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

October 12, 2011 – 1:30 p.m.

On October 12, 2011, the Board of Trustees of the Texas Municipal Retirement System (TMRS) convened for a special meeting at 1:30 p.m. at Hilton Americas Houston, 1600 Lamar, Houston, Texas, with the following members present:

Board of Trustees
April Nixon, Chair
Frank Simpson, Vice Chair *(arrived at 1:41 p.m.)*
Julie Oakley
Jim Parrish
Roel ("Roy") Rodriguez

Absent: Ben Gorzell

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
Debbie Munoz, Director of Member Services
Dev Outlaw, Director of Fixed Income
Kristin Qualls, Assistant Investment Officer for Equities
Bill Wallace, Director of Communications
Dan Wattles, Director of Governmental Relations
Scott Willrich, Director of Information Resources
Mark Randall, Gabriel Roeder Smith & Company
Todd Shupp, R.V. Kuhns & Associates, Inc.
Jeremy Miller, R. V. Kuhns & Associates, Inc.

Also in attendance: Don Byrne, Texas Municipal Human Resources Association
Greg Vick, Texas City Managers Association

Ms. Nixon called the meeting to order at 1:31 p.m. and also gave the invocation.

1. **Consider and Act on Adoption of Minutes from the September 21-22, 2011 Regular Meeting of the Board**

   Ms. Nixon introduced this item and asked if there were any questions or revisions to the Minutes. As there were none, Ms. Oakley moved that the Minutes be adopted as presented. Mr. Parrish seconded the motion, which passed unanimously.

2. **BlackRock Annual Manager Review**

   Mr. Gavia introduced this item and stated that this is the first investment manager review that has been presented to the Board. He summarized the due diligence review process and then introduced Mr. Outlaw to begin his presentation.

   Mr. Outlaw began his presentation by stating that the Investment Policy Statement (IPS) requires periodic review of the Core Fixed Income Manager. He provided a brief summary of the investment manager mandate, the review process, the conclusions of the review, and staff's recommendation to place BlackRock on a "watch list." He reported that he worked closely with R. V. Kuhns on this review and they concur with the findings in this review, the conclusions and staff's recommendation. He reviewed the magnitude of the Core Fixed Income portfolio and reminded the Board that BlackRock is the only manager of TMRS' core fixed income strategy. He discussed the manager monitoring and assessment process.

   Mr. Outlaw then began to discuss the conclusions of the review and staff's recommendations. He indicated that there are three (3) areas of concern. While these areas of concern do not rise to the level of terminating the manager, they do merit further review. The first area of concern is the loss of key personnel since 2010, and Mr. Outlaw summarized some of these personnel changes. The second area of concern is BlackRock's loss of clients. A third area of concern is their composite investment performance. Mr. Outlaw commented that although there has not been enough time to calculate TMRS specific performance, the composite performance can be used as a proxy.

   Mr. Outlaw then reviewed BlackRock's value added benefits, which included their size and strength, organizational breadth, strong global reach, exceptional risk management process, best practice trade execution and low fees.

   Mr. Outlaw explained what it means to be placed on a watch list and summarized the actions that need to occur in order for BlackRock to be removed from the watch list. He indicated that staff will continue to monitor the situation and will report back to the Board. Mr. Rodriguez asked if failure to improve in any one area would keep BlackRock on the watch list. Mr. Outlaw answered affirmatively and commented that continued deterioration could result in a change in staff's recommendation. Mr. Simpson asked about the duration of the BlackRock portfolio. Mr. Outlaw replied that it is about 5.11 and is neutral to the benchmark. Ms. Goerdel added that it is managing relative to the index.

   Mr. Outlaw also reported that the entire fixed income strategy is currently being reviewed, the outcome of which may impact the BlackRock mandate. Ms. Goerdel thanked Mr. Outlaw and R. V. Kuhns for their in depth work on the manager review.

3. **Northern Trust Global Investments Annual Manager Review**

Mr. Gavia introduced this agenda item and informed the Board that this is staff's first presentation of the annual review of Northern Trust Global Investments (NTGI), although this is the third review conducted by the Investment staff of NTGI overall. He then introduced Ms. Qualls to present the annual manager review. Ms. Qualls gave an overview of the NTGI and TMRS relationship which began when TMRS first began diversifying into equity investments, and she highlighted key changes in the relationship that have occurred since that time. She gave a high level review of the due diligence process per TMRS' Investment Policy Statement, reviewed the normal oversight responsibilities, and summarized the review team's conclusions under the categories of People, Process, Philosophy, Portfolio, Performance and Passion. Ms. Qualls then reviewed NTGI's investment process along with personnel changes within the portfolio management team. Additionally, Ms. Qualls reviewed the domestic and the international mandates, along with the rebalancing activities under each mandate that took place in 2011. She discussed trade execution, risk management and compliance. Ms. Qualls reviewed NTGI's performance through August 31, 2011 and provided preliminary performance through September 30, 2011. She discussed past issues that TMRS staff has had on the client service side of the relationship and she contrasted that with the 2011 relationship improvements that have occurred since then and she highlighted the strong positives that exist in the relationship today. She presented a summary of the review process and compared the 2010 due diligence visit with the 2011 due diligence visit.

Without further consideration of future asset class structure changes and/or manager diversification, she concluded with the recommendation that NTGI be retained as manager on the passive equity mandates. She also informed the Board that the presentation's appendix included NTGI's annual report card, executive memos from Ms. Qualls and RVK staff detailing the annual comprehensive review as well as a copy of the most recent quarterly service description document with NTGI. Ms. Goerdel commended Ms. Qualls and R. V. Kuhns for their in depth work on this manager review.

4. **Educational Session: Introduction to Absolute Return Strategies**

Mr. Gavia introduced Mr. Shupp and Mr. Miller from R. V. Kuhns & Associates, Inc., to provide an educational session for the Board on the Absolute Return asset class. Ms. Goerdel highlighted Mr. Shupp's qualifications in the area of Absolute Return.

Mr. Miller began the presentation by stating that this is the first part of the three part educational session on Absolute Return and he briefly discussed the timeline for further education. Ms. Goerdel explained how the three different education pieces would be structured. Mr. Miller discussed how this asset class fits into the current and target portfolios. He explained that the TMRS strategy is designed so that as asset classes are added, more return is generated without adding risk. He reviewed asset allocation assumptions and discussed setting expectations for Absolute Return. He also reviewed the index and how that filters into returns. He discussed Absolute Return Strategy (ARS) as having attractive correlations and risk adjusted returns over the long-term. He illustrated the hypothetical outcomes of the target allocation in past market environments.

Mr. Shupp began the discussion of the asset class itself. Mr. Shupp stated that ARS can have a significant impact on the expected risk/return profile of a portfolio, even with a relatively small allocation. It is a diverse strategy, not easily painted with one brush stroke. He discussed the typical fund legal structure, complexity of the strategy and regulation. He explained that this is a skill-based strategy with a fairly unique fee structure. He covered the unique risks of ARS including: liquidity issues; lower volatility in certain strategies not an indication of lower risk; less transparency; asset control risk; headline risk; counter party risk; and regulatory risk. There was a brief discussion on the transparency issues.

Mr. Shupp next discussed Hedge Fund Management fees. He further discussed that additional costs depend on the implementation approach that is selected. He briefly reviewed some examples.

Mr. Shupp then discussed performance characteristics and mentioned that the Hedge Fund Net Fund of Funds (HFN FOF) Index is a reasonable baseline to benchmark risk and return characteristics of absolute return strategies, and multi-strategy fund of funds is a common approach to investing in absolute return strategies.

In closing, Mr. Shupp reviewed the advantages and disadvantages of the asset class. He determined that ARS are appropriate for plan inclusion but requires conducting an in-depth review of the asset class. He discussed fiduciary duties such as sourcing; adequate diversification; effective process for monitoring performance; exit strategy; and cost effectiveness. Ms. Goerdel said that there must be a good exit process in place, along with good governance structure and a good implementation approach and that TMRS will need to incorporate those into any decision to move forward with this asset class.

Mr. Gavia and Ms. Goerdel briefly reviewed the educational session timeline going forward.

5. **Review and Discuss 2012 Preliminary Operating Budget**

Mr. Gavia introduced Ms. Covarrubias and Mr. Willrich to give the 2012 preliminary operating budget presentation. Ms. Covarrubias discussed how the budget matches up with the objectives in the Strategic Plan. She briefly reviewed each goal and highlighted budget requests designed to meet each goal. She stated that the Absolute Return Strategy may necessitate a budget amendment during 2012. She reviewed the System's accomplishments during 2011. She reported that, with the new items included, the proposed 2012 budget is 10% greater than the 2011 budget. Without the new items, the 2012 budget would only be 2.8% larger.

Ms. Covarrubias then began a section by section review of the budget. She mentioned changes in Personnel Services, including three new position requests. She discussed Professional Services, including business continuity testing, an ISO 27000 security assessment, actuarial fees and audit fees. She reviewed the Communications Section, which was basically unchanged from 2011 to 2012 proposed. She pointed out that Rentals and Equipment is increasing due to IT projects. The Miscellaneous Section is increasing due to increased funds for the risk management system and three proposed IT projects. Capital

Expenditures is also increasing due to the three proposed projects: phone system replacement, virtual server infrastructure replacement and virtual desktop PC replacement. Ms. Covarrubias then discussed in more detail the new personnel requests.

The major new projects were presented by Mr. Willrich. He began with the phone system replacement. He highlighted the call reporting features and redundant features of a new system. He pointed out that the current system is running on a Windows 2000 operating system which cannot be updated. He stated that changing to a unified communications system will meet our current needs. He pointed out that about 20% of the costs were "soft costs" with the remaining 80% being capital costs.

He then moved to the Virtual Server Infrastructure Replacement project. He reported that the current infrastructure is at the end of the manufacture's recommended life, and he highlighted the advantages of replacement, including four years worth of hardware and software support. He reported that the current infrastructure will not be supported after April 2013.

Next, he discussed the PC Replacement project. He reported that most of our current PCs are running on Windows XP, which cannot easily be updated to the Windows 7 operating system. Instead of buying separate PC's, Mr. Willrich recommended purchasing a virtual PC, as the cost of virtualization versus actual purchase of PCs is fairly close.

Ms. Oakley asked for a forecast for 2013. Mr. Willrich stated that from an IT perspective, there should be no major purchases for the next 2-3 years. In 2016, he said he would again ask to replace the virtual server infrastructure, but other than that, there should be no major requests from IT.

6. **Update on GASB Exposure Drafts on Pension Accounting and Financial Reporting**
Mr. Randall and Ms. Hardy gave an update on the impact of the GASB Exposure Drafts. Mr. Randall began his presentation by discussing the background of the Exposure Drafts (EDs) issued in 2011. He outlined the deliberative process that lead to the issuance of the EDs. He stated that GASB's authority extends to accounting and financial reporting, but not to actuarial valuations for funding purposes. He mentioned that the implementation timeline is one troubling factor; it could be just a few months after the final standards are issued.

Mr. Randall reported that the EDs would significantly change current pension accounting and financial reporting standards for state and local governments. There is a disconnect between accounting measures and pension funding measures. The EDs will require employers to recognize an unfunded pension obligation on their balance sheets. It also requires employers to recognize a new measure of the pension expense on their income statements, which would be significantly different from their actuarially determined contributions. In addition, it will replace most of the current note disclosures and required supplementary information (RSI) based on the new measures.

Mr. Randall then moved to the new standards. The new standard will be to disclose a Net Pension Liability (NPL). He defined this NPL, stating that it will have to be calculated on an Entry Age Normal (EAN) basis, while funding will be based on Projected Unit Credit (PUC).

In calculating the NPL, a different discounting method may need to be used. A new Pension Expense will have to be reported and Mr. Randall explained the key components thereof. He discussed items that would have to have immediate recognition, and those that would have deferred recognition. The employers' reporting will be as of the employers' fiscal year end, not the plans' year end. This requires a roll forward from December 31 and requires a monthly allocation of total trust assets to employers on market value basis. This places an administrative burden on the plan to provide required information in a timely manner.

Ms. Hardy discussed how TMRS is going to have a big change in how we provide data, as ten out of the twelve months have city fiscal year ends. So, there will be many challenges in delivering data to cities.

Mr. Randall commented that there will basically be two sets of numbers: one based on EAN and the funding based on PUC. There will be a disconnect between accounting and funding which is going to lead to confusion. The NPL will be volatile as a result of changes in the market value of assets. Public hearings have already begun. With respect to the implementation date, the June 30, 2014 fiscal year end cities will be the first to be affected. Ms. Hardy added that the TMRS comment letter focuses on TMRS issues for an agency multiple employer plan, and extending the implementation date out one year.

7. **Executive Session**

At 4:54 p.m., the Board entered into Executive Session, pursuant to Texas Government Code §§551.071 and 551.074 to consult with Legal Counsel to receive legal advice, and to discuss personnel matters. No action was taken during the Executive Session and the meeting was opened to the public again at 5:19 p.m. All members of the Board who had been present when the Board went into Executive Session were again present.

The meeting was adjourned at 5:19 p.m.

David Gavia
Executive Director

April Nixon
Chair, Board of Trustees