

**Report of the State Board of Education
Committee on School Finance/Permanent School Fund
May 20, 2009**

(Permanent School Fund Items)

The State Board of Education Committee on School Finance/Permanent School Fund met at 9:13 a.m. on Wednesday, May 20, 2009, in Room #1-104 of the William B. Travis Building, 1701 N. Congress Avenue, Austin, Texas. All members of the committee were present, as follows:

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

Non-Committee Members Present: Ken Mercer

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.

DISCUSSION ITEM

**1. Review of Permanent School Fund Securities
Transactions and the Investment Portfolio**
(Board agenda page III-17)

Catherine Civileto, deputy executive administrator, provided a summary of the status of the Permanent School Fund portfolio. All reports presented to the Committee were for the reporting period February 1, 2009 through March 31, 2009, unless otherwise noted. This included the current fair market value of the Fund, the asset allocation mix as of March 31, 2009, PSF transactions summary, income and portfolio gains/losses and expenditures for the period September 1, 2008 through March 31, 2009, GLO managed real estate assets summary of revenues and contributions to the Fund for the period pre 1982 to March 31, 2009, securities lending activity for the period September 1, 2008 through March 31, 2009, Bond Guarantee Program Status Report, the proxy votes against management provided by the proxy vendor RiskMetrics Group, details of purchases and sales on all portfolios, internal fixed income rating changes for the period September 1, 2008 through March 31, 2009, broker commissions cumulative for the period January 1, 2009 through March 31, 2009 and activity in the short term investment assets.

David Anderson, general counsel, addressed the committee to update them on the current status of the Bond Guarantee Program. The program is temporarily closed and cannot reopen unless permission is gained from the IRS. The decline of the investment markets in early March 2009 caused the amount of guaranteed bonds outstanding to exceed the capacity calculated for the

program. Mr. Anderson assured the committee that all previously granted guarantees are safe; however, no new bonds can be guaranteed until the IRS provides guidance. Tax counsel is working on the matter.

Mr. Anderson also reported on the progress of SB 1255 promoting an intercept program for state credit enhancement that school districts can use as an alternative to the Bond Guarantee Program. Under this program, school districts could receive no more than an “AA” rating which is not as good as the “AAA” under the Bond Guarantee Program; however it may allow some districts to come to market and sell their bonds while the IRS works on the Bond Guarantee matter.

CONSENT ITEM

2. Ratification of the Purchases and Sales of the Investment Portfolio of the Permanent School Fund for the Months of February and March 2009

(Board agenda page III-1)

[Consent agenda item #(1)]

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 months of February and March 2009 in the amount of \$572,220,640 and \$433,865,793 respectively (Attachment A).*

DISCUSSION ITEM

3. First Quarter of 2009 Permanent School Fund Performance Report

(Board agenda page III-19)

Tom Heiner, client relationship manager with Mellon Analytical Solutions, presented the first quarter of 2009 Permanent School Fund performance report. Mr. Heiner started with an overview of the U.S and foreign capital markets. He stated that the Permanent School Fund returned -6.29% for the first quarter outperforming the target benchmark by 58 basis points. The Fund ranked in the 51st percentile or the 3rd quartile of the Mellon Universe of Public Funds greater than \$1.0 billion. Mr. Heiner reviewed performance of the Permanent School Fund by asset class stating that the total domestic equity composite returned -10.96% for the quarter and exceeding its benchmark by 11 basis points. He added that international equities returned -10.66% for the quarter, exceeding its benchmark by five basis points. The fixed income portfolio returned 1.16%, for quarter, outperforming its benchmark by 104 basis points. Mr. Heiner stated that the absolute return composite returned 1.91% for the quarter, coming below its long term benchmark. The absolute return composite ranked in the 27th percentile of the preliminary Hedge Fund Universe.

The meeting recessed at 10:22 a.m. and reconvened at 10:30 a.m.

ACTION ITEMS

4. Approval of a Tactical Plan and Investment Procedures for Real Estate

(Board agenda page III-3)

[Official agenda item #8]

Mr. Bradley introduced the item and invited Gary Lawson and Gus Fields of Strasburger & Price, the board's fiduciary counsel, Steven Novick, principal/chief operating officer, Benjamin Blakney, managing director, and Dan Moore, senior analyst, each from Courtland Partners, the board's real estate consultant, and Jim Voytko, director of research and senior consultant of R.V. Kuhns Associates, Inc., the board's general investment consultant, to participate in the discussion.

Mr. Bradley stated that the committee had discussed the Tactical Investment Plan and the Real Estate Procedures Manual (REP) in prior meetings and that the purpose of the current agenda item was to discuss changes to the documents since the April committee meeting and to potentially recommend approval of both documents to the board.

Mr. Bradley then asked Courtland to begin their presentation. Mr. Novick described the contents of the REP and stated that Courtland had worked with staff to develop the final Tactical Plan and REP. He stated that the REP details the responsibilities of each of the parties, including the board, the committee, investment staff, and the real estate consultant. He then reviewed each section of the REP in detail, noting that many of the responsibilities of staff and of Courtland are joint responsibilities and are therefore listed under both parties' responsibilities.

Mr. Bradley asked whether any parties had any additional comments regarding the Real Estate Tactical Plan and the Real Estate Procedures Manual.

Mrs. Dunbar requested that the word "subsequent" be substituted for the word "material" in Section A.1. of the Real Estate Procedures Manual.

MOTION AND VOTE: *It was moved by Mr. Agosto, seconded by Mr. Nuñez, and carried unanimously to recommend to the State Board of Education approval of the Real Estate Tactical Plan and the Real Estate Procedures Manual as recommended by Courtland Partners, Ltd. with an amendment and the placement of this item on the consent agenda of the State board of Education meeting of May 22, 2009.*

5. Authorization to Issue a Request for Qualifications (RFQ) for Investment Management Services for Real Estate

(Board agenda page III-5)

[Official agenda item #9]

The representatives from the board's fiduciary counsel, the board's real estate consultant, and the board's general investment consultant remained to participate in the discussion of this agenda item.

Mr. Bradley introduced the item and asked Mr. Timmins, Chief Investment Officer and Executive Administrator of the Permanent School Fund, to begin his presentation.

Mr. Timmins opened by stating that staff had discussed the RFQ with legal counsel, specifically in regards to the standards for an RFQ. He indicated that legal counsel had indicated that the RFQ

must clearly demonstrate that a firm is qualified to manage institutional funds in the amounts being considered by the real estate plan, currently \$40 million to \$50 million.

Mr. Anderson stated that in the judgment of legal counsel, that in order for the RFQ to meet the requirements to be considered a competitive process, the RFQ must contain minimum standards for qualification which would only allow firms to qualify that are capable of performing the duties outlined in the scope of services.

Mr. Timmins directed the committee to Section 1.3.2, Minimum Qualifications for Firms, item (g), which designates the minimum Assets Under Management (AUM) that firms are required to have in order to be considered eligible for pre-qualification under the RFQ. He stated that staff, after reviewing manager universe data provided by Courtland, recommended that the minimum firm AUM be set at either \$500 million or \$750 million, which would allow the inclusion of 70% or 62% of the managers in Courtland's database to qualify, respectively.

In response to a question from Mr. Bradley, Mr. Blakney stated that Courtland favored an approach for the RFQ that would provide for pre-qualification of a larger set of managers, with increased reliance on the due diligence phase in regards to specific investment opportunities presented by pre-qualified managers. Therefore, he stated that Courtland favored a lower minimum AUM of \$100 million and that they believed that firms of this size could qualify as being institutional quality.

The committee then discussed the expected allocation per investment and the requirements of the Investment Policy Statement in relation to manager size, fund size, and concentration limitations.

Mr. Bradley asked Mr. Lawson what minimum AUM would be prudent. Mr. Lawson stated that the process was the governing standard and that a single number could neither be considered prudent nor imprudent. He stated that given a target of \$50 million per investment, that a minimum AUM requirement of \$250 million would be reasonable. He added that, in this scenario, one could justify a minimum AUM requirement as low as \$100 million, if the fiduciary conditioned the requirement upon stringent due diligence of any manager of that size.

Responding to a question from Mr. Agosto, Mr. Voytko stated that any manager selected for pre-qualification must be capable of accepting and managing a \$40 to \$50 million equity commitment and that he suggested that a requirement for a minimum AUM of \$100 million to be too low. He stated that R.V. Kuhns believed that \$500 million would be reasonable and that the requirement should not be below \$250 million.

MOTION: *It was moved by Mrs. Dunbar, seconded by Mrs. Lowe, to amend the RFQ to set the minimum AUM in Section 1.3.2(g) to \$250 million.*

Mr. Agosto stated that he did not support the motion and that he preferred Courtland's recommendation to set the minimum AUM at \$100 million, in order to broaden the group of eligible managers.

VOTE: *A vote was taken on the motion to amend the RFQ to set the minimum AUM in Section 1.3.2(g) to \$250 million. Mrs. Dunbar, Mrs. Lowe and Mr. Bradley voted yes. Mr. Nunez and Mr. Agosto voted no (Attachment B).*

Mr. Timmins then referred the committee to Section 1.6 of the RFQ and he described that, based upon discussions with legal counsel, the RFQ would have a final term of four years and that the board could periodically reopen the RFQ, with a proposed reopening on an annual basis. He noted that firms could only be added during such a period when the RFQ is reopened.

The committee discussed the proposed frequency of reopening the RFQ, as well as the need to have subsequent review of firms that become pre-qualified throughout the term of the RFQ.

MOTION AND VOTE: *It was moved by Mrs. Dunbar, seconded by Mr. Nunez, and carried unanimously to amend Section 1.6 including friendly amendments offered by Mr. Bradley and accepted by Mrs. Dunbar (Attachment B).*

MOTION AND VOTE: *It was moved by Mr. Bradley, seconded by Mrs. Dunbar, and carried unanimously to amend Section 1.1 (Attachment B).*

Mr. Bradley asked if there were any comments on Section 1.3.1, Minimum Qualifications. There being none, Mr. Timmins stated that the next section up for discussion was Section 1.3.2(h), related to the firm's minimum years of experience in managing real estate investments. He stated that staff recommended that the submitting firm must have a minimum of five years managing real estate investments. Mr. Blakney stated that Courtland believed that three years would be sufficient.

MOTION AND VOTE: *It was moved by Mrs. Lowe, seconded by Mr. Nunez, and carried unanimously to change the minimum years of firm experience in Section 1.3.2(h) from five (5) years to three (3) years.*

MOTION: *It was moved by Mrs. Dunbar, seconded by Mrs. Lowe, to reconsider the motion to amend the RFQ to set the minimum AUM in Section 1.3.2(g) to \$250 million.*

The chair noted that there was no objection to the motion to reconsider.

MOTION AND VOTE: *It was moved by Mrs. Dunbar, seconded by Mr. Nunez, and carried unanimously to amend the RFQ to set the minimum AUM in Section 1.3.2(g) to \$200 million (Attachment B).*

The committee discussed the review process, as described in Section 4.2, with staff and with Courtland.

Mr. Lawson suggested two amendments to Section 3.2, Proposer's Financial Responsibility, to the committee. Mr. Bradley suggested an additional amendment to this section.

MOTION AND VOTE: *It was moved by Mrs. Dunbar, seconded by Mr. Nunez, and carried unanimously to amend Section 3.2 (Attachment B).*

MOTION AND VOTE: *It was moved by Mrs. Lowe, seconded by Mrs. Dunbar, and carried unanimously to recommend to the State Board of Education approval to issue a Request for Qualifications for Investment Management Services for Real Estate for the Permanent School Fund with amendments and the placement of this item on the consent agenda of the State Board of Education meeting of May 22, 2009 (Attachment B).*

The meeting recessed at 12:35 p.m. and reconvened at 2:27 p.m.

6. Consideration of Policies and Procedures for Securities Litigation

(Board agenda page III-7)

[Official agenda item #10]

Fiduciary counsel, Gary Lawson and Gus Fields of Strasburger & Price LLP, made a presentation to the committee regarding the appropriateness of the Fund pursuing securities litigation claims when portfolio losses have been identified. The various solution sets were briefly explored and counsel concluded that they are qualified to offer such services in conjunction with a partnership with the firm of Bernstein Litowitz Berger and Grossman, LLP, a New York based firm that provides portfolio monitoring and case evaluation services to institutional clients. Strasburger & Price would offer such services to the Fund at no charge and asked to have the scope of the existing fiduciary contract expanded to include such services. If asset losses are discovered and such losses are determined to merit a lawsuit, then separate litigation counsel would be hired to litigate the claim.

Mr. Anderson joined the discussion and shared with the committee that there may still be a roadblock to being able to use Fund assets, either current assets or recoveries from future cases to pay contingency fees for litigation. Mr. Anderson referenced Attorney General Opinion No. DM-316 from 1995 as being operative still in defining what Fund assets can be spent on. Mr. Anderson stated that he does not believe that paying securities litigation lawyers from claim recoveries or from Fund assets is allowable because of this particular opinion. As such, a consultation with the Attorney General's Office is necessary and there may be a need to request another opinion about the matter.

Mr. Anderson and Mr. Lawson agreed to pursue further to ascertain next steps. Mr. Lawson concluded by indicating that pursuit of loss claims was a fiduciary responsibility of the board.

Mr. Lawson would continue to draft policies and procedures related to securities litigation.

7. Approval of the Selection of a Firm to Provide Investment Counsel for the Permanent School Fund and Authorization For Contract Execution by the Commissioner of Education

(Board agenda page III-9)

[Official agenda item #11]

The committee postponed action on this item.

8. Authorization to Issue a Request for Proposals for Investment Counsel Services for the Permanent School Fund

(Board agenda page III-11)

[Official agenda item #12]

The committee postponed action on this item.

9. Authorization to Issue a Request for Proposals for Performance Measurement Services for the Permanent School Fund

(Board agenda page III-13)
[Official agenda item #13]

Mr. Timmins advised the committee that two adjustments had been made in the RFP document previously drafted and reviewed at the April meeting. Assets Under Performance Measurement (AUPM) was reduced by 25% and the requirement for daily performance reporting was removed. Amended language was presented and some additional modifications were made by the committee to Sections 1.3.h and 1.3.i to clarify the required experience of proposers.

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 Performance Measurement Services for the Permanent School Fund with amendments and the placement of this item on the consent agenda of the State Board of Education meeting of May 22, 2009 (Attachment C).*

DISCUSSION ITEMS

10. Review of the Trading and Brokerage Policy and Brokerage Usage for the Permanent School Fund

(Board agenda page III-21)

Sandra Smith, Compliance Officer, reviewed the HUB Trading and Brokerage Policy and HUB Brokerage Usage for the Permanent School Fund for the fiscal year 2008-2009. Ms. Smith reviewed with the committee the process of identifying potential HUB brokerage firms and selecting qualified firms through a questionnaire and the onsite due diligence process. Ms. Smith informed the committee that two firms were qualified and approved for the HUB program.

**11. Discussion of Proxy Voting Policy
(Board agenda page III-23)**

Mr. Timmins presented information regarding the proxy voting policy of the Permanent School Fund.

12. Consideration of Texas Attorney General Opinion GA-0707 Regarding Transfers from the Permanent School Fund to the Available School Fund and Consideration of Process to Make Required Determinations

(Board agenda page III-27)

Mr. Anderson, stated that the Texas Constitution gives the board the authority to set the percentage of the Permanent School Fund that will be paid out to the Available School Fund which then buys textbooks and supports the school finance system. He stated that the board set the payout rate last November at 2.5% per year. He added that there is a second provision in the constitution which states that the payout cannot exceed the total return of the fund during a ten fiscal year period including the current fiscal year. This raised a number of questions for paying out from the PSF over the next fiscal year. Dr. McLeroy requested an attorney general's opinion on this issue. He added that the opinion was received and will most likely require the board to slightly change their

procedures or to take on additional tasks. The opinion clearly distinguishes between two items: (1) the percentage setting and (2) the inability to make a payment if it exceeds the Fund's total return over 10 years. The opinion makes it clear that the board will have to make an annual determination during the fiscal year that begins September 1 as to whether there is total return sufficient to pay-out to the Available School Fund. He added that staff has been making this calculation which requires it to look at the previous nine fiscal years and make a projection for the current fiscal year in terms of determining what the total return will be and what could be paid out to the Available School Fund if at all.

Mr. Bradley asked Mr. Anderson what happens if the calculation is not accurate. Mr. Anderson answered that the opinion did not address this question. Mr. Anderson added that the board has leeway to look at the projections made for the year at either their September or November meeting and make a determination as to whether there are funds to distribute the full amounts, partial amounts or none. This determination would be made on an annual basis. Mr. Bradley stated that this would be an ongoing process. He further stated that at some point after September 1, the board needs to make a determination to either allow a fiscal year 2010 distribution or not. Mr. Bradley added that the board would also have to make a decision as to what the expected return for the total fund is going to be for the next 12-month period. Mr. Bradley stated that the difficult part will be to project these short term returns for the PSF.

Mrs. Dunbar stated that to fulfill their responsibility as fiduciaries, the board could make a projection that is based on expert assessment. She asked Mr. Anderson whether the opinion addressed the reasonableness of the projection. Mr. Anderson stated that all the board had to do was to be able to defend their decision. He continued that the board would have to make a rational decision on the issue. The opinion, however, did not answer the question if it was determined that an error was made in the projection and whether there is a mechanism by which distribution could be raised in the following fiscal year for amounts in arrears. Mr. Anderson suggested that the board go back and ask the question to the attorney general.

Mr. Bradley asked to have something in place for action in September and a policy to deal with this issue should be developed over the next couple of meetings.

13. Report of the Permanent School Fund Executive Administrator and Chief Investment Officer
(Board agenda page III-37)

Mr. Timmins had no report.

The meeting of the Committee on School Finance/Permanent School Fund adjourned at 4:10 p.m.