,632,847</b>	<b>\$ 754,004,754</b>

\* Includes interest earned in both the Pension Trust Fund and Supplemental Death Benefits Fund.

\*\* For purposes of this schedule, securities lending income is presented net of related fees of \$352,988,354 and \$171,423,927 for 2006 and 2005, respectively.

**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-E and fund allocations, as defined by the TMRS Act, in Note 5 in the Financial Section. This schedule does not include unrealized appreciation/depreciation in the fair value of fixed income securities.

## Largest Holdings (by Fair Value)

As of December 31, 2006		
Par	Description	Fair Value
\$ 1,999,000,000	U.S. Treasury - 5 1/2%, due 8-15-2028, Rating AAA	\$ 2,159,519,700
3,200,000,000	Resolution Funding - Zero bonds, due 1-15-2030, Rating AAA	1,023,680,000
659,952,500	Illinois State Taxable Pension Bonds - 5.1%, due 6-1-2033, Rating AA	632,498,476
1,437,000,000	U.S. Treasury Principal Strips - due 2-15-2027, Rating AAA	538,300,200
1,660,000,000	Resolution Funding - Zero bonds, due 4-15-2030, Rating AAA	525,224,000
975,000,000	U.S. Treasury Principal Strips - due 11-15-2026, Rating AAA	368,940,000
1,000,000,000	U.S. Treasury Principal Strips - due 8-15-2027, Rating AAA	366,300,000
950,000,000	U.S. Treasury Principal Strips - due 8-15-2026, Rating AAA	363,280,000
274,630,000	Tennessee Valley Authority - 7 1/8%, due 5-1-2030, Rating AAA	345,347,225
655,000,000	Resolution Funding - Zero bonds, due 10-15-2020, Rating AAA	327,369,000

**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, 2006	
<b>Personnel services</b>	
Staff salaries	\$ 413,906
Payroll taxes	21,892
Retirement contributions	52,111
Insurance	<u>22,099</u>
Total personnel services	510,008
<b>Professional services</b>	
Consulting services	<u>340,000</u>
Total professional services	340,000
<b>Communication</b>	
Travel	<u>20,054</u>
Total communication	20,054
<b>Miscellaneous</b>	
Dues, subscriptions and training	140,538
Other administrative expenses	<u>1,450</u>
Total miscellaneous	141,988
<b>TOTAL INVESTMENT EXPENSES</b>	<b>\$ 1,012,050</b>

**Note:** All investment fees incurred during 2006 are related to the System's internally managed portfolio of fixed income securities.