

**Report of the State Board of Education
Committee on School Finance/Permanent School Fund
August 20, 2010**

The State Board of Education Committee on School Finance/Permanent School Fund met at 9:20 a.m. on Friday, August 20, 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

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. Review of the Absolute Return Portfolios Managed for the Permanent School Fund

Mr. Bradley introduced the item. The following two firms gave presentations by their respective representatives:

Grosvenor Capital Management L.P.

Mr. Stephen Brewster, Managing Director, Client Group

Mr. Bradley Meyers, Vice President, Investments

Mesirow Advanced Strategies, Inc.

Mr. Erik Barefield, Managing Director

Mr. Mark Kulpins, Managing Director

2. Discussion of Asset Class Implementation

Holland Timmins, executive administrator and chief investment officer, introduced the item starting with an update on the status of the absolute return RFP. Mr. Timmins stated that the RFP was posted on June 30th with a response deadline date of July 28th. Ten firms responded to the RFP with one deemed non-responsive, leaving nine firms to be reviewed by staff and NEPC.

Mr. Bradley asked if all nine respondents would be invited to Austin for an interview. Mr. Timmins stated that not all would be asked to come since not all met the minimum qualifications established by the board. Mr. Bradley asked about process and the involvement by the committee. Mr. Timmins stated that the process will begin with a review of responses by both staff and NEPC,

followed by interviewing the firms in Austin and performing on-site due diligence with the selected firms. Finalists would then be brought to the committee for consideration in November.

Keith Stronkowsky, senior analyst with NEPC, stated that with the small number of respondents, the numbers can be reduced at each step. He added that the firms would be ranked separately by NEPC and staff.

Mr. Nuñez stated that in the past staff recommended firms and ranked those according to various factors and that he had concerns about staff presenting fee information on the firms to committee members. He stated that this influenced committee members to be unfair to one firm or another based on fees. Mr. Nuñez further stated that board members would have a bias towards those firms charging less and that he would prefer that staff not include fees at the beginning of the decision process since they are negotiable.

Mr. Bradley asked Gary Lawson, fiduciary counsel, to address Mr. Nuñez's concerns. Mr. Lawson stated that fees could be a legitimate part of the evaluation process since they are a factor in a firm's total return. He added that the fee consideration could be left to a later time, but could not be excluded.

Mr. Bradley proposed a solution to the problem whereby the committee would not consider as a finalist any firm whose fees were cause for concern. Mr. Lawson stated that it would be a possible solution and that fees should fall within a suitable range in addition to the firms delivering the service and meeting the board's ultimate rate of return. Mr. Bradley suggested that fees be left out of the matrix once they get to the finalist recommendations. He added that fees would certainly be disclosed but not included in the rankings. Mr. Lawson stated that such an arrangement would be reasonable because the board would be looking for the best qualified firms and not the cheapest firms.

David Anderson, general counsel, stated that his understanding of the discussion was that staff and the consultant would consider fees in the initial screening, but the board's decision would not include that information. Mr. Bradley stated that the information would be brought to the board, but staff and NEPC would eliminate anyone with an outrageous fee structure. Mrs. Lowe asked whether the RFP asked for a fee structure as part of the scoring and if so, it cannot be discounted. Mr. Anderson stated that when the RFP was issued, a number of factors went into the scoring and were stated in the RFP. Mr. Bradley stated that these factors would be part of the scoring prior to bringing finalists to the board; therefore, the committee is asking that staff not weigh the fee structure at the finalist level. Mr. Lawson stated that when firms are brought to the board, a pre-selection would be done based on quality, best of breed and the elimination of outrageous fees. Those firms with outrageous fees would not be brought for consideration. Mr. Lawson continued that of the firms brought to the board, the board must determine which are the best as a whole and not simply the most or least expensive.

Mr. Bradley restated his initial concern regarding the final selection of a firm by the board. For example, if the staff presents three ranked firms and the board selects the second and third ranked firms, the perception can be that the board did not select the best candidate. Mr. Bradley asked how can this perception be eliminated. He specifically asked Mr. Lawson if the issue could be eliminated by removing rankings from the end of the process and the staff simply presenting all finalist firms as qualified.

Mr. Anderson interjected by stating that the board could give discretion to staff and the consultant to evaluate the firms without defined standards. Mr. Bradley stated that a standard exists and the board

is simply asking the investment professionals to determine whether the firms affirmatively meet the standard as opposed to presenting them on a ranked-basis. Mr. Bradley stated, as an example, the minimum standards in the current absolute return RFP. The board, he added, has given authority to the investment professionals to determine which firms are the real gems of the group. Mr. Bradley stated that once the list is narrowed to finalists, the recommendation should be that all are qualified and can perform the job without any reservation or concern from the board. He added that the rankings would come from counting board votes.

Mr. Anderson stated that the board would want staff to document their decision. The board could receive from staff the bids that were ranked the highest but not state exactly how they were ranked. He added that the document ranking the firms would exist and be subject to the public information act. Mr. Anderson stated that he felt comfortable with staff ranking the firms, but not telling the board how the firms ranked.

Mrs. Lowe stated that when the finalists are determined she would like to see their strengths and weaknesses. She added that she does not need to see how the firms ranked in each area, but the advantages and disadvantages of the firms as determined by both staff and the consultant. Mr. Bradley stated that he wants staff and the consultant to be comfortable with the firms selected as finalists and that such a decision is an unqualified statement that the firms are an excellent choice and will serve the Fund well. He added that staff and the consultant should not bring someone about whom they have reservations. Rhett Humphreys, partner with NEPC, stated that the board's process of selection and recommendation is the same process NEPC follows.

Mr. Bradley stated that the decision is for a process that allows the board all the information it needs and that presents only qualified candidates that everyone will be able to support and defend. He added that there will not be a numerical ranking of the finalists. Mr. Anderson stated that there will be a numerical ranking, but the board will not see it.

Mr. Timmins continued with discussion of this agenda item by transitioning to issues related to private equity. Mr. Timmins stated that of the two private equity manager, the contract with Neuberger Berman is in place, but that the contract with Credit Suisse is still a matter of discussion. Credit Suisse notified staff in the previous week that Mike Arpey, co-head of the Customized Fund Group, had resigned and would be working for another firm. Kelly Williams, who served as co-head with Mr. Arpey, is the primary contact with staff and will continue with Credit Suisse. Before signing a contract, Mr. Timmins wanted to bring the matter to the board's attention.

Both John Grubenman, director of private market alternatives, and NEPC submitted memos explaining the matter to the committee. Mr. Grubenman spent time discussing the content of his memo. He emphasized that it appeared Mr. Arpey would not be in a role to compete with Credit Suisse at his new firm. In summary, Mr. Grubenman stated that he does not believe this change is material enough to impact the relationship the Fund has with Credit Suisse. Mr. Stronkowsky agreed with Mr. Grubenman's conclusions.

Mr. Agosto asked about the impact of Mr. Arpey's departure. Mr. Grubenman stated that according to the research he had done, he is confident that the change will not affect the relationship of Credit Suisse with private equity investment managers. Mr. Agosto asked Mr. Grubenman to clarify that the Fund would own any assets managed by Credit Suisse and whether the board would have the option of transitioning them to a new manager, if that ever became necessary. Mr. Grubenman stated that while the contract is still being negotiated, currently it contains a key-man provision which would subject Credit Suisse to an economic penalty if staff turnover rose to a certain level.

Mr. Lawson stated that the process with which staff and the consultant researched this matter and presented it to the board was excellent. Mr. Bradley and Mr. Agosto appreciated the initiative of the staff to bring this matter forward. Mr. Timmins stated that the contract with Credit Suisse would be executed as soon as possible.

Mr. Anderson emphasized that the attorney general's office provided reassurance that the management costs related to the private equity assets could be paid from the corpus of the Fund.

The third matter related to this agenda item was a presentation on the PSF asset allocation by NEPC. The presentation covered the Fund's target asset allocation policy and its implementation. Mr. Humphreys stated that allocations to risk parity, real return, and international small cap have currently not been implemented.

Mr. Agosto asked that the committee consider ranking the three currently unimplemented asset classes by ease of implementation. Mr. Bradley agreed, but stated that they should be ranked according to being in the best advantage of the Fund. Mr. Humphreys stated that the asset classes were ranked in the presentation according to which would have the most portfolio impact.

Mr. Humphreys started at the bottom of the list with the international small cap equity asset class and stated that since the Fund is currently invested greater than 50% in public equity, the impact from allocating additional funds to a type of public equity would have the least impact on the portfolio as compared to the other two asset classes. He further stated that the asset class with the next greatest impact would be real return, with the goal of offsetting both short-term and long-term inflation. He added that with current expectations of either low inflation or possibly even deflation, the benefits from implementing this asset class would likely also have minimal portfolio impact. Mr. Humphreys further added that real return is probably the most difficult of the three asset classes to implement due to board education requirements. Finally, Mr. Humphreys stated that the allocation to risk parity would provide the greatest portfolio impact. He further stated that the second advantage of the risk parity asset class is its composition of a cross-section of the global capital markets and it therefore poses less short-term risk with the exception of movements in short-term interest rates. Mr. Humphreys concluded that NEPC suggests a sequenced approach and did not recommend the board implementing more than one asset class at a time. Ms. Lowe agreed with this approach.

Mr. Humphreys returned to the matter of emerging market equity and noted the difference between that asset class and international small cap equity. He stated that the simplest way to explain the difference is to think of emerging market equity as big companies in small countries; and international small cap would represent little companies in big countries, or economies. He further stated as the board combined international large cap with emerging market large cap, it, in effect, created a global, non-US, large cap composite. He added that this has been a very appropriate approach.

Mr. Humphreys went on to discuss the differences in active and passive management in the international small cap equity asset class. He stated that the real return asset class was described as containing approximately 50% US TIPS and global inflation-linked securities and approximately 50% commodities, but other instruments could be used as well. Due to the complexity of the real return asset class, he explained the need for collaboration between NEPC and staff in the drafting of an RFP.

Mr. Bradley asked Mr. Timmins if he was in agreement with Mr. Humphreys on the principles of the asset implementation presentation. Mr. Timmins agreed that the recommended implementation

order would increase the return and reduce the risk of the Fund and that the process Mr. Humphreys laid out is a good schedule.

Mr. Bradley asked if the staff could present a RFP for the risk parity asset class for approval at the September board meeting. Mr. Timmins said that this could be done. Mr. Humphreys stated that the committee should keep expectations low and be patient with the process since this is a new asset class. Mr. Bradley stated that the target for a vote on the RFP would be September with the ability to delay it to November, if necessary. Final selection by the board would not occur until 2011.

Mr. Lowe and Mr. Bradley discussed the options for an education session of the real return asset class on the board agenda. The item is currently posted on the board's September agenda.

The international small cap equity asset class would be brought forward for discussion and tentative RFP approval at the April 2011 Board meeting with a tentative committee meeting on the subject in March 2011.

Mr. Timmins sought clarification from Mr. Bradley that the international small cap equity asset class would not be on the committee agenda for September. Mr. Humphreys stated his belief that addressing the matter in the context of the asset implementation schedule with the Committee of the Full Board in September would be beneficial. Mr. Bradley said that the item would stay on the agenda.

The meeting recessed at 9:59 a.m. and reconvened at 10:04 a.m.

3. Discussion of Spending Policy

Mr. Bradley introduced the item and asked Mr. Timmins to begin his presentation. Mr. Timmins stated that the School Land Board approved payment of \$100 million for the next fiscal year, to be made in quarterly installments of \$25 million each, unchanged from the previous biennium. Mr. Timmins then made a presentation on the topic of intergenerational equity, which discussed the historical principle of intergenerational equity, alternative hypothetical spending structures, arguments against intergenerational equity, and the current board definition of intergenerational equity. Mr. Veintemillas discussed the hypothetical impact of various spending rates on the market value of the fund per student and real distributions per student over a ten year horizon, using the Fund's current capital market assumptions and other market assumptions.

Mr. Humphreys stated that NEPC has also tested spending rates varying from 1.5% to 4.5% using various sets of market assumptions. He also discussed studies have observed, in general, endowments which consistently spend over 5% have been unable to maintain intergenerational equity. The committee discussed whether the contribution by the GLO could be retained as part of the corpus of the Permanent School Fund-State Board of Education, or whether it must be passed through to the Available School Fund. Mr. Humphreys stated that NEPC would not make a specific spending rate recommendation, but would present further analysis at the September meeting at which time the board would adopt a spending rate for the next biennium.

4. Discussion of Securities Litigation

David Anderson, general counsel, provided a document entitled *Securities Litigation Issues* and attached minutes from the Committee on School Finance/Permanent School Fund Committee meeting in March 2009. In the minutes, David Mattax, division chief, financial litigation, office of the attorney general, stated that the attorney general will not hire a "hired gun" to look for litigation,

but the board must bring specific pieces of litigation. Mr. Mattax had suggested there were services which could be used to evaluate the Fund and performance of managers for litigation; however this service was not always used by law firms.

Mr. Anderson made the following points which referenced his handout: (1) the Fund could contract for this, but it then becomes a budget issue with a fundamental question as to whether the board can agree to a contingent fee contract when PSF assets are constitutionally dedicated and (2) in a separate opinion the AG had held that the GLO could not use a “snitch fee”. The analogy with mutual fund expenses could be used where arguably fees were part of the asset.

Mr. Bradley argued that the old AG rules were made when PSF assets were 60% equity and 40% fixed income, and prior to investments in private equity and real estate where the Fund could be the sole owner of an asset.

Mr. Anderson, Mr. Bradley, and Gary Lawson, fiduciary counsel, agreed that the chair should request a new AG opinion given the above arguments.

The meeting recessed at 12:13 p.m. and reconvened at 1:38 p.m.

5. Energy Presentation by Orleans Capital Management

Mr. Bradley introduced the item. L. Ferrell Crane and Scott Gill, both managing directors with Energy Opportunities Capital Management, a joint venture of Orleans Capital Management and Simmons & Co. International, gave an overview presentation on the energy sector. Mr. Crane and Mr. Gill discussed the fundamentals of the current supply & demand environment for energy and the merits of investing in the energy sector.

The meeting of the Committee on School Finance/Permanent School Fund adjourned at 3:13 p.m.