

**Report of the State Board of Education
Committee on School Finance/Permanent School Fund
February 19, 2010**

The State Board of Education Committee on School Finance/Permanent School Fund met at 9:11 a.m. on Friday, February 19, 2010, in Room #1-100 of the William B. Travis Building, 1701 N. Congress Avenue, Austin, Texas. The following members of the committee were present:

Presiding: David Bradley, chair; Gail Lowe, Rene Nuñez

Absent: Rick Agosto, vice chair; Cynthia Dunbar

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 ITEMS

1. Discussion of 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

Lisa Dawn-Fisher, deputy associate commissioner of school finance and David Anderson, general counsel, presented the item for discussion. No separate exhibit on the summary of Bond Guarantee Program Costs was presented at this meeting.

2. Update on the Real Estate Investment Process
(Board agenda page III-1)

Mr. Bradley introduced Steve Novick, Principal/Chief Operating Officer and Dan Moore, Senior Analyst, representatives of Courtland Partners both of whom presented a report to the Committee discussing current real estate market conditions, current investment opportunities, a recent due diligence trip, and a proposed update to the current tactical plan for the Texas Permanent School Fund.

Mr. Novick, stated that Courtland and staff may present potential funding commitments for the board to consider at the March meeting. He indicated, as a result of the recent due diligence trip by staff and Courtland, two prospective real estate managers were identified as suited for further review. He explained that the managers require further due diligence. Mr. Novick also stated Courtland expects to follow-up with a number of additional managers focused on the core, open-end

real estate opportunities. Mr. Novick further stated that staff and Courtland may bring such opportunities forward in May.

Mr. Novick shared with the committee that Courtland intends to come back to the March meetings with a written recommendation for the board to adopt a modification to the initial target allocation of the real estate markets to moderate the risk/return exposure of the Fund's real estate program. Specifically, Mr. Novick stated he will recommend adjusting the current tactical plan, the core allocation up from 20% and the value and opportunistic allocations down from 60% and 20%, respectively.

John Grubenman, Director of Private Market Alternatives, addressed the committee and stated that he was pleased with the process so far. Mr. Grubenman stated that he was further pleased with the change in the tactical asset allocation and that he was comforted with the increase in the core and core plus allocations. Mr. Grubenman also stated that he agreed with Mr. Novick that the real estate pacing schedule and vintage year diversification are very important.

The meeting recessed at 10:27 a.m. and reconvened at 10:46 a.m.

3. Presentation by NEPC, General Investment Counsel for the Permanent School Fund
(Board agenda page III-)

Tim McCusker, Director of Traditional Research, and Keith Stronkowsky, Senior Analyst, with NEPC presented their firm's Asset Allocation Study. Mr. McCusker began with a review of the 2010 NEPC Capital Market Projections. He described the process by which his firm arrives to capital market projections and asset allocation studies. He stated that 2009 was a relief after 2008 particularly as markets recovered quickly. He stated that fixed income markets recovered in terms of liquidity, equity markets rallied, riskier assets had higher returns including emerging markets which were up 70%, the was up S&P 27% for the year. He added that it was a strong year as the fed replaced the investor and took the risk. He stated that given all that happened, the outlook was for a high risk for long term inflation. He added that there is a lot of capacity in the economy that needs to be used up before prices and wages rise in the short term. Mr. McCusker stated that another source of inflation could be monetary which would have an impact on the U.S. dollar.

Mr. McCusker stated that currently, as they look across markets they see equities around fair value, credit spreads in fixed income close to fair value, low interest rates with the likelihood of going up and commodities that are already pricing future inflation. He added that they see very subdued returns going forward. He stated that in a subdued environment investors should not chase returns by flooding the portfolio with equity risk. He continued by stating that clients should take a risk management approach by: looking at risk budgeting by determining where the sources of risk comes from; and build an asset allocation that will be protected against high inflation, recession, etc. He added that in a high inflation scenario investors should add commodities or TIPS to their portfolio. In a recessionary environment investors should have enough fixed income exposure and liquidity.

Mr. McCusker continued by reviewing the role of fixed income in the portfolio. He stated that the role of fixed income has evolved in institutional portfolios where it has historically been a risk reducer to equity allocations. He added that fixed income could continue to evolve as a liability hedge which is true of corporate pension plans that are trying to manage interest rate risk and where a lot of fixed income makes sense. Mr. McCusker stated that it made sense to consider illiquid investments such as opportunistic commercial real estate if done in a measured fashion. He added

that opportunities in this sector are going to evolve in the next several years as more debt becomes distressed.

Mr. McCusker stated that clients should overweight emerging markets as this sector is strategically a better place to be as these markets are in a better fiscal condition with a growing consumer base. He added that this is an area of potential opportunity for the Fund. He continued by describing the development of his firm's asset class assumptions. He gave a brief description on how the long-term forecasts are arrived to and gave a description of the assumption development for large cap equity. Mr. Bradley noted that there was a change to a five to seven year projection instead of a ten year projection. Mr. McCusker responded that they always look at a seven year projection which is in line with the length of an average business cycle.

Mr. McCusker continued with his presentation by stating that they take the different asset assumptions and build an efficient frontier with typical constraints for an institutional client. He added that the efficient frontier has shifted lower with less return but also lower volatility. Mr. McCusker continued by stating that the market assumptions were taken and applied to the current target portfolio with some adjustments based on the themes that he described.

Mr. Stronkowsky stated that under the current target the expected return is 7.7% with a volatility of 11.7%. He added that they created an illustrative portfolio based on the themes they have talked about including emerging markets, equities, debt, a weakening dollar and the risk of long term inflation. He stated that in the illustrative portfolio they made a couple of adjustments such as bringing down total equity from 53% to 40%. He added that they introduce emerging markets international equities, emerging market debt and raise the allocation to real return from 6% to 9%, given the inflation themes that may play out.

Mr. McCusker continued with a description of risk parity. He stated that risk parity incorporates all the themes that they been talking about including reducing equity exposure, adding risk exposure into emerging markets, and inflation protection exposure through TIPS and commodities. He stated that all of these comprise of a risk parity allocation. Mr. Bradley asked whether risk parity would satisfy all the needs stated above. Mr. McCusker stated that that they would not, but would invest in risk parity as a first step to get real return exposure. Mr. Stronkowsky added that they would bring an education presentation to the board in March. Mr. McCusker added that the portfolios would be levered up to achieve the returns. He added that there is more fixed income exposure through leverage than equity exposure to balance the risk of the portfolio. He stated that this exposure would be done through futures and not be levered with borrowed funds to execute the futures contracts.

Mr. Bradley stated that an education session on real return and risk parity would be presented to the board in March. He added that NEPC should begin work on the Available School Fund distribution rate to bring for discussion in July for potential decision in September.

The meeting recessed at 11:33 a.m. and reconvened at 12:43 p.m.

4. Review of Goldman Sachs Investment Management Services (Board agenda page III-)

Mr. Bradley introduced Tim McCusker, Director of Traditional Research, and Keith Stronkowsky, Senior Analyst, both representatives of NEPC. Referencing the NEPC handout "2010 Asset Allocation & Risk Budgeting Review", Mr. McCusker summarized a meeting held between the

NEPC Hedge Fund Research Team and the Goldman Sachs Hedge Fund of Fund personnel where they addressed Goldman's recent structural changes. Within the same document, Mr. McCusker included an analysis of Goldman Sachs historical changes since 2005. Mr. McCusker also acknowledged that the NEPC analysis included a time frame that was prior to an investment by the Permanent School Fund. In conclusion, NEPC recommended that Goldman Sachs be put up for client review while keeping them on the watch list.

Jim Hubbard, Director of Public Market Alternatives, presented the PSF Manager Review of Goldman Sachs. Mr. Hubbard detailed Goldman Sachs adherence to investment guidelines. Mr. Hubbard further reported several communications, both in person and telephonically, with Goldman post their placement on the watch list, November 20, 2009. Mr. Hubbard's conclusion addressed Goldman's personnel and structural changes and stated that the Fund now feels it can cast some context around them. Holland Timmins, Executive Administrator and Chief Investment Officer recommended that Goldman Sachs remain on the watch list and that a reassessment be made in twelve months.

Mr. Bradley recommended that an RFP for Absolute Return be drafted for the March meeting. Mr. Timmins expressed concern with the labor intensive aspect of an RFP.

The meeting of the Committee on School Finance/Permanent School Fund adjourned at 1:45 p.m.