

Investment



RVKuhns

▶▶▶ & ASSOCIATES, INC.

April 26, 2010

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 has been marked by generally negative performance of the U.S. economy, with turbulent investment markets and mild inflation expectations. U.S. Gross Domestic Product was positive in two of the last four quarters as the economy expanded by 0.3% in 2009.¹ The economy shed approximately 2.75 million jobs from nonfarm payrolls as the unemployment rate rose from 7.4% to 10.0% during the year.² Inflation, as measured by the Consumer Price Index, rose 2.7% during the year. The Federal Reserve kept short-term interest rates steady at a range of 0.00% – 0.25% over the course of the fiscal year, and Treasury yields rose across their range of maturities greater than one year, while falling for maturities less than one year.

The year 2009 exhibited positive returns for nearly every market segment with only private real estate performing negatively for the year. Almost all other market segments posted positive returns with the best performance coming from risk oriented asset classes such as emerging market equities and high yield fixed income. In the United States, the S&P 500 Index returned 26.5%. International developed markets fared even better, returning 31.8% (as measured by the MSCI EAFE Index). Fixed income securities returned 5.9% (Barclays Capital 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 \$14.472 billion to \$15.962 billion in the year ended December 31, 2009.³ 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 10.2% and the System's three-year annualized return was 5.5%. The five-year annualized return for the System was 5.5% and the System's ten-year annualized return was 8.8%. While the three and five year return levels are low in absolute amounts, they represent 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 the global debt and equity markets. We believe these investment allocations are consistent with both investment policy guidelines and the unique legal statutes that govern TMRS.

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

³ As reported by TMRS' custodian State Street Bank & Trust

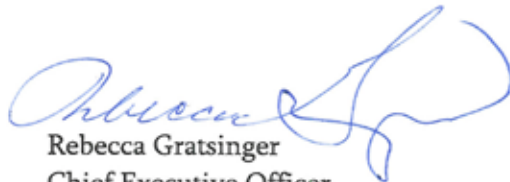
Over the last year TMRS has continued to move in a methodical manner to diversify the portfolio and reduce risk. The equity portfolio has been built up to the current allocation levels through ongoing regularly planned monthly contributions that diversify the risk of timing the transition out of bonds and into equities. The fixed income allocation has been further diversified to include small allocations to non-U.S. and below investment grade debt. 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.

The System's investment policies, goals, and objectives, as well as the performance of its assets and transaction costs are regularly monitored by TMRS staff, the Board, and by R.V. Kuhns & Associates. 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. Market values and returns referenced above are based upon financial statements prepared by State Street. Their statements are, to the best of our knowledge, reliable.

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
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 volatility is the asset allocation decision. The Board's asset allocation policy 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 target asset 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 • Targets			
Asset Class	Minimum %	Target %	Maximum %
Domestic Equities	12%	20%	25%
International Equities	12%	20%	25%
Fixed Income	30%	35%	69%
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%

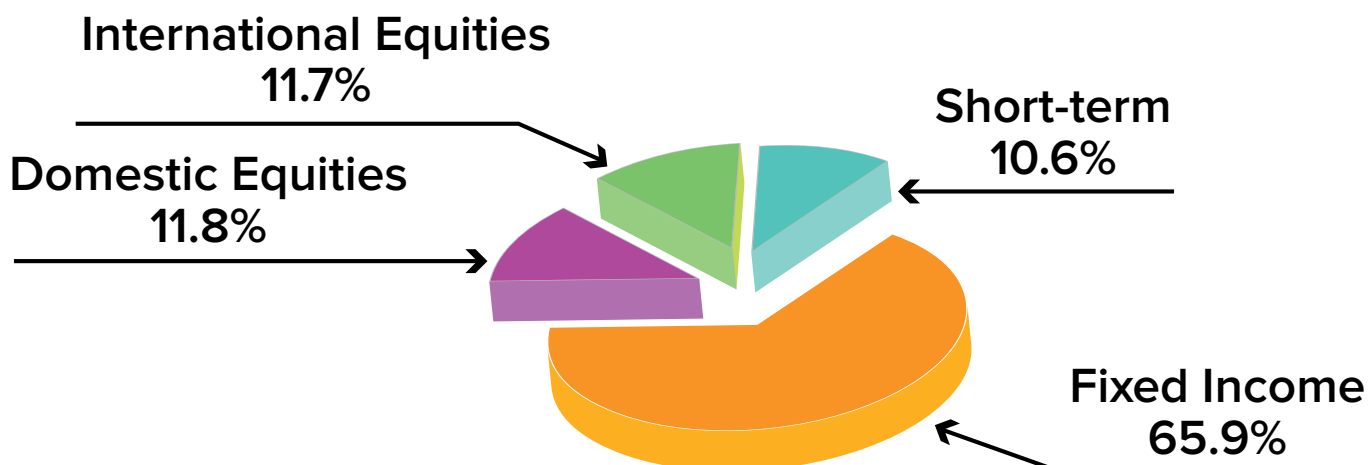
The Board will authorize implementation of these targets in stages. The target allocation will be reviewed at least annually for reasonableness relative to significant economic and market changes or to changes in the Board's long-term goals and objectives. A formal asset allocation study will be conducted at least every three years to verify or amend the targets, and an asset-liability study will be completed 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, 2009		As of December 31, 2008	
	Fair Value	Percent of Total Fair Value	Fair Value	Percent of Total Fair Value
Short-term investments	\$1,686,021,548	10.6 %	\$129,962,439	0.9 %
Fixed Income Securities				
U.S. Treasury bonds/notes	1,440,239,925	9.0	-	-
U.S. government agency	672,287,096	4.2	2,202,622,989	15.2
U.S. government agency mortgage-backed	2,602,446,345	16.3	3,316,586,406	22.9
State/local government	225,792,991	1.4	397,207,337	2.7
Corporate	4,418,430,749	27.7	5,128,363,437	35.4
Commercial mortgage-backed	996,804,645	6.2	1,558,046,237	10.8
Other asset-backed	92,741,388	0.6	-	-
Foreign government	74,167,096	0.5	-	-
Total fixed income securities	10,522,910,235	65.9	12,602,826,406	87.0
Equity Index Funds				
Domestic	1,887,886,605	11.8	876,208,203	6.1
International	1,865,025,351	11.7	863,179,543	6.0
Total equity index funds	3,752,911,956	23.5	1,739,387,746	12.1
TOTAL INVESTMENTS	\$15,961,843,739	100.0 %	\$14,472,176,591	100.0 %

Asset Allocation



Largest Holdings (by Fair Value)

Fixed Income Securities • As of December 31, 2009

Par Value	Description	Fair Value
\$ 367,825,000	U.S. Treasury Note - 3.375%, due 11/15/19, Rating AAA	\$ 353,803,511
334,725,000	U.S. Treasury Bond - 4.5%, due 8/15/39, Rating AAA	327,140,132
260,470,000	U.S. Treasury Bond - 4.25%, due 5/15/39, Rating AAA	244,354,721
222,466,239	FNMA Pool 995736 - 5.5%, due 5/1/39, Rating AAA	233,820,916
210,450,000	Fannie Mae - 3.0%, due 9/16/14, Rating AAA	213,145,865
206,790,000	General Electric Capital Corp - 2.0%, due 9/28/12, Rating AAA	207,056,759
163,881,556	FNMA Pool 555421 - 5.0%, due 5/1/33, Rating AAA	168,858,639
159,961,877	Federal Home Loan PC Pool G04232 - 5.5%, due 3/01/38, Rating AAA	167,742,423
137,918,000	General Electric Capital Svcs - 7.5%, due 8/21/35, Rating AA2	149,540,350
144,640,696	Federal Home Loan PC Pool G02086 - 5.0%, due 2/01/36, Rating AAA	148,603,851

Equity Index Funds • As of December 31, 2009

Shares/Units	Description	Fair Value
134,295,942.17	NTGI - QM Collective Daily Russell 3000 Index Fund - Non Lending	\$ 1,851,000,971
9,341,013.33	NTGI - QM Collective Daily EAFE Index Fund - Non Lending	1,830,446,290
56,471.98	NTGI - QM Collective Daily Russell 3000 Index Fund - Lending	36,885,634
100,621.44	NTGI - QM Collective Daily EAFE Index Fund - Lending	34,579,061

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.

	1 Year	3 Years	5 Years	10 Years
TMRS Total Return	10.2%	5.5%	5.5%	8.8%
All Public Funds > \$1 Billion - Total Fund Median	19.2%	-1.1%	3.6%	3.9%
TMRS Domestic Fixed Income Return	6.7%	5.4%	5.5%	8.7%
Barclays Capital US Aggregate Bond Index	5.9%	6.0%	5.0%	6.3%
TMRS Domestic Equity Return ⁽¹⁾	28.4%	-	-	-
Russell 3000 Index ⁽¹⁾	28.3%	-	-	-
TMRS International Equity Return ⁽²⁾	32.1%	-	-	-
MSCI EAFE Index ⁽²⁾	31.8%	-	-	-

(1) For 2008, the 1-year returns were calculated from inception date of 1/4/2008 and were -33.4% and -34.6% for TMRS' Domestic Equity return and the Russell 3000 Index, respectively.

(2) For 2008, the 1-year returns were calculated from inception date of 1/4/2008 and were -41.3% and -42.2% for TMRS' International Equity Return and MSCI EAFE Index, respectively.

Note: Rates of return presented were calculated using a time-weighted rate of return methodology based upon market values.

All Public Plans > \$1 Billion - Total Fund Median – As of December 31, 2009, the Total Fund Composite – All Public Plans > \$1B-Total Fund plan sponsor peer group consists of a total of 81 public funds with total assets of greater than \$1 billion, 8 of which include public plan clients of R.V. Kuhns and Associates. The remaining participants are anonymous plan sponsors whose data is provided quarterly by BNY Mellon and RogersCasey. Total participants may fluctuate each quarter, and historical performance and asset allocation is not available for all peer group members.

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.

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.

MSCI EAFE Index – This index is market capitalization weighted and includes a selection of stocks from 21 developed markets, but excludes those from the U.S. and Canada.

This table displays the 5-Year Risk-Adjusted Return of the TMRS Total Return in comparison to that of the Actual Allocation Custom 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, 2009	TMRS	Actual Allocation Custom Benchmark ⁽³⁾
5-Year Risk-Adjusted Return	0.30	0.21

(3) Actual Allocation Custom Benchmark is a dynamic index calculated monthly and is comprised of a weighted average of Barclays US Aggregate Bond Index, Russell 3000 Index, MSCI EAFE Index (net), and Merrill Lynch 3-Month Treasury Bill Index based on the underlying allocations from December 2007 to present. Prior to December 2007, the benchmark is comprised of 100% Barclays Gov't/Credit Long Term Bond Index.

Summary of Investment Operations

For the Years Ended December 31, 2009 and 2008		
	2009	2008
Investment Income		
Interest earned on short-term investments	\$ 2,359,122	\$ 14,643,420
Interest earned on U.S. Treasury securities	23,742,761	85,037,666
Interest earned on U.S. government agencies	42,292,592	199,156,816
Interest earned on U.S. government agency mortgage-backed	189,965,259	83,291,976
Interest earned on state/local government bonds	18,865,174	33,187,857
Interest earned on corporate bonds	236,341,089	281,768,234
Interest earned on commercial mortgage-backed	98,483,651	52,411,013
Interest earned on other asset-backed	702,673	-
Interest earned on foreign government securities	345,806	-
Net appreciation/(depreciation) in fair value of investments	873,137,944	(1,008,385,369)
Net securities lending income ⁽¹⁾	3,326,522	1,850,967
Other	14,805	161,790
Investment activity expense ⁽²⁾	<u>(6,268,446)</u>	<u>(4,167,578)</u>
Total	1,483,308,952	(261,043,208)
Less: Unrealized appreciation/(depreciation) in the fair value of securities ⁽³⁾	-	(1,007,824,880)
Net depreciation in fair value of collateral pool ⁽³⁾	-	(44,507,068)
TOTAL INVESTMENT INCOME AVAILABLE FOR ALLOCATION	\$ 1,483,308,952	\$ 791,288,740
Investment Income Allocation		
Employees Saving Fund	\$ 186,614,181	\$ 176,235,114
Municipality Accumulation Fund	407,352,827	260,271,316
Current Service Annuity Reserve Fund	261,079,841	241,554,813
Supplemental Disability Benefits Fund	44,216	47,297
Supplemental Death Benefits Fund	1,304,784	1,229,567
Endowment Fund ^{(2) (4)}	626,913,103	111,950,633
TOTAL ALLOCATION TO FUNDS	\$ 1,483,308,952	\$ 791,288,740

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-D, and fund allocations, as defined by the TMRS Act, can be found in Note 5 in the Financial Section.

- (1) For purposes of this schedule, securities lending income is presented net of related fees and expenses of \$20,526,258 and \$183,525,961 for 2009 and 2008, respectively.
- (2) See Schedule of Investment Fees for a detail of these expenses. The Endowment Fund provides an amount to cover administrative expenses during the annual budget process.
- (3) Prior to 2009, unrealized gains/losses on investments and net depreciation on the securities lending collateral pool were not considered income available for allocation. Effective with the passage of HB 360, such amounts were included in the 2009 allocation.
- (4) Effective with the passage of HB 360, the Endowment Fund no longer receives a statutory interest allocation. Instead, amounts allocated in 2009 represent funding of the Interest Reserve.

Schedule of Investment Fees

For the Year Ended December 31, 2009	
Personnel services	
Staff salaries	\$ 557,510
Contract labor	9,667
Payroll taxes	33,856
Retirement contributions	88,254
Insurance	<u>42,971</u>
Total personnel services	732,258
Professional services	
Investment management	4,913,773
Consulting services	<u>365,000</u>
Total professional services	5,278,773
Communication	
Travel	<u>30,186</u>
Total communication	30,186
Miscellaneous	
Dues, subscriptions, and training	225,929
Other administrative expenses	<u>1,300</u>
Total miscellaneous	227,229
TOTAL INVESTMENT EXPENSES	\$ 6,268,446

Asset Class	External Investment Manager	Fees	Assets Under Management at December 31, 2009
Fixed Income Securities	BlackRock Financial Management, Inc.	\$4,170,327	\$11,504,404,115
Fixed Income Securities	Pacific Investment Management Company (PIMCO)	177,875	692,103,004
Fixed Income Securities	The TCW Group, Inc.	73,789	-
Equity Index Funds	Northern Trust Global Investments	491,782	3,752,911,956
TOTALS		\$4,913,773	\$15,949,419,075

