TEACHER RETIREMENT SYSTEM OF TEXAS MEETING
BOARD OF TRUSTEES
AND
COMPENSATION COMMITTEE

(Committee Chair and Members are Subject to Change at the September Board Meeting — Ms. Sissney, Chair; Mr. Colonnetta; Mr. Kelly; Ms. Palmer; & Ms. Ramirez, Committee Members)

AGENDA

September 18, 2014 – 1:30 p.m.
TRS East Building, 5th Floor, Boardroom

The September 18, 2014 meeting of the Compensation Committee and TRS Board of Trustees will be held by telephone conference call as authorized under Texas Government Code Section 551.130. The Board intends to have a quorum physically present at the following location: ***1000 Red River Austin, Texas 78701 in the TRS East Building, 5th Floor, Boardroom.***

1. Consider the approval of the proposed minutes of the July 11, 2014 committee meeting – Committee Chair.

2. Discuss and consider personnel matters, including the appointment, employment, evaluation, compensation, performance, duties, discipline, or dismissal of the Chief Investment Officer – Committee Chair.

3. Discuss and consider recommending to the Board proposed amendments to and ratification of the Performance Incentive Pay Plan for the period beginning October 1, 2014 – Jerry Albright, Sylvia Bell, and Dennis Gold.

NOTE: The Board of Trustees (Board) of the Teacher Retirement System of Texas will not consider or act upon any item before the Compensation Committee (Committee) at this meeting of the Committee. This meeting is not a regular meeting of the Board. However, because a quorum of the Board may attend the Committee meeting, the meeting of the Committee is also being posted as a meeting of the Board out of an abundance of caution.

Teacher Retirement System of Texas

Minutes of the Compensation Committee

July 11, 2014

The Compensation Committee of the Board of Trustees of the Teacher Retirement System of Texas (TRS) met on July 11, 2014 in the boardroom located on the fifth floor of the TRS East Building offices at 1000 Red River Street, Austin, Texas. The following committee members were present:

The following members of the committee were present:
Nanette Sissney, Chair
Joe Colonnetta
David Kelly
Anita Palmer
Dolores Ramirez

Other TRS Board members present:
Todd Barth
Christopher Moss
Karen Charleston
David Corpus

Others present:
Brian Guthrie, TRS
Ken Welch, TRS
Carolina de Onís, TRS
Howard Goldman, TRS
Britt Harris, TRS
Janet Bray, TRS
Jerry Albright, TRS
Don Green, TRS
Betsey Jones, TRS
Amy Morgan, TRS
Marianne Woods Wiley, TRS
Christine Bailey, TRS
Ronnie Bounds, TRS
Mary Chang, TRS
Mike Debbs, TRS
Janie Duarte, TRS
Dan Herron, TRS
Dan Junell, TRS
Eric Lang, TRS
Lynn Lau, TRS
Mike Pia, TRS
Jim Pinkard, TRS
Kristi Vorce, TRS
Randy Villarreal, TRS
Brady O'Connell, Hewitt EnnisKnupp
Steve Huff, Reinhart Boerner Van Deuren
Leroy DeHaven, Texas Retired Teachers Association
Ann Fickel, Texas Classroom Teachers Association
Paula Stern, Texas Retired Teachers Association
Ted Melina Raab, Texas American Federation of Teachers
Tim Lee. Texas Retired Teachers Association

Ms. Sissney called the meeting to order at 8:37 a.m. with a quorum of committee members present.

1. Consider the approval of the proposed minutes of the June 5, 2014 committee meeting – Nanette Sissney.

On a motion by Mr. Kelly, seconded by Ms. Ramirez, the committee unanimously approved the proposed minutes of the June 5, 2014 committee meeting, as presented.

2. Discuss and provide direction to staff regarding TRS compensation matters, including compensation for individual positions and related duties of the Executive Director – Brian Guthrie; Janet Bray; and Keith Robinson, Focus Consulting.

Mr. Guthrie recapped the direction given by the board in June to adjust the compensation of IMD staff based on the McLagan study. He stated that at the current meeting he would brief the board on TRS compensation philosophy and other compensation issues relating to the Red River staff.

Mr. Guthrie highlighted the challenge in filling vacant investment attorney positions because the current salary ranges for those positions were based on the State Classification Plan and were not competitive. He noted that two investment attorneys recently left TRS for significantly higher paying jobs. He stated that management proposed to diverge from the State Classification Plan and create new classifications for investment attorneys so TRS could offer them competitive wages. These adjustments would cost approximately $500,000 in FY 2015. Responding to Ms. Sissney, Mr. Guthrie said that the Legal Services Department had four vacant positions for investment attorneys. Ms. de Onís noted that one vacancy was for the chief compliance officer position. She also confirmed for Ms. Sissney that having in-house investment counsel instead of outside counsel would save from $400,000 to $600,000 a year per position. Responding to Ms. Charleston, Ms. de Onís explained that the presented market data for salaries were national averages that took into consideration data from financial hubs, such as Charlotte, Chicago, New York and Los Angeles.

Mr. Guthrie stated that TRS' Legislative Appropriation Request sought to increase the allocation for salary actions such as merits and promotions from 1.5% to 3% for FY 2016 and FY 2017. He clarified for Ms. Sissney that such increase would be in addition to the 2% across the board increase awarded by the state this year to employees. Responding to a question from Mr. Colonnetta about the proposed allocation, Mr. Guthrie replied currently division directors allocate the funds to their staffs, but he would like to evaluate that approach. Ms. Sissney stated that the fact that 16.9% of employees were under-classified concerned her and wanted to ensure that it would be corrected. Mr. Guthrie clarified for Ms. Sissney that the average individual merit increase ranged from 2.7% to 4.1% based on reviews and one-time awards are also granted for completion of a special project or periodical outstanding performance.

Ms. Sissney suggested providing time off instead of one-time awards for those purposes. Mr. Kelly stated that he wanted to see a more consistent practice across the system. He said he preferred having the Executive Director allocate merit salary increases or one-time awards based on a general compensation philosophy. Mr. Guthrie concurred and suggested using the IMD incentive compensation plan as a model for implementing a consolidated plan.

Mr. Guthrie clarified for Ms. Charleston that any reclassifications would be implemented as they were identified and necessary. Responding to a question from Mr. Colonnetta regarding salary adjustments for misclassified underperformers, Mr. Guthrie explained that any salary actions would be considered in light of their performance review. Mr. Guthrie briefly described the typical evaluation process for Ms. Charleston. Mr. Harris outlined how IMD evaluated its staff.

Ms. Bray explained that as part of revamping TRS' compensation methodology, employees would have updated job descriptions with clear expectations. Mr. Green noted that another goal was to

make the timeline of disbursing merit increases consistent, systematic, and predictable. Ms. Charleston stated that she would like to receive more details about the proposed process. Ms. de Onís confirmed for Ms. Sissney that the majority of the additional $500,000 allocated for Legal Services would be for new and existing specialized positions within the department. Mr. Guthrie summarized the next steps in implementing the proposed plan.

Ms. Sissney announced that the committee would go into executive session on agenda item 2 under sections 551.074 and 551.071 of the Government Code to deliberate personnel matters and, as needed, to seek advice from legal counsel. She asked all members of public and staff not needed for the executive session to leave the meeting room and take their belongings with them.

Whereupon the meeting was recessed at 9:17 a.m.

Ms. Sissney announced that the meeting reconvened in open session at 10:16 a.m.

The meeting adjourned at 10:16 a.m.

APPROVED BY THE **COMPENSATION COMMITTEE** OF THE BOARD OF TRUSTEES OF THE TEACHER RETIREMENT SYSTEM OF TEXAS ON THE 18TH DAY OF SEPTEMBER, 2014.

ATTESTED BY:

Dan Junell Secretary to the TRS Board of Trustees	Date

Proposed Modifications to Performance Incentive Plan (PIP)

Jerry Albright, Deputy Chief Investment Officer
Sylvia Bell, Investment Operations
Dennis Gold, TRS Legal

Proposed Modifications

Modification Number	Description
1	Incorporation of Risk Parity into PIP
2	Align TAA, Stable Value/SAA, and Quantitative Equity Strategies under new area
3	Modify World Equity strategy benchmark to better align with TRS tax-exempt status
4	Modify ENR return calculation from TWR to IRR calculation
5	Modify SPN benchmark and return calculation for Private Markets SPN investments
6	Provide for GBI Portfolio and Sector Incentives
7	Adjust Real Assets Payout Allocation
8	Add Eligible Position for Junior Analyst and modify Max Potential Award for CIO
9	Allow Retiring Employees to Receive the Full PIP

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Modification 1

Incorporation of Risk Parity into PIP

Background Information

- The 2014 SAA study recommends Risk Parity as a new asset allocation strategy
- If approved, the new allocation will be implemented by the Risk Group via a combination of internal and external strategies

Rationale

- This new strategy is an important part of the Trust's asset allocation and requires an appropriate means to incentivize efficient and high quality execution

Proposal

- Set Risk Group excess return target to 25 bp (12.5 bp during first year of transition)
  - 50% of the Risk Parity portfolio will be internally managed as an efficient beta portfolio with an emphasis on the best balance of risk and reduced emphasis on outperforming the benchmark
  - 50% will be externally managed and will match the benchmark which will further reduce the opportunity for outperformance
- During the first year of transition, 25% will be managed internally and 75% externally

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Modification 2

Align TAA, Stable Value/SAA, and Quantitative Equity Strategies under new area

Background Information

- Tactical Asset Allocation (TAA), Stable Value/Strategic Asset Allocation(SAA), and Quantitative Equity Strategies have merged to become the Asset Allocation (AA) team

Rationale

- Multiple teams were merged in order to better integrate investment processes and align resources

Proposal

- The AA team's PIP Weights (Benchmarks) would be as follows:
  - 40% Total Fund (Total Fund Composite Index)
  - 20% Stable Value/SAA (Daily Weighted Excess Based on Actual Portfolio Weights)
  - 20% Integrated TAA (Profit & Loss/Total Trust Average Daily Balance)
  - 20% Quantitative Equity Strategies (MSCI ACWI (net) with USA (gross))
- Establish Quantitative Equity Strategies target at 100 bps in order to align with portfolio tracking error target

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Modification 3

Modify World Equity strategy benchmark to better align with TRS tax-exempt status

Background Information

- World equity managers such as IPM GBI and EPU World Equity use the MSCI ACWI (net) for their PIP benchmark
- MSCI ACWI (net) is an index that assumes maximum tax withholding rates on dividends, including on dividends paid by US companies
- TRS, like other tax-exempt organizations, does not pay tax in the US although it does incur foreign taxes
- MSCI has introduced an index series that calculates the MSCI AWCI net of foreign tax but gross of US tax
- HEK recommends clients adopt this benchmark as a more accurate benchmark for world equity portfolios

Rationale

- Modification will better measure world equity portfolio performance for a tax-exempt organization such as TRS

Proposal

- Revise benchmark for World Equity strategies to MCSI AWCI (net) with USA (gross)

TRS

Modification 4

Modify ENR return calculation from TWR to IRR calculation

Background Information

- Current PIP uses time weighted return calculation for Energy & Natural Resources investments
- Time weighted return is the best calculation methodology when assets are priced daily and when TRS controls timing and the amount of contributions and withdrawals
- IRR is the best calculation methodology when asset pricing lags and when General Partner controls the timing and amount of contributions and withdrawals

Rationale

- ENR investments are private equity assets in nature and therefore price quarterly
- Return on TRS Private Equity portfolio is calculated using IRR methodology
- ENR performance should be calculated consistent with TRS Private Equity

Proposal

- Use the IRR return calculation methodology as is done for TRS Private Equity portfolio

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Modification 5

Modify SPN benchmark and return calculation for Private Markets SPN investments

Background Information

- Current PIP uses time weighted return calculation for Private Market SPN investments

Rationale

- Align the PIP calculations for the Private Market SPN portfolio to existing PIP calculations for Private Equity and Real Assets

Proposal

- Incorporate the following PIP Weights (Benchmarks) would be as follows:
  - 30% Total Trust (Total Fund Composite Index)
  - 30% Public Markets SPN (Daily Weighted Excess Based on Actual Portfolio Weights)
  - 20% Private Equity SPN (State Street Private Equity Index)
  - 10% Real Assets SPN (NCRIEF ODCE)
  - 10% ITAA (Profit & Loss/Total Trust Average Daily Balance)
- Benchmarks and targets for the Private Market SPNs will be the same as the TRS private portfolios:
  - Private Equity SPN – SSPEI @ 300 bps alpha target
  - Real Assets SPN – NCREIF ODCE @ 250 bps alpha target
- Benchmarks and targets for Public Market SPN remain the same

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Modification 6

Provide for GBI Portfolio and Sector Incentives

Background Information

- PIP does not measure and reward individual performance based on Portfolio and Sector contribution to GBI portfolio return

Rationale

- GBI Portfolio and Sector incentives further aligns individuals with Total Fund return requirements

Proposal

- Create Individual Component for IPM Portfolio and Sector Managers
- IPM receives 60% of incentive from GBI portfolio in current PIP
  - Allocate incentive to IPM Portfolio Manager as follows:
    - 70% from GBI Portfolio returns
    - 30% from Individual Component returns
  - Allocate incentive to IPM Sector Manager as follows:
    - 30% from GBI Portfolio returns
    - 70% from Individual Component returns

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Modification 7

Adjust Real Assets Payout Allocation

Background Information

- Real Assets group currently earns 10% of its Payout Allocation from ENR investments
- Real Assets group works closely with Private Equity team on Principal Investments as well as private equity general partners; relationship is not reflected in the Payout Allocation.
- Real Assets group shares resources with Private Equity

Rationale

- Payout Allocation should incentivize the appropriate teams to work together

Proposal

- Modify Payout Allocation so Real Assets earns 5% from ENR and 5% from Private Equity and Private Equity earns 5% from Real Assets

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Modification 8

Add Eligible Position for Junior Analyst and modify Max Potential Award for CIO

Background Information

- Add Eligible Position for Junior Analyst in order to provide equity for differing levels of education, experience and career path
- Current Maximum Potential Award level for Chief Investment Officer is 125%; Award level is not in line with IMD compensation philosophy

Rationale

- Individuals seeking and executing additional responsibilities or are being trained to become an Analyst are properly incentivized
- Adjusting maximum award for Chief Investment Officer aligns performance pay with IMD compensation philosophy and marketplace

Proposal

- Create additional tier called Junior Analyst with a maximum potential award of 15% (lowered from 25% as Analyst); certain existing professionals classified as Analyst will remain Analysts
- Modify maximum potential award for Chief Investment Officer from 125% to TBD%

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Modification 9

Allow Retiring Employees to Receive the Full PIP

Background Information

- Retiring employees only receive 50% performance pay for the plan year; remaining 50% is forfeited
- Primary reason for extending payout over 2 years is to encourage employee retention

Rationale

- Employee retention is not a factor for retiring employees
- Allows employees more flexibility in determining their retirement date
- Facilitates better succession planning by allowing potential retirements to occur

Proposal

- Modify PIP to allow retiring employees to receive 100% payout for incentive compensation year
- Assumes retiring employee retire no earlier than January 1 of the year following the PIP performance period

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