

**Report of the State Board of Education  
Committee on School Finance/Permanent School Fund  
March 9, 2010**

The State Board of Education Committee on School Finance/Permanent School Fund met at 9:07 a.m. on Tuesday, March 9, 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; Cynthia Dunbar, Gail Lowe, Rene Nuñez

Absent: Rick Agosto, vice chair

**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 heard public testimony on agenda item #1. Information regarding the individuals who presented public testimony is included in the discussion of that item.

The committee considered items #4 through #13 prior to items #1 through #3.

**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**

(First Reading and Filing Authorization)  
(Board agenda page III-1)  
[Official agenda item #18]

Public testimony was provided by the following individuals:

NAME: Laura Slaughter  
AFFILIATION: Municipal Advisory Council of Texas

NAME: Tom Canby  
AFFILIATION: Texas Association of School Business Officials

Lisa Dawn-Fisher, deputy associate commissioner of school finance, and David Anderson, general counsel, presented the item for discussion.

**MOTION AND VOTE:** *It was moved by Mrs. Lowe, seconded by Mr. Nuñez, and carried unanimously to approve for first reading and filing authorization 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, to maintain the \$2,300 application fee.*

**MOTION AND VOTE:** *It was moved by Mrs. Lowe, seconded by Mr. Nuñez, and carried unanimously to approve for first reading and filing authorization 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, to set the multiplier at three times the cost value of the Permanent School Fund.*

**2. Proposed Ratification of Decrease in the Reserve for the Guarantee Program for School District Bonds**

(Board agenda page III-15)  
[Official agenda item #19]

**MOTION AND VOTE:** *It was moved by Mrs. Lowe, seconded by Mr. Nuñez, and carried unanimously to ratify the proposed decrease in the reserve for the Guarantee Program for School District Bonds from 8 percent to 5 percent.*

**DISCUSSION ITEMS**

**3. Review of 19 TAC Chapter 109, Budgeting, Accounting, and Auditing**

(Board agenda page III-25)

Rita Chase, director of financial audits, and Mr. Anderson presented this item for discussion. She explained that the rules on the Budgeting, Accounting and Auditing are subject to sunset review every four years. The review is intended to both ensure that the need for the rule continues to exist and to update the language in the rule, as appropriate.

**4. Report by Weaver & Tidwell on the Audit of the Permanent School Fund's Financial Statements for the Period Ending August 31, 2009**

(Board agenda page III-37)

Kevin Sanford, Partner, and Laura Lambert, Manager, Weaver & Tidwell, L.L.P. were present to review the results of the annual audit of the Permanent School Fund's Financial Statements for the fiscal year ending August 31, 2009. Mr. Sanford noted that the audit resulted in an unqualified opinion which provides the highest level of assurance that the financial statements fairly present, in all material respects, the financial position of the Fund and the changes in financial position for the year ended August 31, 2009. Mr. Sanford highlighted key information on the Balance Sheet and the Statement of Revenues, Expenditures and Changes in Fund Balance, which combine the PSF assets managed by the State Board of Education and real assets managed by the School Land Board. He noted beginning fund balance increased by \$197,208,267 for the cumulative effect of the implementation of GASB Statement 52, which now requires that land and other real estate held as investments by endowments must be stated at fair market value. Sovereign land continues to be reported at historical cost. Mr. Sanford also noted that the Fund Balance at August 31, 2009 was \$22.5 billion and that the net change in Fund Balance for the fiscal year was negative \$2.8 billion.

Mr. Sanford thanked the board and staff and stated that Weaver & Tidwell appreciated the opportunity to perform the audit. He noted that the audit went smoothly due to the cooperation of the Permanent School Fund and General Land Office staff.

The meeting recessed at 9:34 a.m. and reconvened at 9:46 a.m.

**5. Review of Permanent School Fund Securities Transactions and the Investment Portfolio**  
(Board agenda page III-39)

Catherine Civileto, deputy executive administrator, provided a summary of the status of the Permanent School Fund portfolio. Reports presented to the committee were for the reporting period December 1, 2009 through January 31, 2010 unless otherwise noted. Ms. Civileto 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 December 31, 2009, 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, and broker commissions for internal equity portfolios cumulative for the period January 1, 2009 through December 31, 2009 and cumulative for the period January 1, 2010 through January 31, 2010. Time was then allocated for answering questions from the committee.

**CONSENT ITEM**

**6. Ratification of the Purchases and Sales of the Investment Portfolio of the Permanent School Fund for the Months of December 2009 and January 2010**  
(Board agenda page III-17)  
[Consent agenda item #(2)]

**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 December 2009 and January 2010 in the amount of \$728,512,795 and \$453,101,093 respectively (Attachment A).*

**DISCUSSION ITEM**

**7. Fourth Quarter 2009 Permanent School Fund Performance Report**  
(Board agenda page III-41)

Tom Heiner presented the fourth quarter of 2009 Permanent School Fund performance report. Mr. Heiner began with an overview of the U.S and foreign capital markets. Mr. Heiner then reviewed the performance of the Fund for the fourth quarter 2009. He stated that the PSF returned 4.11% for the fourth quarter outperforming the target benchmark by 39 basis points. The Fund ranked in the 19th percentile or the top first quartile of the Mellon Universe of Public Funds greater than \$1.0 billion. Mr. Heiner added that the outperformance for the quarter was attributed to the performance of the Domestic Fixed Income and Absolute Return asset classes against their

respective benchmarks. Mr. Heiner added that for calendar year 2009, the Fund returned 25.02% outperforming the target benchmark by 189 basis points.

Mr. Heiner reviewed performance of the Permanent School Fund by asset class stating that the total domestic equity composite returned 5.93% for the quarter, falling three basis points below its benchmark for the quarter. He added that international equities returned 3.80% for the quarter, exceeding its benchmark by six basis points. The fixed income portfolio returned 0.71%, for quarter, outperforming its benchmark by 51 basis points. Mr. Heiner stated that the absolute return composite returned 3.07% for the quarter, outperforming its long term benchmark by 182 basis points.

## **ACTION ITEM**

### **8. Authorization to Issue a Request for Proposals for Absolute Return Asset Class** (Board agenda page III-19) [Official agenda item #20]

Holland Timmins, executive administrator and chief investment officer, presented a draft document entitled Request for Proposal RFP # 701-10-042 for Absolute Return Discretionary Separate Account Fund-of-Funds Manager. Mr. Timmins explained the draft was in response to the committee's request at the meeting in February.

Rhett Humphreys, Partner & Senior Consultant with NEPC, stated that NEPC staff had reviewed the draft, and had no further changes to suggest for the RFP. Mrs. Lowe requested clarification as to what steps should be taken once the RFP was issued. Mr. Timmins stated that the process of transitioning from one manager to another was very complex, and warranted further discussion and clarification of a number of issues.

**MOTION AND VOTE:** *It was moved by Mr. Nuñez 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 and the placement of this item on the consent agenda of the State Board of Education meeting of March 12, 2010.*

## **CONSENT ITEM**

### **9. Authorization to Issue a Request for Qualifications (RFQ) for Legal Counsel for the Permanent School Fund** (Board agenda page III-21) [Consent agenda item #(3)]

Mr. Timmins introduced this item by stating that the current legal contracts for fiduciary counsel, contracts counsel and tax counsel would all expire at the end of the fiscal year. It was noted that the Office of the Attorney General has oversight over such external legal counsel relationships and contracts are usually allowed in two year cycles. It would be appropriate at this time to issue a request for qualification (RFQ) to solicit proposals from law firms who can provide these services.

**MOTION AND VOTE:** *It was moved by Mr. Nuñez and carried by unanimous consent that the State Board of Education approve the issuance of a Request for Qualifications (RFQ) for Outside Legal Counsel for the State Board of Education and the Permanent School Fund: Fiduciary Counsel, Alternative Assets Portfolio/Contracting and Tax Counsel.*

## **DISCUSSION ITEM**

### **10. Discussion on the Status of the RFP for Performance Measurement Services for the Permanent School Fund** (Board agenda page III-43)

Mr. Bradley introduced this item and stated that the RFP had been responded to but the Board had not taken any action. Mrs. Lowe stated that she has been very pleased with the services the current contract holder provides and did not see a need to hire a new performance consultant. She added that the committee should close this RFP. The committee unanimously agreed to close the RFP.

The meeting recessed at 11:39 a.m. and reconvened at 12:29 p.m.

## **ACTION ITEM**

### **11. Decision on Real Estate Investments** (Board agenda page III-23) [Official agenda item #21]

Mr. Bradley introduced representatives of the Fund's real estate consultant, Courtland Partners. Ben Blakney, Managing Director, framed the real estate recommendations brought to the committee by Courtland and staff which included opportunity for the committee to review and consider amendments to the real estate tactical plan, investment with Mesa West Real Estate Income Fund II, L.P., and investment with Invesco Mortgage Recovery Fund.

Steve Novick, Principal/Chief Operating Officer, recapped the February committee discussion regarding Courtland's intent to return to the March committee meeting with a written recommendation for the board to adopt a modification to the real estate tactical plan. Mr. Novick presented Courtland's written recommendation to change the targets of core, value and opportunistic to 40%, 40%, and 20% respectively, and the committee acknowledged and accepted the change. Mr. Novick noted that these targets fall within the PSF investment policy ranges established for real estate and commented that similar adjustments are being executed across Courtland's client-base.

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 PSF staff. He first introduced real estate general partner Mesa West Capital, LLC, and its fund offering the Mesa West Real Estate Income Fund II, L.P., a real estate debt fund. Second, Mr. Moore introduced real estate general partner Invesco Mortgage Recovery Master Associates, LLC ("Invesco"), and its offering the Invesco Mortgage Recovery Fund, also a real estate debt fund. For each, Mr. Moore fully explained the objectives of the fund, investment terms, advantages, and risks. He described the in-depth due diligence activities conducted by both Courtland and PSF staff, including on-site visits. Mr. Moore walked through the merits of both proposed investments and the reasons Courtland and PSF staff were making the recommendations.

Mr. Novick addressed the committee and restated that Courtland recommends both funds for committee and board approval and further recommends a \$40 million dollar commitment to each fund. PSF staff concurred with Courtland's recommendation.

**MOTION AND VOTE:** *It was moved by Mr. Nuñez and carried unanimously to recommend to the State Board of Education approval to execute agreements, subject to continued due diligence, with Mesa West Real Estate Income Fund II, L.P. necessary to make an investment commitment of \$40 million.*

**MOTION AND VOTE:** *It was moved by Mr. Nuñez and carried unanimously to recommend to the State Board of Education approval to execute agreements, subject to continued due diligence, with Invesco Mortgage Recovery Fund necessary to make an investment commitment of \$40 million.*

## **DISCUSSION ITEMS**

### **12. Report by NEPC, General Investment Counsel for the Permanent School Fund** (Board agenda page III-45)

Mr. Humphreys gave an abbreviated report to the committee which he will present in greater detail to the Committee of the Full Board at the March 10 meeting. Mr. Humphreys gave a brief review of NEPC 2010 Capital Market Assumptions and the PSF current target and actual asset allocations, and "risk budgeting" as a planning tool. Mr. Humphreys also gave a brief overview on risk parity and real return asset class.

### **13. Report of the Permanent School Fund Executive Administrator and Chief Investment Officer** (Board agenda page III-47)

Mr. Timmins reported that the Fund had received all required disclosures for transactions between service providers and that none reported any transactions that involved PSF assets. He also reported that Standard & Poor's had reaffirmed the PSF's AAA rating.

The meeting of the Committee on School Finance/Permanent School Fund adjourned at 1:41 p.m.