



# TEXAS MUNICIPAL RETIREMENT SYSTEM

## INVESTMENT POLICY

DECEMBER 2005

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**TEXAS MUNICIPAL RETIREMENT SYSTEM  
INVESTMENT POLICY**

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**TEXAS MUNICIPAL RETIREMENT SYSTEM**  
**STATEMENT OF POLICIES FOR INVESTMENT OF THE ASSETS**  
**December 2005**

**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 nontraditional, 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 years<sup>1</sup> 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.<sup>2</sup> 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 OBJECTIVES**

**Philosophy**

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

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<sup>1</sup> 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 additional years.

<sup>2</sup> 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 the date of the “updated service credit” study. Both “credits” are funded by employer contributions.

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.

### **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 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, for the following purposes:
  - 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 31<sup>st</sup> 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.

## **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 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.

## **General Investment Strategy Guidelines**

1. Funds of the System shall be invested only in fixed income securities, and shall not be invested in 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 United States Treasury bonds.
2. Funds should be invested in U.S. 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 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 that 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 Strategies**

**Core Fixed Income Strategy:** Objective is to produce continuity of the income return through investment in quality securities with a long-term horizon. Corporate securities are diversified according to industry and issuer exposure and active trading decisions are made in consideration of improvement to income over the long term as well as protection of the credit quality of the portfolio.

**Short-Term Trading Fixed Income Strategy:** Objective is to produce additional income beyond the yield provided by long-term government-guaranteed securities. This is done through the active trading of those securities to capture gains made available by the volatility of the fixed income market. Allocation of assets to the short-term trading strategy will be limited to 10% of the total invested assets.

**Equity Strategy:** Objective is to produce total income in excess of that available in the fixed income market, over a long-term horizon. Stocks will be selected and disposed of on the basis of a well-defined strategy generally considered to be a value strategy focused on yield with a well-defined buy and sell discipline.

## **Short-Term (Temporary) 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,
- b. U.S. Government-Sponsored Enterprise (GSE) 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 in the highest rating category by Moody's Investors Service, Standard and Poor's Corporation, or FitchRatings.
- 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 "A" or better by Moody's Investors Service, Standard and Poor's Corporation, or FitchRatings.
- g. Bonds of a state, county, school district, city, or other municipal corporation of the United States, rated in the AA category by Moody's Investor Service, Standard and Poor's Corporation, or FitchRatings.

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; and
- b. Satisfy the criteria for stocks as described in this policy under General Investment Strategy Guidelines item (1).

### **Asset Type Limits**

Assets will be allocated in such a manner that the portfolio will be diversified within the following limits:

- 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%. At such times that the short-term yield approximates or exceeds the long-term yield on equivalent securities, the Executive Director may, at his discretion, authorize the accumulation of greater amounts of short-term investments pending longer-term commitment.
- f. Common and preferred stocks: minimum, 0%; maximum, 20%.

**Investment Risk**

**Credit risk** is managed by credit rating standards and asset type limits as described within the Portfolio Management section of this Investment Policy, and through issuer diversification and subject to the following limits as a percent of total assets:

Corporations and their controlled subsidiaries	2%
Municipal Issuers	5%
GSEs and federally related institutions not backed by the full faith and credit of the U.S. government nor collateralized by U.S. Treasuries	7%

**Interest rate risk** is defined as reinvestment risk and market value fluctuations due to changes in interest rates. Reinvestment risk is managed through the focus on long-term high-quality securities with extended call protection, particularly when market yields exceed the statutory target interest rate. As stated in the Philosophy section of this Investment Policy, the primary focus is on income rather than market value fluctuations due to changes in interest rates. The primary market value exposure is attributable to the Short-Term Trading Strategy and as stated in the section on Portfolio Strategies, this strategy is limited to 10% of the total invested assets.

When stocks are purchased, TMRS staff shall strive to manage **market risk** through diversification of the stock holdings. In addition, not more than 5% of the voting stock of a corporation may be acquired by the System.

**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 sales 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;
3. Summary of the System's quarterly investment performance; and
4. 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;
2. Summary Report on the Securities Lending Program;



3. Report and recommendation of the System's economic advisor(s); and
4. 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 of the following nationally recognized rating services: Moody's Investors Service, Standard and Poor's Corporation, and FitchRatings; 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, with a minimum long-term rating of "A" by at least two of the following nationally recognized rating services: Moody's Investors Service, Standard and Poor's Corporation, and FitchRatings.
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 at least two of the following nationally recognized rating services: Moody's Investors Service, Standard and Poor's Corporation, and FitchRatings; or short-term dollar-denominated corporate securities rated A-1, P-1 and/or F-1 by at least two of the following: Moody's, Standard & Poor's and FitchRatings.
4. State Street's "Quality D Short-Term Investment Fund," managed according to the Fund's Investment Policy Guidelines in effect at the time the contract is executed, with any revisions to be approved by TMRS.

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. Under ordinary circumstances, the average effective duration of the "Quality D Short-Term Investment Fund" will be managed such that it will not exceed 120 days, or fall below 1 day. In the event that the average effective duration of the "Quality D Short-Term Investment Fund" does exceed 120 days, the Trustee shall, (1) notify TMRS within 5 business days and (2) take appropriate action as is necessary to return the Quality D Fund to below 120 days average effective duration. The Quality D Fund average effective duration will be calculated using the weighted average effective duration of its holdings. 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 while remaining cognizant of the System's preference for return of the securities on loan over the collection of cash collateral.

## **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 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.