

TEXAS MUNICIPAL RETIREMENT SYSTEM

INVESTMENT POLICY

DECEMBER, 2003

Board of Trustees:

Rick Menchaca, Chair
Pat Hernandez, Vice Chair
Connie Green
Carolyn Linér
H. Frank Simpson
Kathryn Usrey

TEXAS MUNICIPAL RETIREMENT SYSTEM
INVESTMENT POLICY

TABLE OF CONTENTS

	Page
Purpose.....	1
Background (Plan Design).....	1
Investment Philosophy and Strategy	
Philosophy.....	1
Time Horizon.....	2
Investment Objectives.....	2
Investment Strategy.....	2
Portfolio Management	
General Investment Policies.....	3
Short-Term Investments - Eligible Securities.....	3
Long-Term Investments - Eligible Securities.....	3
Common and Preferred Stock Restrictions.....	4
Asset Type Limits.....	4
Investment Risk.....	4
Implementation	
Investment Procedures.....	5
Delegation of Authority.....	5
Trade Execution.....	5
Trade Settlement.....	5
Trade Documentation.....	5
Reporting Requirements.....	6
Securities Lending	
Lending Agent.....	6
Eligible Collateral.....	6
Cash Collateral Reinvestment Guidelines.....	6
Borrower Limits.....	7
Other	
Code of Ethics	7
Confidentiality.....	7

TEXAS MUNICIPAL RETIREMENT SYSTEM
STATEMENT OF POLICIES FOR INVESTMENT OF THE ASSETS
December, 2003

PURPOSE

The Board of Trustees of the Texas Municipal Retirement System adopts this statement of policies for investment of the assets of the Texas Municipal Retirement System (hereinafter, "TMRS" or "System").

BACKGROUND (Plan Design)

TMRS is a statewide agent multi-employer public employee retirement system that administers non-traditional, joint contributory, defined benefit plans covering usually all of the employees of each member city. Under these plans the retirement annuity of a member is the actuarial equivalent of the sum of (a) the member's own monthly contributions during working years¹ at a fixed percent of compensation, accumulated with interest as System investment earnings permit, plus (b) an equal or greater multiple sum out of the employer's "accumulation account" and (c) any additional credits granted by the employer.² The employer makes monthly contributions to this account at the rate determined annually by the actuary (not exceeding certain maximum rates, if applicable), and the System allows interest (at the same rate as for employee's accounts) on beginning annual balances in the account.

Annuities are paid during the post-retirement life of the member, calculated on assumption of compound annual interest during the payout period at a rate fixed by the statute (presently 5%). Alternative benefits that are the actuarial equivalent of a straight-life benefit are authorized by statute.

INVESTMENT PHILOSOPHY AND STRATEGY

Philosophy

1. Because 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

¹ The average System retiree has 23 years of creditable service at time of retirement; the average retirement age is 56, and the 56 year-old retiree (under present unisex mortality tables) has a life expectancy of 23.55 years.

² The benefit formula is modified to allow a member "prior service credit" for service antedating the municipality's participation date. The prior service credit is calculated as a dollar sum, which then becomes part of the money-purchase formula for calculating the annuity.

Most cities, but not all, allow "updated service credit," which is a similar dollar amount calculated as if the member's contributions had been made throughout employment, on a uniform salary equal to the average of the three years before date of the "updated service credit." Both "credits" are funded by employer contributions.

management strategy rather than a total return strategy which may result in credits below the 5% statutory minimum target level.

As such, neither market value declines nor rises of its fixed-income portfolio is 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.

Time Horizon

The System's investment objectives are promoted by assured annual income returns over long periods, consistent with the matching of long term assets and liabilities and in support of the annual interest credit.

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
 - a. To allow annual interest on the reserve funds at the minimum statutory rate;
 - b. To pay annual administrative costs of the System; and
 - c. To allow annual interest on the member and municipality accumulation accounts at the minimum statutory rate.
3. To consistently earn additional income, if feasible, for the following purposes:
 - a. To maintain a "general reserves" account to better ensure continued credits at the statutory minimum target rate during low yielding market periods;
 - b. To pay a distributive benefit to annuitants on December 31st of each year; and,
 - c. To credit additional annual interest to the individual accounts of members and to the accumulation accounts of municipalities

Investment Strategy

1. Funds of the System shall be invested only in fixed-income securities, and shall not be invested in common stocks except, as a bond alternative, stocks whose: (a) earnings yield is 120% of and (b) dividend yield is 50% of, the yield available on long maturity U.S. Treasury bonds.
2. Funds should be invested in United States Treasury obligations (which are considered free from credit risks), unless greater returns on the alternative securities, as authorized in this policy, justify the added credit risks.
3. Investments should be selected with longer-term assured income returns as a primary consideration. The portfolio should be structured in such a manner (including the sale of shorter maturity securities and reinvestment in longer, higher-yield securities) that the average life of the portfolio, inclusive of principal repayments and assuming a five-year life on all stocks, exceeds twelve years.

4. Capital gains may be taken as the market permits provided the quality and maturity structure of the portfolio continues to satisfy the portfolio strategy guidelines. In addition, capital gains may be generated through the active trading of liquid, high quality instruments provided that such trading is limited to projected cash available to invest and does not impair the investment strategy and income objectives of the core portfolio.
5. Except for short-term investments, the System shall not own securities that have a floating or variable rate.

PORTFOLIO MANAGEMENT

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 these 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 prevailing at the time of the investment, that persons of ordinary prudence, discretion and intelligence exercise in the management of their own affairs, not in speculation but when making a permanent disposition of their funds, considering the probable income from the disposition and probable safety of their capital.

Short-Term Investments - Eligible Securities

Funds may be invested, pending accumulation of amounts sufficient to warrant longer-term commitment, in the following:

- a. United States Treasury securities of one year maturity or less, except that when short-term yields exceed long-term yields, as described in Asset Type Limits item (e), maturities may be greater than one year.
- b. U.S. Government-Sponsored Enterprise (GSE's) discount notes of one year maturity or less,
- c. Commercial paper of 270 days or less in maturity issued by corporations whose commercial paper is rated A-1 by the Standard and Poor's Corporation, or P-1 by Moody's Investors Service,
- d. Custodian bank's short term investment fund, provided such fund is restricted to securities rated A or better, provides daily liquidity, and satisfies the requirements for ERISA-qualified plans.

Long-Term Investments - Eligible Securities

Funds may be invested in the following:

- a. United States Treasury notes and bonds,
- b. U.S. government agency securities, backed by the full faith and credit of the U.S. government or collateralized by U.S. Treasury securities,
- c. U.S. Government-Sponsored Enterprise Securities and Federally Related Institution Securities,

- d. Mortgage Pass-Thru Securities issued by U.S. government and federally chartered agencies, rated A or better
- e. Collateralized Mortgage Obligation (CMO) Bonds issued by U.S. Government and federally chartered agencies or collateralized by U.S. Government Agency securities, rated A or better,
- f. U.S. Corporate Bonds rated in the "A" category or better by a nationally recognized credit rating service.
- g. Bonds of a state, county, school district, city, or other municipal corporation of the United States, rated at least Aa3 or AA-, respectively, by Moody's Investor Service or Standard and Poors Corporation.

Except for securities eligible for trading exemption under Rule 144-a (an SEC rule permitting large institutions to trade privately placed securities among themselves), private placements of securities that are not registered are not eligible for purchase.

Common and Preferred Stock Restrictions

Funds may be invested in common or preferred stocks of U.S. corporations that:

- a. have paid a cash dividend for five consecutive years immediately before the date of purchase;
- b. satisfy the criteria of the stated investment strategy as described in this policy under Investment Strategy item (1).

Asset Type Limits

Assets will be allocated in such a manner that the portfolio will be structured as follows:

- a. Securities that are issued by (1) the U.S. Treasury and (2) Agencies of the United States of America backed by full-faith and credit of the U.S. Government or collateralized by U.S. Treasury securities, combined: minimum 15%; maximum, 100%.
- b. Federally Related Institutions whose securities qualify as collateral security for the deposit of public moneys, and Government-Sponsored Enterprises, combined: minimum 0%, maximum, 85%.
- c. Mortgage-Pass Thru Securities and CMO Securities, combined: minimum, 0%; maximum, 20%
- d. Corporate securities (other than commercial paper): minimum, 0%; maximum, 50%; and
- e. Short-Term Investments: minimum, 0%, maximum, 15%.
- f. At such times that the short-term yield approximates or exceeds the long-term yield on equivalent securities, the Executive Director may, in his discretion, authorize the accumulation of greater amounts of short-term investments pending longer-term commitment.
- g. Common and preferred stocks: minimum, 0%; maximum, 20%.

Investment Risk

Risk is defined as credit risk and the probability of not meeting the System's investment objectives. Credit risk of corporate obligations shall be reduced through diversification. Not more than 2% of the assets of the System shall be invested in the securities of any one corporation and its controlled corporate entities or subsidiaries except that not more than 5% of the assets of the System will be invested in the securities of any one GSE issuer; and not more than 5% of the voting stock of a corporation may be owned by the System. The risk of not meeting the System's investment objectives shall be managed

through a focus on long-term high quality securities with extended call protection when market yields exceed the statutory target interest rate.

When stocks are purchased, staff shall strive to manage market risk through diversification of the stock holdings.

IMPLEMENTATION

Investment Procedures

The Executive Director shall determine the amount of cash required to be kept on hand for payment of benefits, refunds, administrative expenses and other obligations, and shall invest the funds of the System not so required. In the performance of that duty, the Executive Director shall exercise his best judgment and discretion to effectuate the policies herein set forth.

Delegation of Authority

The Executive Director has delegated to the Director of Investments and the Investment Officer, the authority and duty of selecting investment securities for purchase or sale, pursuant to these policies and the authority to place such buy and sell orders. The Executive Director may delegate to any employee or employees the authority to perform all other acts required to settle transactions and to receive and hold investment securities.

Trade Execution

1. No securities shall be purchased from, or loan made directly to, the obligor, but securities shall instead be acquired by purchase in the open market.
2. Dealers should be selected based on their ability to perform efficiently for the System. Business should be conducted with those dealers that demonstrate the financial ability to perform. The ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength and operating results is a primary consideration. Dealer financial statements will be maintained as permanent records of the System.

Trade Settlement

Payment for securities will be made versus delivery of the security. The assets of the retirement system may be held in the name of agents, nominees, depository trust companies or other entities designated by the Board of Trustees. The records and all relevant reports or accounts of the retirement system must show the ownership interests of the retirement system in these assets and the facts regarding the system's holdings.

Trade Documentation

1. Purchases and sales of fixed income securities will be documented at the point of transaction by electronic prints of the active U.S. Treasury security or other relevant pricing benchmark of a nationally recognized electronic data system. Trade documentation will include the details of the transaction, the electronic pricing benchmark page, and the confirmation from the dealer.

2. Purchases and sale of stocks will be documented by electronic prints of the security's bid and ask price at the point of transaction and the day's trading range and volume for that security.
3. Transaction documentation will remain in the permanent files of the System.

Reporting Requirements

The following reports will be provided to the Board of Trustees on a quarterly basis:

1. Summary of the System's investments and portfolio characteristics;
2. Except for the investment of temporary cash, a summary of all purchase and sale transactions for the quarter; and
3. Other information as may be requested by the Board of Trustees.

The following will be provided to the Board of Trustees on an annual basis:

1. Summary of investment performance and evaluation of the System's investment results relative to the investment objectives as defined in this policy. For investment performance comparison purposes, the income and total return performance benchmarks will be the income and total returns of the Lehman Long Government Credit Index; and
2. If appropriate, recommended changes to the Investment Policy.

SECURITIES LENDING

Lending Agent

The securities lending agent must:

1. be experienced in the operation of a fully secured securities lending program;
2. indemnify the System against any loss resulting from borrower default or from its own failure to properly execute its responsibilities under the lending agreement; and
3. be rated at least A by two nationally recognized rating services and maintain Risk 1 and Total Capital Ratios of 7% and 10%, respectively.

Eligible collateral

1. Cash (U. S. dollars)
2. U.S. Government Securities

Cash Collateral Reinvestment Guidelines

The securities lending agent may reinvest cash collateral in the following:

1. U.S. Government Securities, issued or guaranteed as to principal and interest by the U.S. Government, its agencies, instrumentalities or establishments.
2. Dollar-denominated securities with debt-like characteristics on a fixed rate and floating rate basis with the highest short-term quality ratings by at least two nationally recognized rating services, and as applicable, whose long term ratings are at least A3 and A- by Moody's and Standard & Poor's rating services, respectively.
3. Repurchase agreements collateralized by U.S. Treasury and government agency securities, AAA-rated asset-backed securities, long term dollar-denominated

corporate securities with a minimum long-term rating of AA by Moody's and Standard & Poor's, or short-term dollar-denominated corporate securities rated A-1 and P-1 by Moody's and Standard & Poor's.

4. State Street's "Quality D Short-Term Investment Fund".

The reinvested cash collateral shall be diversified consistent with the System's overall portfolio diversification policy.

The lending agent shall manage the market risk of the reinvestment of cash collateral through careful monitoring and consideration of the maturity structure of the reinvested cash collateral relative to the System's outstanding loans and in no event shall the overall maturity of the reinvested cash collateral exceed 90 days. For purposes of calculating the overall maturity of the reinvested cash collateral, a floating rate instrument shall be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate.

Borrower Limits

Consistent with the securities lending agent's indemnification of the System for loss resulting from borrower default, the securities lending agent shall be responsible for the limits placed on individual borrowers in accordance with in-depth ongoing credit reviews.

OTHER

Code of Ethics

All TMRS staff involved in the investment of TMRS assets are charged with making all investment decisions in the best interest of the System, and may not solicit, accept, or agree to accept any gifts of more than *de minimus value*, personal benefits, or personal favors offered to them because of their positions with the TMRS. Cash gifts are prohibited. In all cases, staff should use reasonable care and judgment to not place themselves in a situation that might cause, or be perceived to cause, a loss of independence or objectivity. TMRS investment staff shall also comply with TMRS policies on personal investment activities, where applicable.

Confidentiality

All TMRS staff having access to specific information regarding TMRS investment transactions and related activity shall consider the information confidential in nature, and any requests for disclosure of such financial information shall be directed to TMRS Legal Counsel.