

**Report of the State Board of Education  
Committee of the Full Board  
July 22, 2010**

The State Board of Education Committee of the Full Board met at 9:07 a.m. on Thursday, July 22, 2010, in the State Board of Education Room, #1-104, of the William B. Travis Building, 1701 N. Congress Avenue, Austin, Texas. The following members of the committee were present:

Presiding: Gail Lowe, chair; Rick Agosto, Lawrence A. Allen, Jr., David Bradley, Barbara Cargill, Bob Craig, Cynthia Dunbar, Pat Hardy, Mavis B. Knight, Terri Leo, Don McLeroy, Ken Mercer, Geraldine Miller, Rene Nuñez

Absent: Mary Helen Berlanga

**DISCUSSION ITEMS**

**1. Discussion of Parliamentary Procedures**  
(Board agenda page I-23)

Parliamentarian Kirk Overbey discussed the differences between a motion to adjourn, which means to bring a meeting to a close, and a motion to recess, which is an intermission in a meeting. If a meeting has been adjourned, a new meeting commences the next time the body convenes. If the meeting is recessed, it is considered a continuation of the original meeting when the body reconvenes. When a body stands at ease, that represents a temporary pause in a meeting.

**2. Commissioner's Comments Regarding the SBOE Agenda**  
(Board agenda page I-25)

Commissioner of Education Robert Scott discussed the origination of the Texas Progression Measure (TPM) and its use. He also noted that the Fordham Foundation released a report this week that compared state standards to the Common Core Standards. Texas' English language arts and reading standards received a grade of A- from Fordham, while the state's mathematics standards received a grade of C. The commissioner said a substantial review of the Texas math standards would begin this fall.

**ACTION ITEM**

**3. Consideration of Petition for Adoption of Rule  
Concerning 19 TAC Chapter 66, State Adoption  
and Distribution of Instructional Materials**  
(Board agenda page I-1)  
[Official agenda item #3]

Christopher Lucas, manager of review and adoption in the division of instructional materials and educational technology, introduced the item and explained that the measures recommended by the petition were largely similar to existing processes.

Public testimony was provided by the following individual:

NAME: Carl Olson  
AFFILIATION: Textbook Trust

**MOTION AND VOTE:** *It was moved by Mr. Craig, seconded by Mr. Bradley, and carried unanimously to recommend that the State Board of Education deny the petition for adoption of a rule concerning 19 TAC Chapter 66, State Adoption and Distribution of Instructional Materials, in light of the existing program that allows the public to report errors. (Mr. Allen and Ms. Dunbar were absent for the vote.)*

#### **DISCUSSION ITEM**

##### **4. Update on Commissioner's List of Electronic Textbooks** (Board agenda page I-27)

Public testimony was provided by the following individual:

NAME: Carl Olson  
AFFILIATION: Textbook Trust

John Lopez, managing director of instructional materials and educational technology, introduced the item and updated the committee on the status of the review of materials submitted for inclusion on the commissioner's list. He explained that some of the submissions are still under consideration. A brief discussion followed.

#### **ACTION ITEMS**

##### **5. Review of the Report on Permanent School Fund Percentage Distribution Rates Under Consideration for Fiscal Years 2012 and 2013** (Board agenda page I-15) [Official agenda item #4]

Holland Timmins, executive administrator and chief investment officer, presented the first portion of this item entitled *A Review of the Texas Permanent School Fund Distributions to the Available School Fund*. Mr. Timmins stated that this was a refresher of the historical activities and payments of the Permanent School Fund to the Available School Fund. He directed the committee to page 5 of his presentation and highlighted that the last time the board set the rate it set it at 2.5% and because of the ten year rule, the Fund was only able to distribute \$61 million dollars; and if the Fund is able to maintain its current value, it should be able to make a catch-up payment in excess of one billion dollars in fiscal year 2011. He then directed the committee to page 12 of the document where he explained the rule of thumb arithmetic calculation of the spending rate. He continued that numbers were plugged in the rule of thumb calculation which showed a spending rate range of 3.16% and 3.56%. Mr. Timmins stated that the reason for this presentation was to satisfy the requirements of Rider 68 of House Bill 1 of the 81<sup>st</sup> Legislature which requires that TEA notify the Legislative Budget Board and the governor of the range under consideration.

Mr. Bradley referred to page 13 of the presentation and stated that there was a credit for GLO contributions which was being treated as a pass-through to the Available School Fund. Mr. Bradley added that the contributions from the GLO should be additions to corpus and should be part of the total return calculation.

Rhett Humphreys, partner with NEPC, continued with the second part of the presentation and directed the committee to his presentation entitled *Asset Allocation & Spending Policy Analysis*. He added that the board was familiar with the majority of the presentation and his presentation was a follow up to Mr. Timmins' presentation. He directed the committee to pages 13 through 15 of his presentation, which shows a spending analysis under various scenarios using Mr. Timmins' arithmetic spending formula, as well as contributions from various economic scenarios and using the current allocation target they generated various spending and projected market value numbers. He added that they modeled spending under different spending rates from 1.5% to 4.5%. He stated that more importantly, that looking at pages 13 and 15 under most of the scenarios and outside of having a bad five year economic and market environment such as deflation, the Fund holds its own with real value and falls slightly in a recessionary environment. He added that these cases validate the range that Mr. Timmins just introduced.

Mr. Bradley asked whether the expected return quoted is based on the Fund's policy asset allocation which contains some unfunded allocations or is it on the Fund's current allocation. Mr. Humphreys stated that it was the actual policy and assume that all asset classes would be funded over the next five years.

Mr. Craig asked whether the range that staff had calculated between 3.16% and 3.56% was a reasonable range. Mr. Humphreys responded that it was a reasonable range although as you bump up to the higher range in a down market the Fund would be bumping up to the corpus. Mr. Craig asked whether a range between 2.5% and 3.5% would be reasonable and prudent range to consider at this point and adopted in September. Mr. Humphreys responded that it would be a reasonable range and that NEPC has a recommendation of 1.5% to 3.5% range.

**MOTION AND VOTE:** *It was moved by Dr. McLeroy, seconded by Mr. Craig, and carried unanimously that the percentage distribution rate to the Available School Fund from the Permanent School Fund for fiscal years beginning September 1, 2012, and September 1, 2013, shall be between 1.5% and 3.5%.*

**6. Approval of Question and Answer Document for Supplemental Science**

(Board agenda page I-19)  
[Official agenda item #5]

Anita Givens, associate commissioner for standards and programs, introduced the item and reviewed some of the information contained in the question and answer document. (See Attachment A.) The committee requested that clarifying language be added to the document. Staff will present the new language to the full board on Friday, July 23.

**MOTION AND VOTE:** *It was moved by Mr. Craig, seconded by Dr. McLeroy, and carried unanimously to recommend that the State Board of Education consider approval of the Question and Answer Document for Supplemental Science Instructional Materials on Friday, July 23, after revisions are provided by staff. (Mr. Agosto and Mr. Nuñez were absent for the vote.)*

**7. Review and Adoption of the Long-Term Strategic Asset Allocation Plan of the Permanent School Fund**

(Board agenda page I-21)

[Official agenda item #6]

Mrs. Lowe introduced this item and gave the floor to Mr. Humphreys. Mr. Humphreys directed the committee to his presentation on Asset Allocation & Spending Policy Analysis. He added that the board has seen most of this presentation which has been updated. He directed the committee to page 56 of the presentation which depicts the various 2010 asset allocation recommendations. He stated that what was different in this presentation was the inclusion of the Permanent School Fund investment in charter school land and buildings in Texas. He added that NEPC, working with Courtland Advisors, came up with a set of assumptions for specific tracks of land in Texas. These include a return forecast, a risk forecast and correlations to determine how this particular asset class provides diversification when compared to other asset classes. He added that one of the challenges to come up on the assumptions for this asset class is that it does not have a history so they had to be forward looking. NEPC had to look at core real estate since a Texas real estate track would have similarities to this, but be somewhat different in relation to its risk and return profile. So they built up on that baseline and looked at decreasing the return forecast to be conservative and reduce the current yield on core real estate from 4% to 1.75% and added inflation to arrive to 5.75%. The risk factor on this was almost that of U.S. small cap equities or 50% higher than core real estate holding. The final piece was to assign a correlation similar to that of private equity real estate environment. When the numbers were pulled together, these assumptions were in line with their commodities assumptions. Mr. Humphreys directed the committee to page 56 and described the numbers under the current policy portfolio including the 7.80% expected return with 11.23% risk. He continued that using the same portfolio and adding charter schools in Mix 2, where they took out 0.5% from the unfunded real return allocation and put it into the new potential opportunity, charter schools. Returns move from 7.80% to 7.82% in return and risk remains the same. He added that their recommendation to the board from a five to seven year outlook would be Mix 1, which includes a 7% allocation to risk parity. However if the board elects to move to charter schools, their recommendation is Mix 3.

**MOTION:** *It was moved by Mr. Craig and seconded by Ms. Hardy to recommend that the State Board of Education adopt Mix 1 of the Permanent School Fund Long-Term Strategic Asset Allocation Plan as presented on page 56 of the NEPC Asset Allocation & Spending Policy Analysis presentation. (See Attachment B.)*

Mr. Craig added that he did not believe that it was prudent to use PSF funds for charter school facilities funding at this point. He added that there are many unresolved issues at this point and does not believe it is sound and prudent investment. Mrs. Miller stated that this type of investment was unsuitable for the Permanent School Fund. Ms. Hardy stated that she sees no value in the charter school allocation and supported Mr. Craig's position on it.

After some discussion, Mr. Craig withdrew his motion.

**MOTION:** *It was moved by Mr. Craig and seconded by Mrs. Miller to recommend that the State Board of Education readopt the Current Policy of the Permanent School Fund Long-Term Strategic Asset Allocation Plan as presented on page 56 of the NEPC Asset Allocation & Spending Policy Analysis presentation.*

Mr. Nuñez asked Mr. Humphreys to give a brief description of risk parity. Mr. Humphreys stated that a number of large funds were using this strategy and that its main benefit is that it is the best and more efficient way to get exposure in the financial markets and balance the risks. Mr. Bradley stated that NEPC had given the board three asset allocation proposals with changes from current policy that increase the expected rate of return on all three alternatives from current policy with a reduction or no change in risk.

Mrs. Lowe asked Mr. Timmins to give his opinion on risk parity. Mr. Timmins stated that staff was not convinced on risk parity and that staff had done quite a bit of research on the strategy. He added that having come out of a deep recession the fund has performed extremely well. He added that staff's advice is to be extremely cautious before making changes. He added that risk parity is a hedge fund strategy. So the first question is how does this strategy perform against other hedge fund strategies, how does it perform relative to a diversified pool of hedge funds. He added that staff had modeled the Bridgewater All Weather Fund and if the PSF had placed 7% of its assets on this strategy, instead of the pool of hedge funds the PSF invested in, it would have cost the Fund approximately \$100 million. He expressed that during this period, the Fund's investment in a diversified pool of hedge funds outperformed risk parity. He stated that the second issue comes from the numbers on page 7 of NEPC's presentation where the projected expected return and volatility for risk parity was 5.30% and 11.10%, respectively. He added that these numbers compared unfavorably with the expected return and risk profile of low volatility hedge funds of 6.25% and 7.00%, respectively. He added that another issue related to leverage. This strategy levers fixed income, an asset class that has been in a bull market for the past 28 years and the question in 2010 is whether we want to lever an asset class that has been in a bull market. He added that leverage is an extremely dangerous tool that works well when markets are heading in the right direction and creates a real risk when markets are heading in the wrong direction as occurred in 2008.

Mr. Craig stated that his concerns were that maybe risk parity is a good investment but not at this time. He added that the board will have the opportunity to adjust the asset allocation as it goes forward and learn more about it. But, he added, as Mr. Timmins stated, the track record of risk parity has not been good and the Fund would have lost rather than made money in risk parity. He added that the board should continue with the current policy and fund the remaining asset classes and review risk parity in the future.

Mr. Agosto stated that this was the first time he had heard staff having any concerns on risk parity. He asked Mr. Timmins if he provided any member of the committee with these concerns. Mr. Timmins responded that staff has provided a variety of balanced information on the strategy. Mrs. Lowe stated that staff had general questions all along and this may have been the first time that the board has heard specific concerns; but in fairness to staff, they have had questions about this area for a while. Mrs. Lowe added that the Committee of the Full Board was the right committee to consider concerns, questions and information from both the consultant and staff on risk parity. Mrs. Knight added that in the times she was present at PSF committee meetings, at no time was staff asked for their opinion on a matter before the committee. She added that the committee should start to ask those types of questions at the committee level.

Mrs. Lowe added that asset allocation was the most important decision before the board and the discussion should be held by the Committee of the Full Board and not the subcommittee, although some details and preparatory work should be held at the subcommittee level. She added that she believes that each member should have access to information and have the opportunity to ask questions and be fully informed and aware of what the board is doing. Mrs. Lowe stated that she had requested that this presentation be given to the entire board.

**VOTE:** *A vote was taken on the motion to recommend that the State Board of Education readopt the Current Policy of the Permanent School Fund Long-Term Strategic Asset Allocation Plan as presented on page 56 of the NEPC Asset Allocation & Spending Policy Analysis presentation. The motion failed.*

**MOTION:** *It was moved by Ms. Dunbar and seconded by Mr. Bradley to recommend that the State Board of Education adopt Mix 3 of the Permanent School Fund Long-Term Strategic Asset Allocation Plan as presented on page 56 of the NEPC Asset Allocation & Spending Policy Analysis presentation.*

Ms. Dunbar stated that the goal of the board is to provide for education and preserve the PSF. She added that the consultant analysis shows that Mix 3 is the combination with the highest rate of return coupled with the lowest risk. She added that the board has the fiduciary responsibility and when the asset allocation is adopted, the board also has the time frame by which it has to implement it. So by adopting the asset allocation, the board is showing its direction but the implementation does not have to be immediate, and the board can ask for an attorney general's opinion to confirm that it is meeting its fiduciary obligations.

Mr. Allen stated that he would like to keep the discussion open. He added that there is a need for an AG's opinion and he is not ready to vote for an allocation unless he had to vote for Mix 3 just to keep the discussion open. He added that it is important to look at what the board can do to deal with a serious issue such as charter school facilities funding. Mr. Mercer concurred with Mr. Allen and wondered if he voted for Mix 3 the discussion would continue or if he voted against Mix 3 the discussion would be over. Mr. Bradley added that voting for Mix 3 would keep the discussion open and show intent. Mrs. Lowe stated that she would seek an opinion from the attorney general. She added that the AG opinion would take time to develop and the chair would pursue an opinion and members of the board would have to decide their comfort in proceeding with an allocation target before or after the opinion.

**VOTE:** A vote was taken on the motion to recommend that the State Board of Education adopt Mix 3 of the Permanent School Fund Long-Term Strategic Asset Allocation Plan as presented on page 56 of the NEPC Asset Allocation & Spending Policy Analysis presentation. The motion failed, with 7 members voting Aye and 7 members voting No, as follows:

<u>Aye:</u>	Mr. Bradley	Dr. McLeroy
	Mrs. Cargill	Mr. Mercer
	Ms. Dunbar	Mr. Nuñez
	Ms. Leo	

<u>No:</u>	Mr. Agosto	Mrs. Knight
	Mr. Allen	Mrs. Lowe
	Mr. Craig	Mrs. Miller
	Ms. Hardy	

**MOTION AND VOTE:** It was moved by Mr. Craig, seconded by Ms. Hardy to recommend that the State Board of Education adopt Mix 1 of the Permanent School Fund Long-Term Strategic Asset Allocation Plan as presented on page 56 of the NEPC Asset Allocation & Spending Policy Analysis presentation. The motion carried, with 14 members voting Aye and 0 members voting No, as follows:

<u>Aye:</u>	Mr. Agosto	Mrs. Knight
	Mr. Allen	Ms. Leo
	Mr. Bradley	Mrs. Lowe
	Mrs. Cargill	Dr. McLeroy
	Mr. Craig	Mr. Mercer
	Ms. Dunbar	Mrs. Miller
	Ms. Hardy	Mr. Nuñez

## **DISCUSSION ITEM**

### **8. Discussion of Pending Litigation** (Board agenda page I-31)

The committee did not discuss pending litigation; therefore, no executive session was held.

Mrs. Lowe adjourned the meeting at 1:45 p.m.