Position Paper on Market Conditions

June 2009

The situation

The United States is in the midst of one of the most severe equity market declines of the past 50 to 100 years. This decline is due primarily to a massive global deleveraging stemming from an overextension in mortgage lending in the real estate market. The effects have come primarily through the financial sector and have spread to other areas of the global economy. In the first week of October 2008, most stock markets experienced the largest single weekly decline since the 1930s. Since then, every sector and investment in every country in the world has fallen in value. The TRS portfolio has also declined significantly along with the global markets.

TRS Trust is healthy

While the portfolio's value has declined, it remains large and has enough assets in place to cover expected benefit payments through 2040. As of June 2009, Trust assets were valued at approximately $83 billion, which is up from the $70.6 billion cited by an actuarial assessment conducted Feb. 28, 2009. Between Feb. 28, 2009, and the previous actuarial report on Aug. 31, 2008, the fund had decreased in value by 32 percent. Over the same period, U.S. stocks and international equities were down more than 40 percent.

However, it is important to remember that TRS operates a defined benefit plan, not a defined contribution plan. Pensions are therefore not directly impacted by short-term changes in the financial markets. However, should projected long-term revenues prove insufficient to cover long-term pension obligations, the Texas Legislature will need to consider adjustments to Trust contribution rates, retirement eligibility criteria and/or the structure of pension benefits.

Current Fund contributions are at 12.98 percent with 6.58 percent of that provided by the State and the other 6.40 percent contributed by TRS members. According to the latest actuarial report, these contribution levels are no longer adequate to fund TRS' future liabilities over the long term. The report recommends "a stair step increase in the contribution rates towards a long-term solution, with either an increase in the State's contribution rate or a combination increase of State and member contribution rates."

In the meantime, TRS is a long-term investor and, unfortunately, these kinds of conditions are periodically a part of any investor's experience. At times like these, it is most important to react in a calm, disciplined and objective manner.

Proactive steps

TRS has advantages in the management of its plan that many pension plans don't have. The size of the Trust, its long-term investment horizon and its liquidity are all factors that are helping it weather these tough economic times. TRS has restructured the Trust to reduce its dependence on any single factor. As an added precaution, TRS has put into place additional policies and procedures to closely monitor the shifting financial markets in order to fine-tune current investments as necessary. For example:

- TRS has developed a restructuring plan for its hedge fund portfolio to orient it more to an absolute return strategy that is expected to generate a positive absolute return regardless of stock market performance.

- TRS has funded five new external fund managers, who are already adding value to the team. TRS also is adjusting the size of fundings to reflect the new economic conditions.

- The investment team is running valuation models daily instead of monthly so that it can rebalance TRS' investment portfolio, if needed.

- In the wake of this market downturn, the investment staff has identified unique investment opportunities that are only available to larger institutional investors. The Fund's reputation as a world-class investor brings these opportunities to our doorstep on a daily basis.

- TRS is managing credit risks proactively.

Portfolio diversification worked

The current decline in world financial markets is precisely the reason why the TRS Board of Trustees elected to begin further diversifying the investment portfolio more than one year ago. The intent of this strategy was to move assets away from the U.S. equity market into a variety of other areas. Those areas include U.S. treasury bonds, inflation-linked bonds, private equity, real estate, hedge funds and commodities, all of which have helped diversify the portfolio during this period of market turmoil. The idea was to better diversify and protect against economic events like the one that we're experiencing now – without reducing TRS' long-term target return of 8 percent.

The current economic environment should end any debate about the need for that diversification. Unfortunately, a change of this magnitude with a fund of this size takes several years to implement. The current decline occurred one year into the transition process and so additional time is needed for the Trust to reach the full long-term diversification that it is seeking.

Closing Thoughts

The TRS trust fund is diversified and focused on the long term. Although the Fund's value has declined, TRS is well-positioned to take advantage of the current situation and invest cheaply in assets that should provide a healthy long-term return. TRS is focused on getting through the current downturn, maintaining a disciplined, long-term vision and restoring the Trust to a higher level once this downturn ends.