

**Report of the State Board of Education
Committee on School Finance/Permanent School Fund
April 30, 2010**

The State Board of Education Committee on School Finance/Permanent School Fund met at 9:14 a.m. on Friday, April 30, 2010, in Room #1-104 of the William B. Travis Building, 1701 N. Congress Avenue, Austin, Texas. The following members of the committee were present:

Presiding: David Bradley, chair; Rick Agosto, vice chair; Gail Lowe, Rene Nuñez

Absent: Cynthia Dunbar

Non-Committee Members Present: Lawrence A. Allen, Jr.

Public Testimony

This item provides an opportunity for the public to present testimony at the time the related item comes up for committee discussion or action. The procedures for registering and taking public testimony at State Board of Education committee meetings and general board meetings are provided at <http://www.tea.state.tx.us/index4.aspx?id=3958> or in the information section (yellow pages) of the agenda.

The Committee on School Finance/Permanent School Fund received no presentations of public testimony.

ACTION ITEMS

1. **Proposed Amendment to 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, §33.65, Guarantee Program for School District Bonds**
(Second Reading and Final Adoption)
(Board agenda page III-1)
[Official agenda item #13]

Lisa Dawn-Fisher, deputy associate commissioner for school finance, presented the item for second reading and final adoption.

MOTION AND VOTE: *It was moved by Mr. Nuñez, seconded by Mr. Agosto, and carried unanimously to recommend that the State Board of Education, by an affirmative vote of two-thirds of the members of the board, approve for second reading and final adoption the proposed amendment to 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, §33.65, Guarantee Program for School District Bonds, with an effective date of 20 days after filing as adopted with the Texas Register.*

MOTION AND VOTE: *It was moved by Mr. Nuñez, seconded by Mr. Agosto, and carried unanimously to recommend that the State Board of Education set the multiplier to determine the capacity of the program at three times the cost value of the Permanent School Fund.*

MOTION AND VOTE: *It was moved by Mr. Nuñez, seconded by Mr. Agosto, and carried unanimously to recommend that the State Board of Education maintain the \$2,300 application fee.*

**2. Adoption of Review of 19 TAC Chapter 109,
Budgeting, Accounting, and Auditing**
(Board agenda page III-17)
[Official agenda item #14]

Rita Chase, director for financial audits, presented the item to adopt the review of the Budgeting, Accounting, and Auditing found in 19 TAC Chapter 109, Subchapters A, B, C, and D.

MOTION AND VOTE: *It was moved by Mr. Nuñez, seconded by Mr. Agosto, and carried unanimously to recommend that the State Board of Education adopt the review of 19 TAC Chapter 109, Budgeting, Accounting, and Auditing, Subchapter A, Budgeting, Accounting, Financial Reporting, and Auditing for School Districts, Subchapter B, Texas Education Agency Audit Functions, Subchapter C, Adoptions By Reference, and Subchapter D, Uniform Bank Bid or Request for Proposal and Depository Contract, and the placement of this item on the consent agenda of the State Board of Education meeting of May 21, 2010.*

DISCUSSION ITEMS

3. Education Session on Risk Parity
(Board agenda page III-101)

Holland Timmins, executive administrator and chief investment officer, introduced Joel Whidden, senior relationship manager, and Paul Podolsky, portfolio strategist, both of Bridgewater Associates. Mr. Whidden provided a brief overview of Bridgewater and Mr. Podolsky provided a theoretical overview of risk parity strategies, including what the strategy entails, why Bridgewater thinks there is a benefit to holding it in the portfolio, and how these types of strategies are constructed. The presentation was theoretical in nature with no product return streams used for illustrative purposes.

The meeting recessed at 10:34 a.m. and reconvened at 10:49 a.m.

**4. Review of Permanent School Fund Securities
Transactions and the Investment Portfolio**
(Board agenda page III-103)

Carlos Veintemillas, deputy chief investment officer, provided a summary of the status of the Permanent School Fund portfolio. Reports presented to the committee were for the reporting period ending February 28, 2010, unless otherwise noted. Mr. Veintemillas reported on the current fair market value of the Fund, the asset allocation of the Fund, PSF transactions occurring in the reporting period, historical summary of revenues and contributions of General Land Office managed real estate assets through February 28, 2010, current status of the Bond Guarantee Program and the available capacity in the program, proxy votes against management, details of purchases and sales on all portfolios, fixed income portfolio ratings changes and broker commissions for internal equity

portfolios cumulative for the period January 1, 2010 through February 28, 2010. Time was then allocated for answering questions from the committee.

CONSENT ITEM

5. Ratification of the Purchases and Sales of the Investment Portfolio of the Permanent School Fund for the Month of February 2010

(Board agenda page III-71)

[Consent agenda item #(4)]

MOTION AND VOTE: *Based on the information provided by staff and the recommendation of the executive administrator and chief investment officer and the commissioner of education, the committee recommended by unanimous consent to ratify the purchases and sales for the month February 2010 in the amount of \$262,933,624 and \$163,427,082, respectively. (Attachment A)*

ACTION ITEMS

6. Decision on Real Estate Investments

(Board agenda page III-73)

[Official agenda item #15]

Mr. Bradley introduced representatives of the Fund's real estate consultant, Courtland Partners. Steve Novick, principal/chief operating officer, provided an update on real estate recommendations previously brought to the committee by Courtland and staff. Mr. Novick indicated that the first two real estate investments opportunities approved by the board were executed as directed. Next, Mr. Novick recommended that the committee consider moving into the next stage of real estate investing. He framed the discussion by distinguishing the two types of real estate investments. He described the core open-end funds as having an infinite life, providing an instantaneous investment, and offering a pool with known property and geographic diversification benefits. Mr. Novick stated that because of the recent devaluation of the underlying assets, the going-in-yield was now much better than it was a few years ago and today the income yield is expected to be higher than it was in the past.

Dan Moore, senior analyst, presented two proposed investment reports to the committee, prepared by Courtland, documenting the evaluation and due diligence activities of Courtland and staff. He introduced UBS Global Asset Management's UBS Trumbull Property Fund, a core-open end fund. Secondly, Mr. Moore introduced INVESCO Real Estate's INVESCO Core Real Estate Fund, also a core open-end fund. For each, Mr. Moore explained the objectives and constraints, terms and fees, and advantages and risks of the fund. He described the in-depth due diligence activities conducted by both Courtland and staff, including on-site visits. Mr. Moore walked through the stand-alone merits of both proposed investments. He noted the complementary nature of the two and cited these as reasons Courtland and staff were making the recommendations.

John Grubenman, director of private alternative investments, explained the complementary nature of the two funds, including philosophy, strategy, size, and tactical approach to over and under-weighting industry sectors. Mr. Grubenman compared the performance history of each fund to peers, to real estate sector experience, and to the overall performance of the real estate market.

Mr. Novick referenced the annual tactical plan, briefly reviewed the next steps and reiterated the plan for a staged approach to the implementation of the real estate sectors: core, value, and opportunistic.

MOTION AND VOTE: *It was moved by Mr. Agosto and carried unanimously to recommend to the State Board of Education approval to execute agreements with INVESCO Core Real Estate Fund and UBS Trumbull Property Fund, necessary to make an investment commitment of up to \$100 million in each fund, subject to continued due diligence.*

The meeting recessed at 12:10 p.m. and reconvened at 1:11 p.m.

7. **Proposed Amendment to 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, §33.5, Code of Ethics**
(Second Reading and Final Adoption)
(Board agenda page III-75)
[Official agenda item #16]

Christopher Maska, agency ethics officer, presented proposed changes in response to comments made by representatives of the State Auditor's Office and the Texas Ethics Commission. Changes to the rule text recommended by the committee are reflected in Attachment B.

MOTION AND VOTE: *It was moved by Mr. Nuñez and carried unanimously to recommend that the State Board of Education approve by an affirmative vote of two-thirds of the members of the board, for second reading and final adoption, proposed amendment to 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, §33.5, Code of Ethics, as amended, with an effective date 20 days after filing as adopted with the Texas Register.*

8. **Review of Absolute Return Asset Class**
(Board agenda page III-99)
[Official agenda item #17]

Mr. Timmins introduced Jim Hubbard, director of public market alternative investments, to present a report that addressed the March 12, 2010 board motion to send the draft RFP back to the committee in order to facilitate further discussion regarding an alternative solution of distributing the Raven 5 assets to the four existing Raven managers and how the board could do that.

Rhett Humphreys, partner and senior consultant with NEPC, represented that maintaining a balance in the allocation to global macro and trading strategies was a primary reason for choosing an RFP for a new manager.

The draft RFP with a schedule for board decision in January 2011 was discussed and revised. Mr. Bradley directed staff to submit a draft RFP to the comptroller as soon as possible for review under the CATRAD requirements in order to facilitate the board motion on May 21, 2010, and release of the RFP by May 31, 2010. He also directed staff to adjust the RFP timeline to reflect proposals due in purchasing and contracts by June 30, 2010, with final selections to be made in November 2010. David Anderson, general counsel, noted that if it was the committee's intent to use

global macro and trading strategies exposure as a screening requirement, the RFP language should reflect this. Mr. Bradley requested that staff effect the amendments to the RFP with the help of NEPC in submitting the RFP draft to the comptroller.

Mr. Timmins stated that the Permanent School Fund's assets are unaffected by the events referred to in the SEC's civil suit against Goldman Sachs.

MOTION AND VOTE: *It was moved by Mrs. Lowe, seconded by Mr. Agosto, and carried unanimously to recommend to the State Board of Education approval to issue a Request for Proposals for Absolute Return Discretionary Separate Account Fund-of-Funds Manager for the Permanent School Fund, as amended.*

The meeting recessed at 2:18 p.m. and reconvened at 2:35 p.m.

DISCUSSION ITEMS

9. Review of Charter Facilities Funding (Board agenda page III-105)

Mr. Bradley expressed that there is a dual mandate of the board to promote public education and seek a prudent rate of return for the PSF. He added that charter schools have initial five-year contracts with the state and then can receive ten-year contracts; therefore, borrowing funds at longer terms is virtually impossible. He stated that charter schools can borrow privately, but for shorter terms and higher rates than local school districts.

Mr. Bradley proposed that the board allocate a certain percentage of assets in the real estate portfolio to invest in charter school facilities in Texas. He added that a solution for assisting charter schools financially is for the PSF to become the property owner of the charter facilities. Mr. Bradley asked Courtland Partners and NEPC if such an arrangement would be a prudent investment vehicle for the Fund.

Mr. Humphreys asked about the size of the allocation to the charter facilities. Mr. Bradley stated that it would be small and that a pilot program could start with an allocation of about \$100 million. Mr. Humphreys stated that such an amount would be de minimus in terms of the total size of the Fund. Mr. Humphreys added that NEPC would not be able to forecast a specific rate of return for such a charter facilities portfolio and the NEPC would expect it to be folded into the broader real estate asset class rate of return. Mr. Humphreys added that NEPC would leave the specifics of such a proposal to the board and its real estate consultant, Courtland Partners.

Mr. Bradley stated that the relationship between the PSF and the charter schools would be that of a lessor and lessee, respectively.

Robert Scott, commissioner of education, stated that he is supportive of pursuing funding for charter school facilities. He recommended that opportunities for surplus federal land be explored.

Ben Blakney, managing director with Courtland Partners, stated that the board would not be the first institutional investor to pursue investing in social infrastructure assets. He further stated that if capital can be matched with PSF assets, it would be advantageous. He added that the lower the land acquisition costs, the better in terms of achieving a good rate of return.

Mr. Anderson stated that the board is allowed to purchase real estate directly. He added that the concern would be investments that benefit a particular person or entity.

Mr. Blakney stated that such investments could be implemented within the constraints of the board's fiduciary responsibilities. He added that the investments would consist of investment alpha and social alpha. He stated that if investment alpha is met first, then the social alpha is acceptable. Mr. Blakney recommended allowing Courtland partners and NEPC to discuss exactly into which asset class (real estate, private equity, and infrastructure investments) such investments would be placed.

Mr. Blakney stated that an investment of \$100 million would not move the needle much so the board could put it in real estate. He further stated that Courtland however, would need to review the real estate policy to determine allowable investments. He added that NEPC and Courtland needed to make certain they craft the right bucket out of which to draw the capital. He stated that investments would include an operating component which would fall outside of Courtland's contract with the board. Mr. Blakney stated that Courtland and NEPC will take a look at the initiative and try to determine a reasonable rate of return that would be acceptable for such an investment. He added that the board would need to consider how it would exit investments in such properties. In conclusion, Mr. Blakney stated Courtland and NEPC will restrict their focus to the financial structure of such a proposal so the integrity of the investment platform is able to stand on its own merit.

Mr. Bradley requested the committee's consent to work towards developing a proposal to invest in charter facilities could be brought to the board in a two-to-four month time frame.

**10. Report of the Permanent School Fund Executive
Administrator and Chief Investment Officer**
(Board agenda page III-107)

Mr. Timmins had no report.

The meeting of the Committee on School Finance/Permanent School Fund adjourned at 3:12 p.m.