

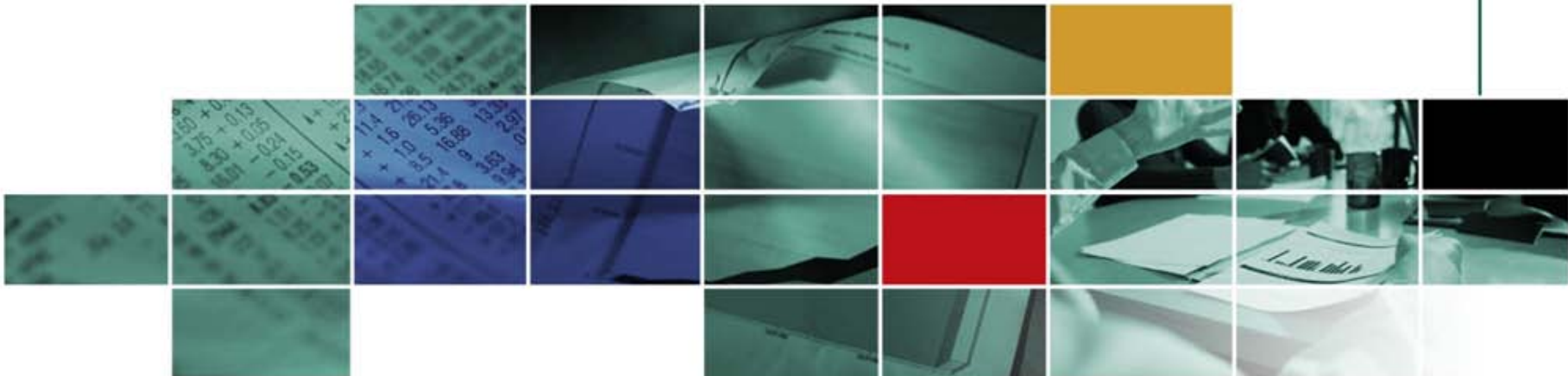
RVKuhns

▶▶▶ & ASSOCIATES, INC.

TMRS Investments Today and Tomorrow

Texas Municipal Retirement System

October 2009





Presentation Agenda

- I. **Introduction:** Laying the Foundation for Tomorrow
- II. **Historical Portfolio:** Why We Changed
- III. **Portfolio Construction:** How We Diversify
- IV. **TMRS Today:** Diversification in Progress
- V. **TMRS Tomorrow:** What's Next?



Introduction:

Laying the Foundation for Tomorrow



Diversification and Risk

Background and introduction:

- ▶ TMRS was invested in 100% bonds
 - ▶ Lacked diversification
 - ▶ Potentially insufficient return given long-term market dynamics
- ▶ Broad diversification and a long-term perspective can lead to higher returns without undue risk
 - ▶ Methodical and incremental approach to change
 - ▶ Diversification initiated in early 2008

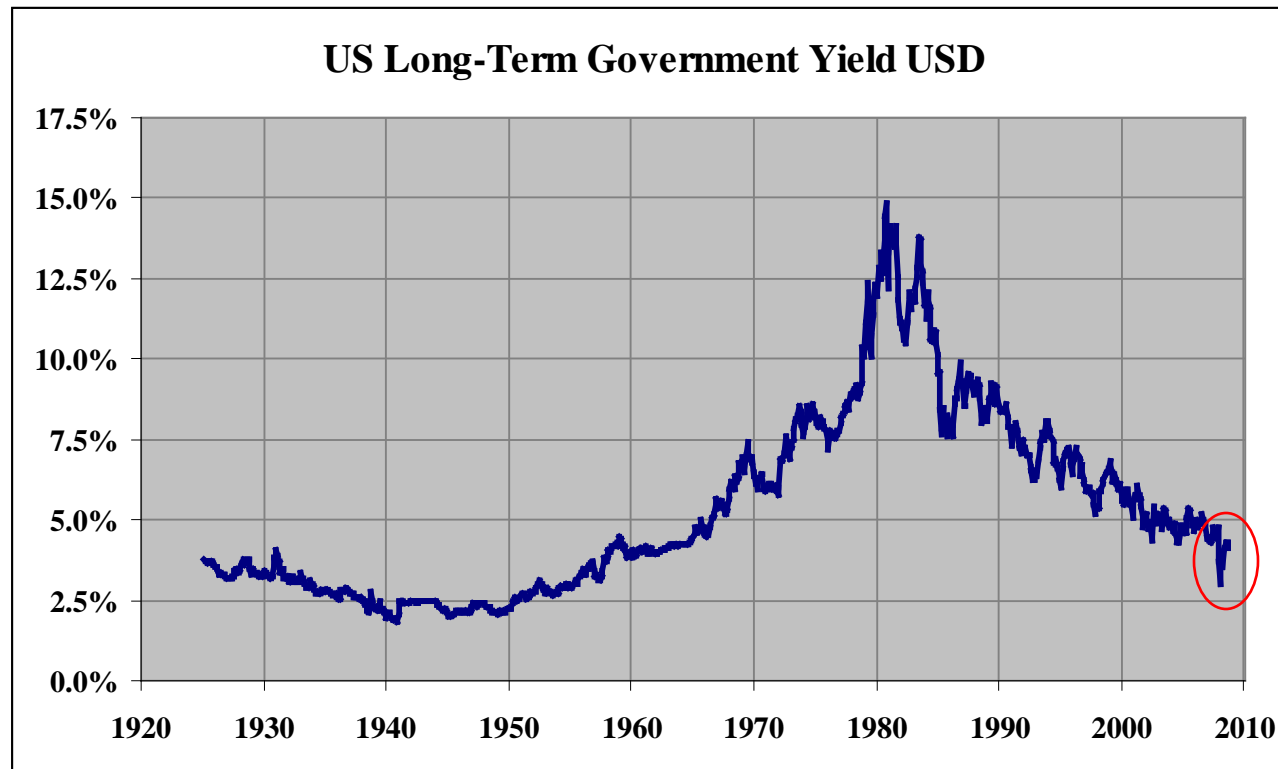


Historical Portfolio:

Why We Changed

Risk of Historical Status Quo

- ▶ Portfolio has held long-term bonds in a period of high and declining interest rates
- ▶ An unusual environment – How low can rates go?





Risk of Historical Status Quo

Results of initial analysis:

- ▶ The risks to the portfolio included a lack of diversification as well as significant interest rate exposure
- ▶ The impact of falling rates provided a tailwind for bond values, but posed reinvestment risk
- ▶ The impact of rising rates would be an erosion of the capital base for future investing and an end to surpluses that have been a source for benefit increases
- ▶ It was a strategy that worked well for many years
- ▶ However, market and participant dynamics required a change

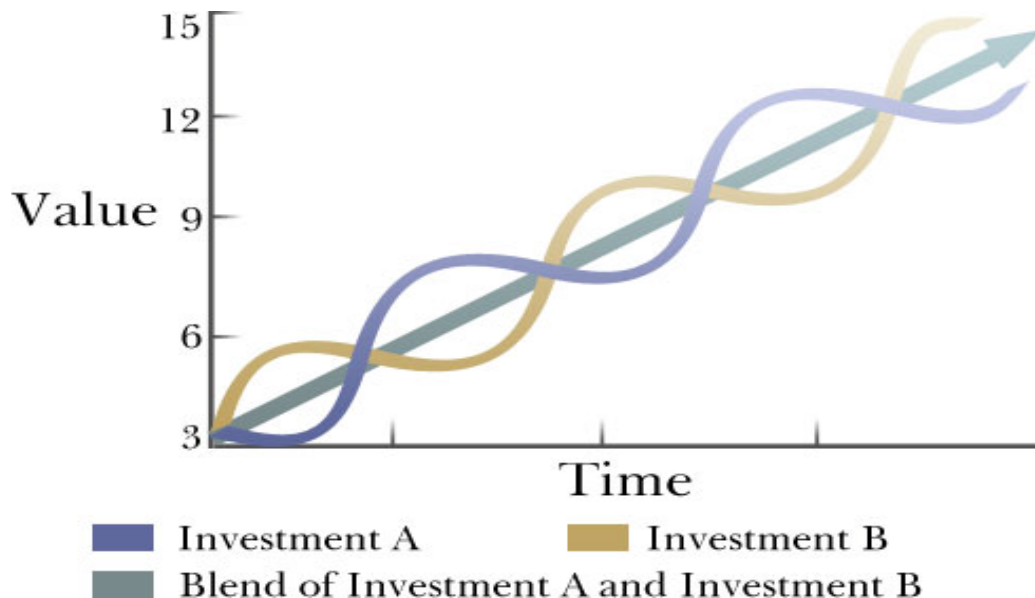


Portfolio Construction:

How We Diversify

Effects of Diversification

- ▶ We look to find asset classes that are subject to different influences and produce diverse return streams
- ▶ Using diverse asset classes provides a smoother return profile over time and allows for greater compounding – otherwise known as the benefit of **diversification**





Diversification - Asset Classes

- ▶ Traditional asset classes included in the current portfolio:
 - ▶ Stocks – U.S., non-U.S., small company, etc.
 - ▶ Bonds – Treasuries, Corporates, Mortgages, etc.
 - ▶ Cash – T-Bills, commercial paper, etc.

- ▶ Alternative asset classes for the future include:
 - ▶ Real Estate (private investment in debt and equity of commercial property)
 - ▶ Real Return (commodities, TIPS, etc.)
 - ▶ Absolute Return (hedge fund of funds)
 - ▶ Private Equity (venture capital, private debt financing, etc.)



TMRS Today:

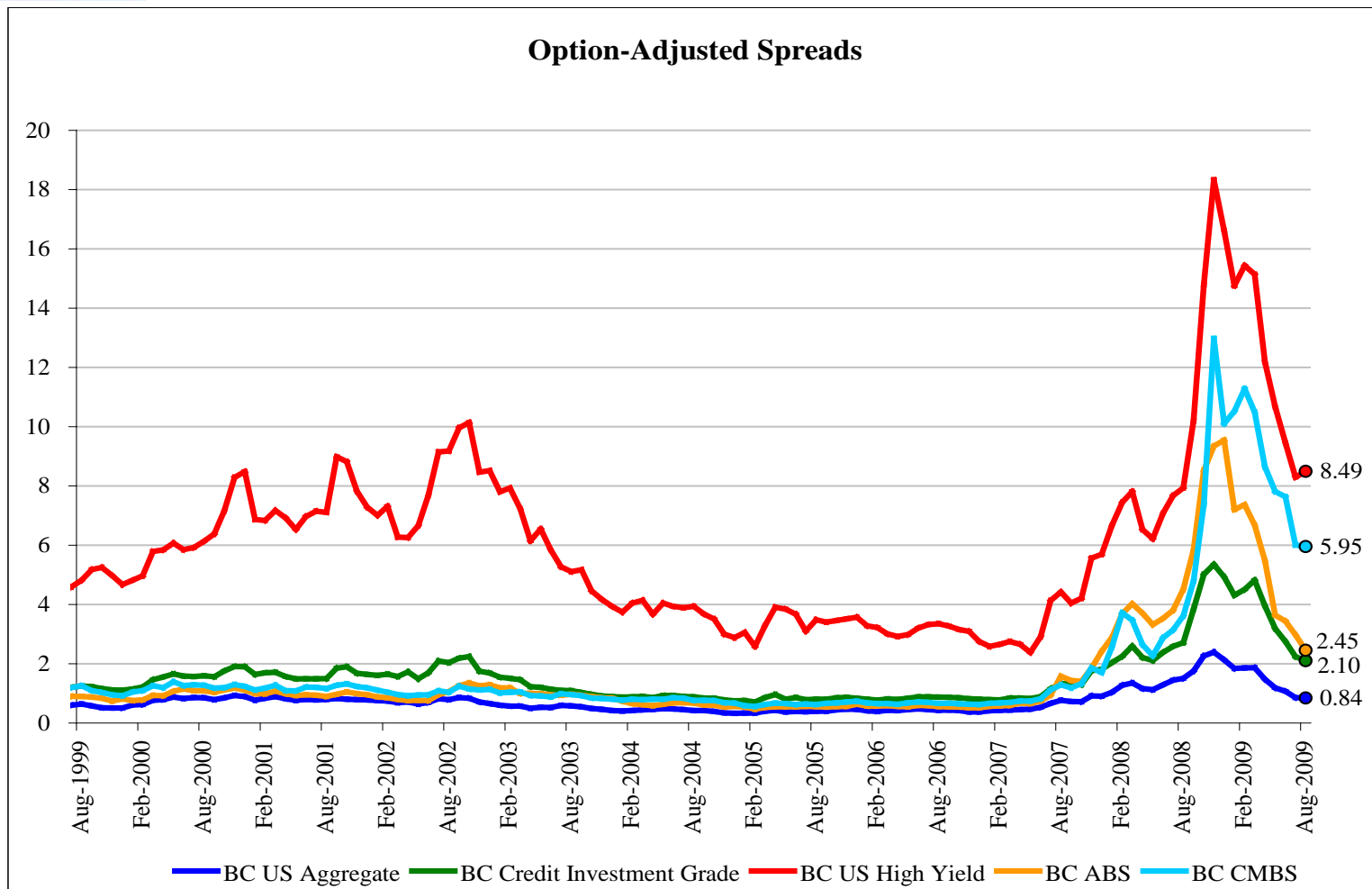
Diversification In Progress



Current Market Environment

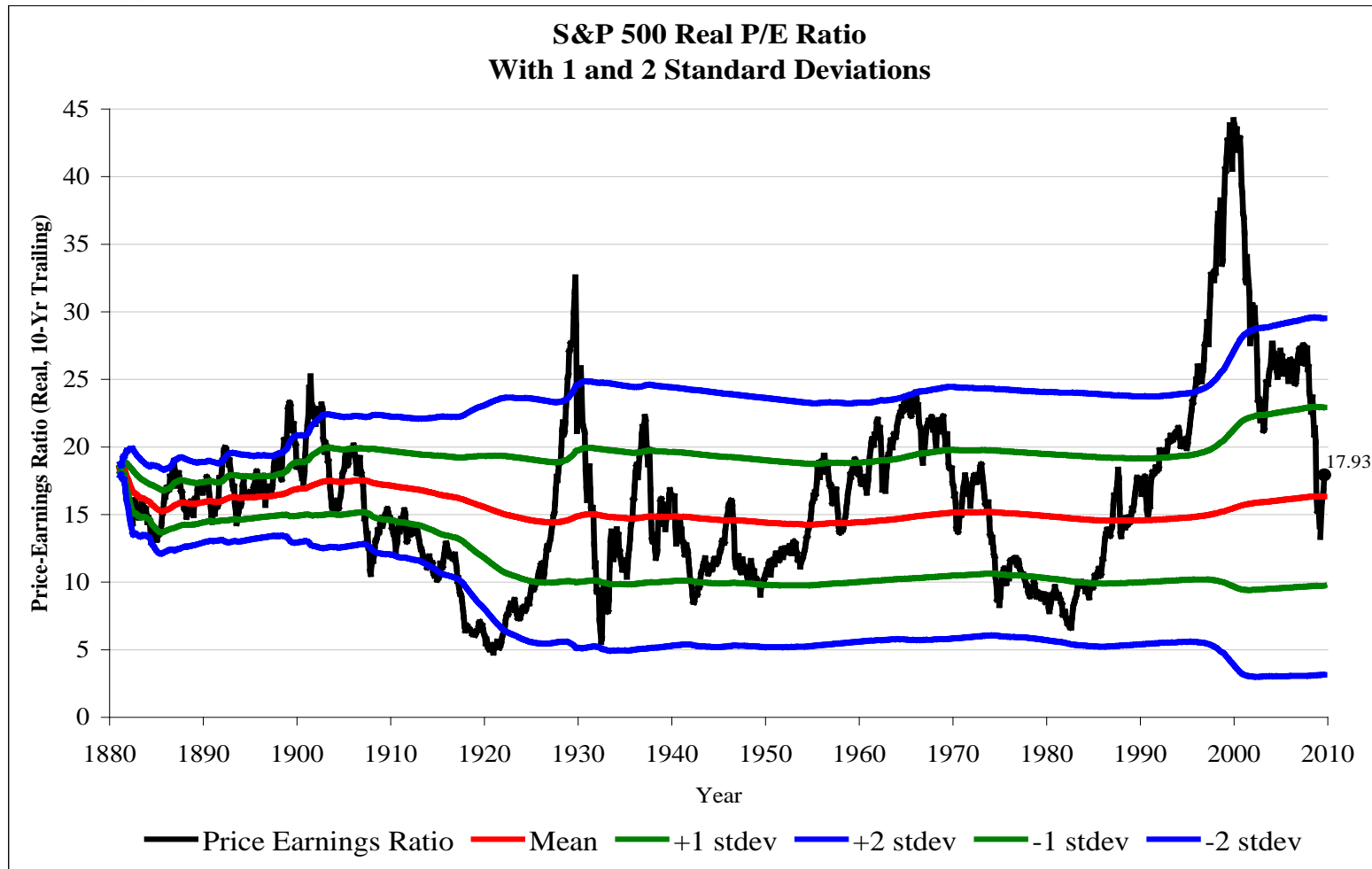
- ▶ Historic period in capital markets
 - ▶ TMRS original portfolio of high quality, long duration bonds were sold at an advantageous time
 - ▶ TMRS equity investments have been made in a period of high volatility and uncertainty, with relatively attractive valuations
- ▶ TMRS has weathered the storm well through implementing methodical change

Risky Assets Re-Priced, but Recovering



Basis point spreads are relative to Treasury securities (wider spread = cheaper price)
As of August 31, 2009.

Historical P/E Ratio Averages



The S&P P/E ratio is based on real historical 10-year earnings.
Estimated through August 31, 2009.



Recent Portfolio Events

- ▶ Domestic Equity has been added to the portfolio
 - ▶ Passive (indexed) exposure
 - ▶ Dollar cost averaging to minimize risk
 - ▶ 8% position as of 8/31/2009
- ▶ International Equity has been added to the portfolio
 - ▶ Passive (indexed) exposure
 - ▶ Developed countries only to date
 - ▶ Dollar cost averaging to minimize risk
 - ▶ 8% position as of 8/31/2009



Recent Portfolio Events

- ▶ Fixed income investments - interest rate risk has been reduced and portfolio has become more diversified
 - ▶ BlackRock managed the transition portfolio and is now managing to a more traditional core mandate
- ▶ Total return orientation
 - ▶ Legislative change from income only orientation occurred in June 2009
 - ▶ Allows for meeting plan objectives through broader diversification



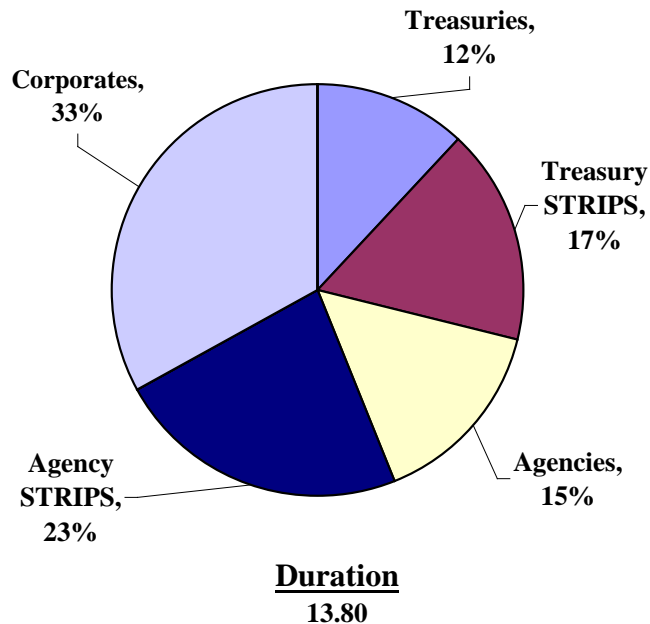
Recent Portfolio Events

- ▶ Core plus implementation underway
 - ▶ “Core plus” is the addition of non-index security types to the portfolio
 - ▶ High yield
 - ▶ Non-U.S. fixed income
 - ▶ Adding the “plus” sectors introduces moderate risk yet enhances returns and provides diversification
 - ▶ Core plus allocation is targeted to be 10% of the total portfolio
 - ▶ Two managers with different investment styles reduces manager risk
 - ▶ PIMCO and TCW
- ▶ The portfolio continues to be 100% externally advised by best in class fiduciaries
 - ▶ Each investment manager is hired through a process managed and executed in conjunction with TMRS staff

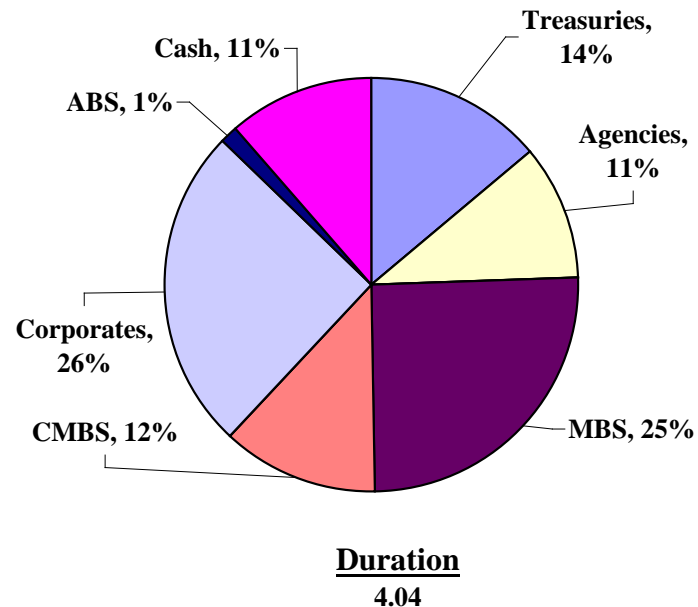
Recent Portfolio Events

- ▶ TMRS fixed income previous and current allocations
 - ▶ Additional sectors to diversify risk and maintain income
 - ▶ Shortened duration to reduce interest rate risk

TMRS May 22, 2008



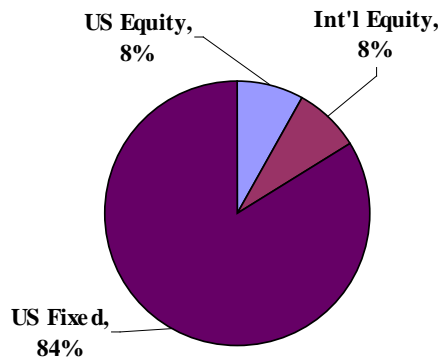
TMRS September 22, 2009



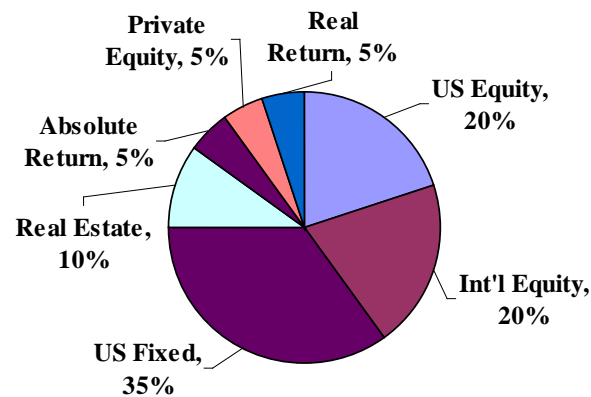
Recent Portfolio Events

- ▶ Current TMRS asset allocation (8/2009) and target allocation compared to the average public retirement fund asset allocation (12/2008)

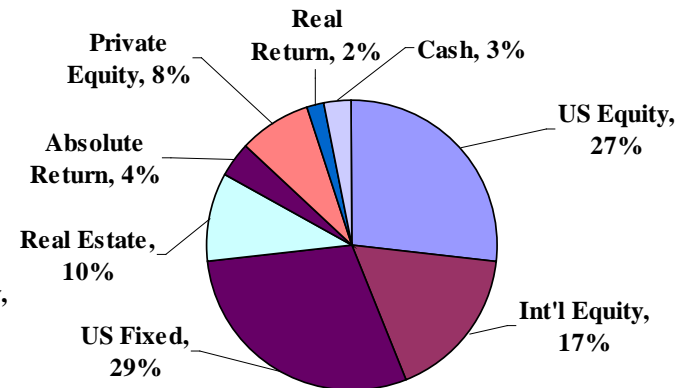
Current Allocation



Long-Term Allocation



Average Public Fund





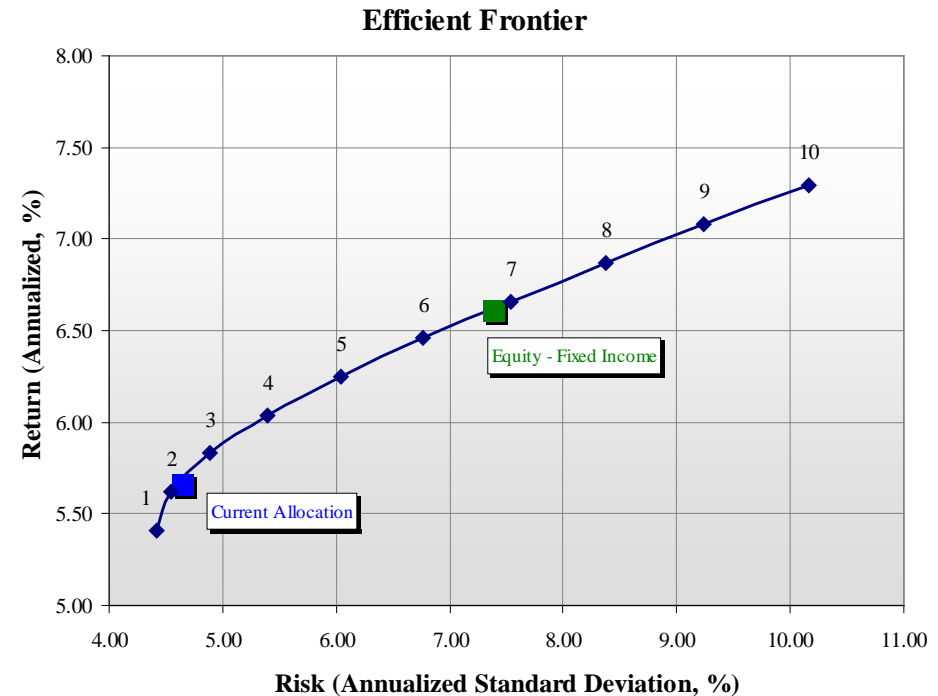
TMRS Tomorrow:

What's Next?

What's Next?

- ▶ Step 1 was a simple and long term plan to reach the actuarial return

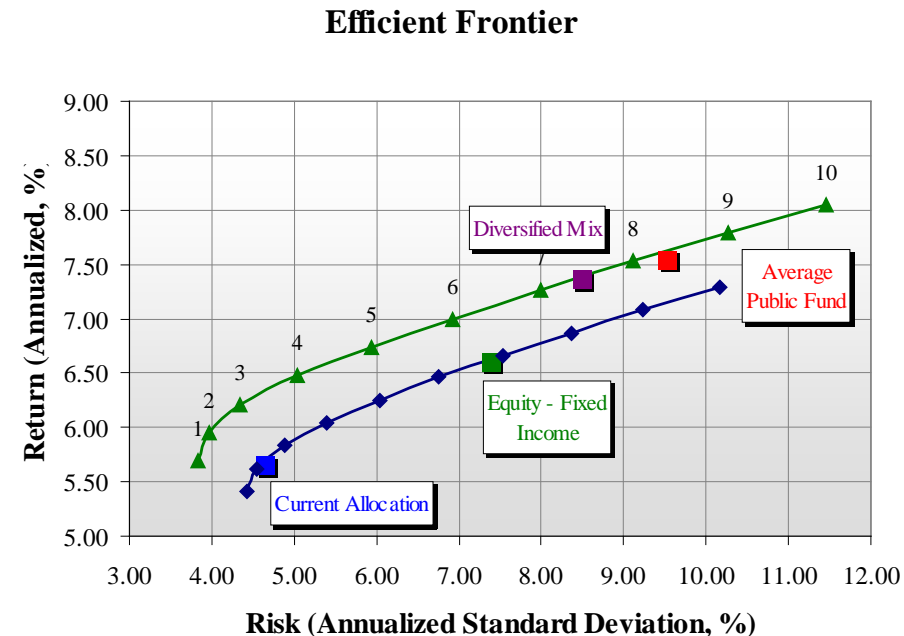
Asset Classes	Min	Max	Current Allocation	Equity - Fixed Income
Broad US Equity	0	30	6	20
Broad International Equity	0	30	6	20
US Core Fixed Income	0	100	88	60
Total			100	100
Total Equity	0	60	12	40
Return			5.66	6.61
Risk (1 Year Holding Period)			4.65	7.38



What's Next?

- ▶ The long-term portfolio will be more diversified and similar to peers, yet unique to 'TMRS' risk tolerance and return objectives
- ▶ Many steps along the way, slow and methodical

Asset Classes	Min	Max	Current Allocation	Equity - Fixed Income	Diversified Mix	Average Public Fund
Cash Equivalents	0	0	0	0	0	3
Broad US Equity	0	30	6	20	20	27
Broad International Equity	0	30	6	20	20	17
US Core Fixed Income	0	100	88	60	35	29
Real Estate - Core	0	10	0	0	10	10
Real Return	0	5	0	0	5	4
Private Equity	0	5	0	0	5	8
Absolute Return	0	5	0	0	5	2
Total			100	100	100	100
Total Equity	0	60	12	40	40	44
Return			5.66	6.61	7.37	7.55
Risk (1 Year Holding Period)			4.65	7.38	8.48	9.52





Fixed Income – Timeline

- ▶ **Fixed income diversification:**

- ▶ Additional sub-asset classes within fixed income offer potential diversification benefits and enhanced returns to the fixed income allocation as well as overall portfolio. The role of fixed income as deflation hedge, anchor to safety, or need for income will be considered.

- ▶ Core plus fixed income manager search initiated: Jun 2009
- ▶ Managers interviewed and selected: Sep 2009
- ▶ Introduction to non-U.S. and EM fixed income: 2010
- ▶ Passive core fixed income fund: 2011
- ▶ High yield fixed income: 2012



Equity – Timeline

- ▶ **Equity diversification:**

- ▶ Continuation of additional allocation increase to U.S. and international equity by approximately 1.5% per month
- ▶ Further diversification within equity portfolio by introducing additional sub-asset classes

- ▶ International small cap and emerging markets: 2010
- ▶ Structure and implementation recommendation: 2010
- ▶ Manager recommendations and selections: 2010



Real Estate – Timeline

- ▶ **Real estate:**

- ▶ Real estate provides an alternative source of income and is often used as a substitute for fixed income. The nature of direct ownership of core properties can range in expected returns and volatility.

- ▶ Real estate education and discussion: Sep 2009
- ▶ Real estate consultant selection: Feb-Mar 2010
- ▶ Potential implementation: 2010-2013



Alternative Investments – Timeline

- ▶ **Alternative investments:**

- ▶ Alternative investments, with low correlation to traditional asset classes, are typically utilized by investors to further increase returns and decrease portfolio volatility. Other risks besides volatility will be discussed.

- ▶ Real return educational presentation: 2010-2011
- ▶ Private equity educational presentation: 2010-2011
- ▶ Absolute return educational presentation: 2010-2011
- ▶ Potential manager recommendations and selections: 2011-2013



Summary

- ▶ **Continue progress toward optimal diversification in an incremental manner**
 - ▶ Continue to increase and diversify equity allocation
 - ▶ 2009 current exposures increased
 - ▶ 2010 consider adding non-U.S. small cap and emerging markets exposures
 - ▶ Continue to diversify fixed income allocation
 - ▶ 2009 implement core plus mandate (including exposure to high yield and non-U.S.)
 - ▶ 2010 continue to diversify fixed income
 - ▶ Introduce real estate allocation
 - ▶ 2010 seek real estate consultant
 - ▶ 2010 real estate manager searches
 - ▶ Introduce real return allocation
 - ▶ 2010 introduce TIPS or commodities



Questions?

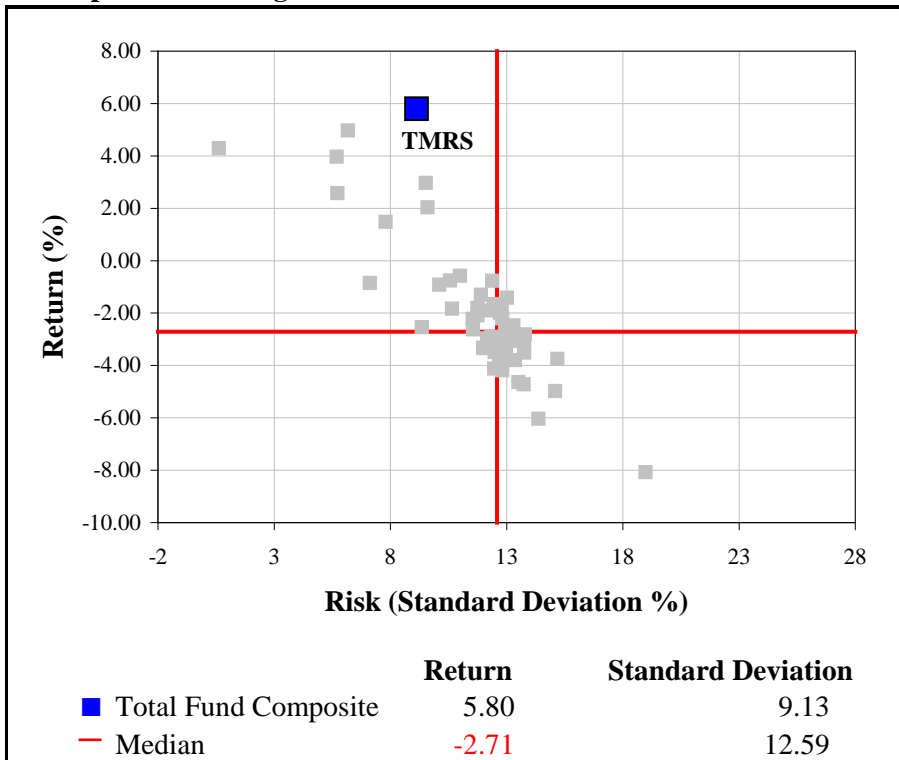


Appendix

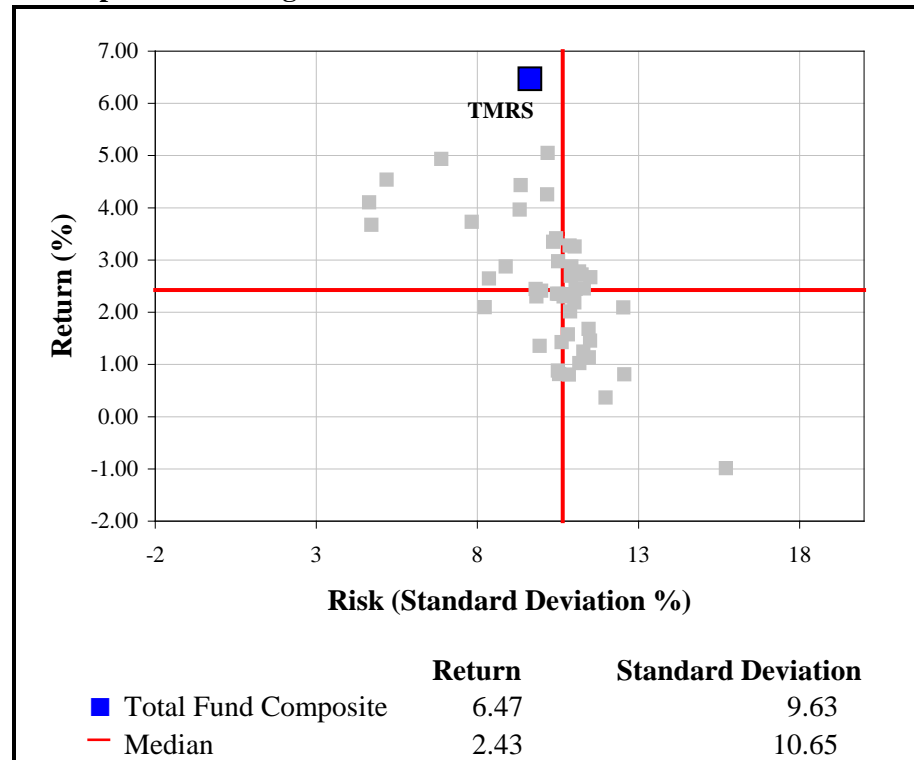
Public Fund Comparison June 30th 2009

- ▶ 3 & 5 year risk and return profile compared to peers as of June 30, 2009

Plan Sponsor Scattergram - 3 Years



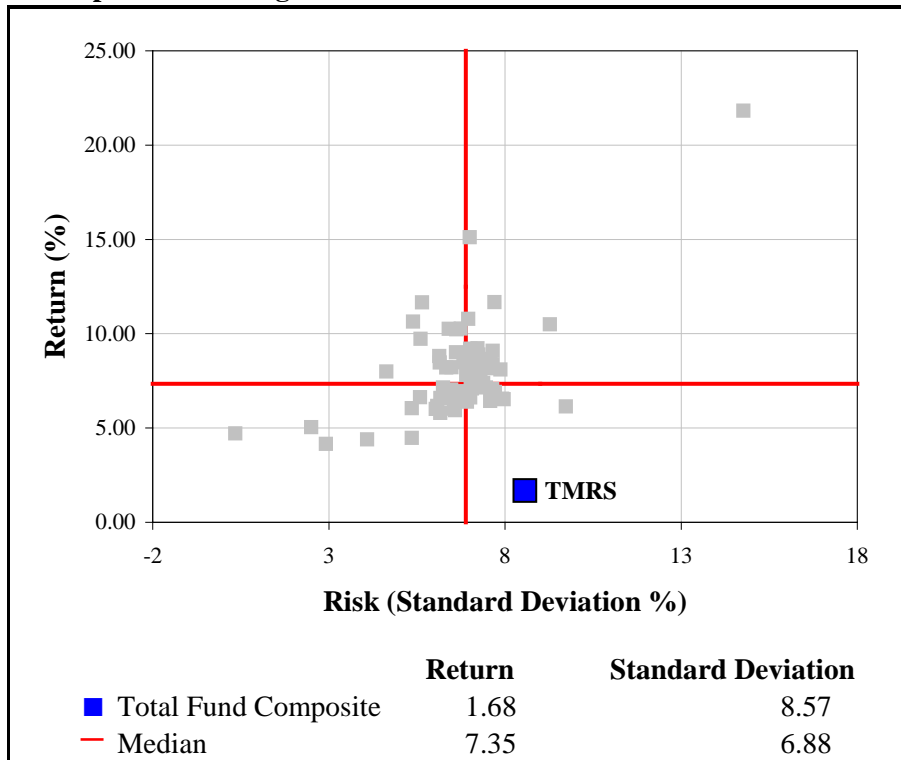
Plan Sponsor Scattergram - 5 Years



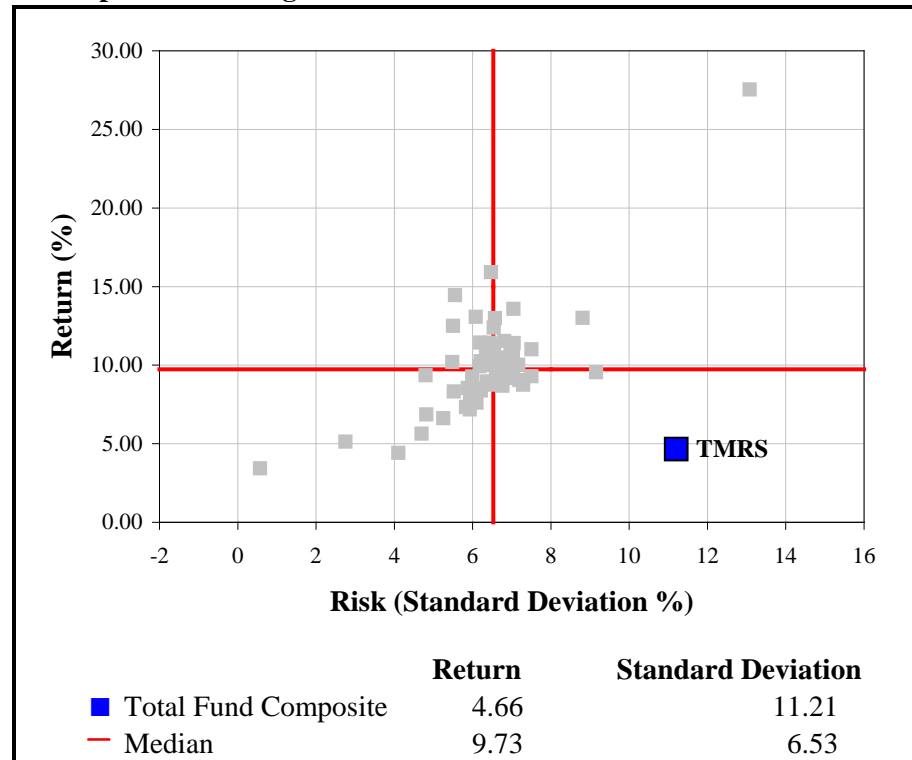
Public Fund Comparison June 30th 2008

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Plan Sponsor Scattergram - 3 Years



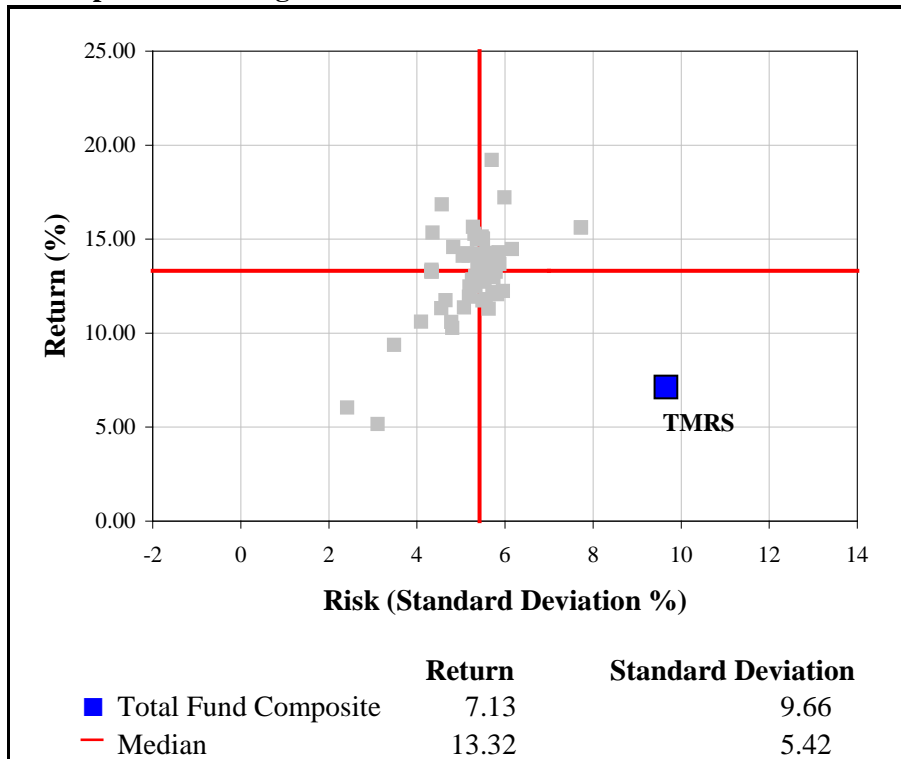
Plan Sponsor Scattergram - 5 Years



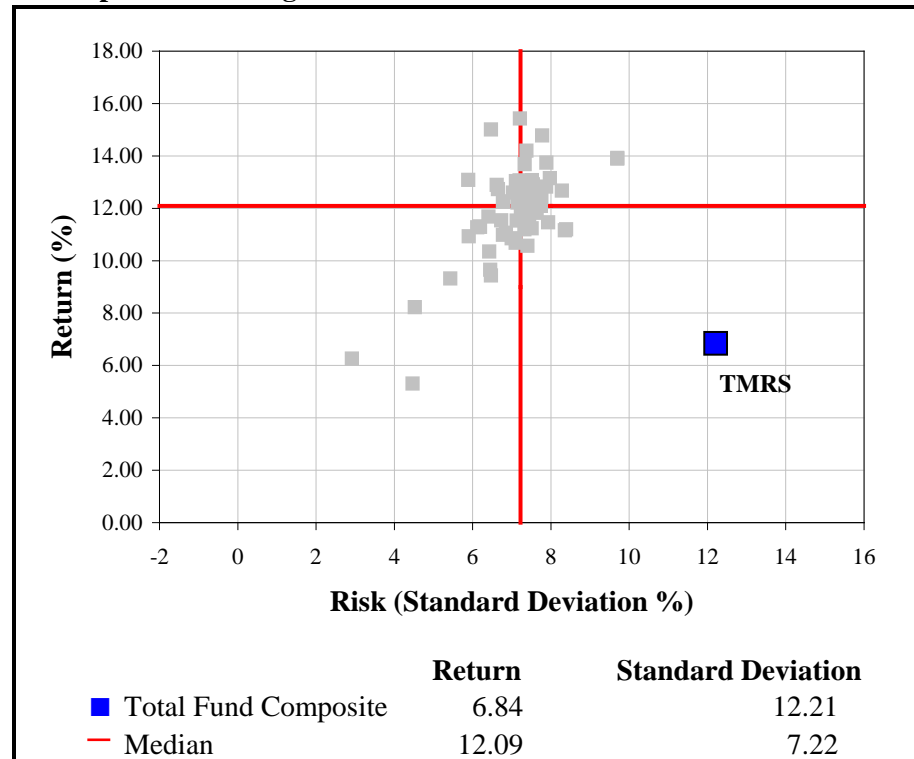
Public Fund Comparison June 30th 2007

- ▶ 3 & 5 year risk and return profile compared to peers as of June 30, 2007

Plan Sponsor Scattergram - 3 Years



Plan Sponsor Scattergram - 5 Years





Public Fund Comparison

- ▶ 3 & 5 year Sharpe Ratio compared to peers ending June 2009, 2008, and 2007

Sharpe Ratio

	as of 6/2009		as of 6/2008		as of 6/2007	
	3 - Years	5 - Years	3 - Years	5 - Years	3 - Years	5 - Years
Total Fund Composite	0.32 (2)	0.37 (1)	-0.25 (100)	0.19 (100)	0.38 (100)	0.38 (100)
Median	-0.40	-0.02	0.41	0.92	1.54	1.20

* Parentheses contain percentile ranks.

Sharpe Ratio - Represents the excess rate of return over the risk-free return, divided by the standard deviation of the excess return. The result is the absolute rate of return per unit of risk. The higher the value, the better the product's historical risk-adjusted performance.