

**Report of the State Board of Education
Committee on School Finance/Permanent School Fund
November 14, 2012**

The State Board of Education Committee on School Finance/Permanent School Fund met at 9:03 a.m. on Wednesday, November 14, 2012, 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: Pat Hardy, chair; Lawrence A. Allen, Jr.; David Bradley; Bob Craig; Thomas Ratliff

Non-Committee Members Present: Barbara Cargill, Marsha Farney, Charlie Garza, Mavis B. Knight, Gail Lowe

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=2147497741> or in the information section (yellow pages) of the agenda.

The Committee on School Finance/Permanent School Fund received no presentations of public testimony.

ACTION ITEM

1. Per Capita Apportionment Rate for the 2012-2013 School Year

(Board agenda page III-1)
[Official agenda item #8]

Belinda Dyer, manager of financial reporting and accountability, presented this item. The committee was asked to adopt a revised preliminary Available School Fund per capita apportionment rate of \$390.743 for the 2012-2013 school year based on a revised estimate of the amount available for expenditures from the fund (Attachment A).

Mr. Ratliff asked whether it was accurate that this rate was different from the rate associated with funding for the Instructional Materials Allotment and Ms. Dyer confirmed that that was accurate.

MOTION AND VOTE: *It was moved by Mr. Ratliff, seconded by Mr. Bradley, and carried unanimously to recommend that the SBOE adopt a revised preliminary per capita apportionment rate of \$390.743 for the 2012-2013 school year and to place this item on the consent agenda of the SBOE meeting of November 16, 2012.*

Later in the meeting the following action occurred.

MOTION AND VOTE: *It was moved by Mr. Craig, seconded by Mr. Bradley, and carried unanimously to reconsider the per capita apportionment rate for the 2012-2013 school year. (Mr. Allen and Mr. Ratliff were absent for the vote.)*

Ms. Dyer explained that the rate presented earlier in the meeting did not reflect the most recent revisions to the estimate of the amount available for expenditure from the Available School Fund. She asked the committee to adopt a further revised preliminary Available School Fund per capita apportionment rate of \$406.100 for the 2012-2013 school year based on the most recently revised estimate of the amount available for expenditures from the fund (Attachment B).

MOTION AND VOTE: *It was moved by Mr. Craig, seconded by Mr. Ratliff, and carried unanimously to recommend that the SBOE adopt a revised preliminary per capita apportionment rate of \$406.100 for the 2012-2013 school year, instead of a rate of \$390.743, and to place this item on the consent agenda of the SBOE meeting of November 16, 2012.*

DISCUSSION ITEM

2. Texas Education Agency Administrative and Program Strategic Budget for Fiscal Year 2013 (Board agenda page III-25)

Shirley Beaulieu, associate commissioner for finance and chief financial officer, presented for review and comment the agency program and administrative budget for the 2012-2013 biennium as well as the legislative appropriations request (LAR) for the 2014-2015 biennium (Attachment C).

Ms. Beaulieu responded to questions from committee members regarding major components of the budget and the LAR, including the Foundation School Program (FSP), instructional materials, and administration of the Permanent School Fund (PSF). She explained that the amounts requested for budget items have remained flat except for the amount requested for the FSP, which has increased in part because of student growth and in part because of a payment to school districts that will be deferred from the 2012-2013 biennium to the 2014-2015 biennium.

In response to questions from Mr. Bradley, Ms. Beaulieu explained that the additional \$16.8 million for PSF administration for the 2014-2015 biennium had been carried over from the 2012-2013 biennium. She explained that the amount budgeted for PSF administration may not necessarily be expended and that it represents items other than staff costs. Ms. Beaulieu stated that Holland Timmins, executive administrator and chief investment officer of the PSF, would be able to provide more information about PSF administration costs.

Ms. Beaulieu also responded to questions about the line items for the Teach for America program and specialty license plates. Ms. Hardy asked whether it made sense to provide funding for the Teach for America program given current state budgetary constraints and given that the program benefits a relatively small percentage of Texans. Ms. Beaulieu stated that the agency had proposed reducing funding for this program as part of the 10 percent budget reduction exercise it conducted at the request of the Legislative Budget Board. Mr. Bradley asked why the agency was spending money on specialty license plates. Ms. Beaulieu explained that the line item with that name represented funds from the sale of specialty license plates that flowed through the agency from the Texas Department of Transportation to several nonprofit organizations. In response to a question from Ms. Hardy, Ms. Beaulieu stated that the agency does not retain any of the license plate money but does incur costs for the accounting work necessary to disburse it.

CONSENT ITEM

3. Approval of Costs of Administering the 2012-2013 State of Texas Assessments of Academic Readiness (STAAR™) and the Exit-Level Texas Assessment of Knowledge and Skills (TAKS) to Private School Students

(Board agenda page III-5)

[Consent agenda item #(1)]

Gloria Zyskowski, director for student assessment, presented for approval the per-student assessment costs for the 2012-2013 school year as shown in the attachment of the SBOE agenda (see Attachment D). The item is presented annually based on TEC, §39.033, which charges the SBOE with approving the cost for the administration of the state-developed assessments to private school students. During the 2012 spring administration, approximately 20 private schools and 1,700 students participated in the assessment program. These numbers have remained consistent over the years.

MOTION AND VOTE: *It was moved by Ms. Hardy, seconded by Mr. Ratliff, and carried unanimously to recommend that the SBOE approve the per-student costs for administering the STAAR and TAKS tests to private school students in 2012-2013, as reflected in Attachment D. (Mr. Bradley was absent for the vote.)*

DISCUSSION ITEMS

4. Review of 19 TAC Chapter 30, Administration, Subchapter B, State Board of Education: Purchasing and Contracts

(Board agenda page III-27)

The Texas Government Code, §2001.039, establishes a four-year rule review cycle for all state agency rules, including SBOE rules. Norma Barrera, director of purchasing and contracts, presented this item, a review of 19 TAC Chapter 30, Administration, Subchapter B, State Board of Education: Purchasing and Contracts, as part of the four-year rule review process. The review is intended to ensure that the need for the rules still exists and to determine whether any amendments are necessary.

Ms. Hardy introduced Chuck Campbell with Jackson, Walker LLP, fiduciary counsel for the Permanent School Fund.

5. Review of Permanent School Fund Securities Transactions and the Investment Portfolio

(Board agenda page III-35)

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 June 1, 2012 through September 30, 2012, unless otherwise noted. Ms. Civileto's report included reporting on the current fair market value of the Fund, the asset allocation mix as of September 30, 2012, PSF transactions occurring in the reporting period, the securities lending program, the status of transfers from the General Land Office as per the resolution they agreed to for the current fiscal year, 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, broker commissions on both the internal and external equity portfolios for the period beginning January 1, 2012 through September 30, 2012, and short-term cash investments.

CONSENT ITEM

6. Ratification of the Purchases and Sales of the Investment Portfolio of the Permanent School Fund for the Months of June, July, August and September 2012

(Board agenda page III-11)

[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 June, July, August and September 2012 in the amount of \$1,888,967,475 and \$1,417,720,725 respectively (Attachment E).*

DISCUSSION ITEM

7. Third Quarter of 2012 Permanent School Fund Performance Report

(Board agenda page III-37)

Paul Schmidt with BNY Mellon Asset Servicing, presented the third quarter of 2012 Permanent School Fund performance report. Mr. Schmidt began with an overview of the U.S. and foreign capital markets. Mr. Schmidt then reviewed the performance of the Fund for the third quarter 2012. He stated that the PSF returned 4.91% for the third quarter outperforming the target benchmark by 30 basis points. The Fund ranked in the 35th percentile of the Mellon Universe of Public Funds greater than \$1.0 billion for the period ending September 30, 2012.

Mr. Schmidt reviewed performance of the Permanent School Fund by asset class stating that the total domestic equity composite returned 6.17% for the quarter, beating its benchmark by one basis point. He added that international equities returned 7.42% for the quarter, beating its benchmark by two basis points. The fixed income portfolio returned 2.09%, for quarter, outperforming its benchmark by 50 basis points. Mr. Schmidt stated that the absolute return composite returned 2.98% for the quarter, outperforming its benchmark, the HFRI Fund of Funds Composite Index, by 67 basis points. Mr. Schmidt added that the real estate composite returned 1.87% for the quarter, underperforming its benchmark by 60 basis points. Mr. Schmidt added that total risk parity strategies returned 6.77% in the third quarter of 2012, outperforming its benchmark by 234 basis points. He further stated that the real return asset class returned 2.26% for the quarter outperforming its benchmark by 14 basis points. Finally, Mr. Schmidt stated that private equity returned 0.90% for the quarter.

CONSENT ITEMS

8. Determination as to Whether Transfers May be Made from the Permanent School Fund to the Available School Fund

(Board agenda page III-13)
[Consent agenda item #(3)]

Ms. Hardy called on Carlos Veintemillas, deputy chief investment officer, to address the item. Mr. Veintemillas explained that the board needs to affirm that the distribution in fiscal year 2013 will meet the constitutional restrictions. He described the methodology and the calculations used to determine the distribution. The distribution rate set by the board for fiscal years 2012 and 2013 is 4.2%.

Rhett Humphreys, consultant with NEPC, agreed with the methodology and the calculations used by PSF staff to determine the distribution amount. Mr. Humphreys also agreed that, based on the constitutional restrictions, a distribution is allowed for fiscal year 2013.

MOTION AND VOTE: *By unanimous consent, the committee recommended that the State Board of Education determine that a distribution of \$1,020.9 million for fiscal year 2013 is permitted under Texas Constitution, Article VII, Subsection 5(a)(2).*

9. Decision on Real Estate Investments

(Board agenda page III-17)
[Consent agenda item #(4)]

The PSF real estate consultant, Courtland Partners, was represented by Steve Novick, principal/chief operating officer, and Dan Moore, senior consultant, joined by John Grubenman, director of private markets for PSF. Mr. Grubenman provided an introduction to the recommendation.

Mr. Novick and Mr. Moore presented the recommendation of AREA European Real Estate Fund IV, L.P.. Mr. Novick provided a brief overview of how the fund fits into the current real estate program and is in compliance with the real estate investment policy.

Mr. Moore explained the objectives, constraints, terms, fees, benefits and concerns of the investment. Mr. Moore and Mr. Grubenman described the due diligence process conducted by both Courtland and PSF staff.

MOTION AND VOTE: *By unanimous consent, the committee recommended to the State Board of Education approval to execute agreements with AREA Property Partners, L.P. necessary to make an investment commitment of up to \$75 million in AREA European Real Estate Fund IV, L.P., subject to continued due diligence and negotiation of fund terms.*

10. Proposed Amendments to the Investment Procedures Manual

(Board agenda page III-19)
[Consent agenda item #(5)]

Mr. Veintemillas presented proposed amendments to the Investment Procedures Manual. Mr. Veintemillas stated that edits to the Investment Procedures Manual were made to accommodate

the new asset allocation approved by the State Board of Education at their July 2012 meeting. Mr. Bradley directed staff to change language on page 1, Section A.1.c., to replace the words “may approve” with the words “shall approve any”.

NEPC provided a memo in which they recommended approval of the amendments.

MOTION AND VOTE: *By unanimous consent, the committee recommended to the State Board of Education adoption of the amendments to the Investment Procedures Manual (Attachment F).*

DISCUSSION ITEMS

11. Presentation by Mellon Bank on the Custody and Securities Lending Services Provided to the Permanent School Fund (Board agenda page III-39)

The Bank of New York Mellon (BNY Mellon) was represented by Catherine Wargo, vice president/relationship executive, Lisa Candy, vice president/senior client service officer, Paul Schmidt, vice president/manager, performance & risk analytics, Mellon Analytical Solutions and Mike McDermott, first vice president/manager of client services/global securities lending. Ms. Wargo reviewed BNY Mellon and Permanent School Fund (PSF) partnership milestones and accomplishments since being appointed as global custodian. She also provided an overview of the BNY Mellon organization, including financial highlights and recent quality rankings. Ms. Candy reviewed the custodian services provided to PSF.

Mr. Schmidt reviewed services provided by the performance & risk analytics group which include performance measurement, compliance monitoring and reporting. Mr. McDermott presented an overview of the securities lending program.

12. Presentation on the Global Risk Control Strategies Management Services Provided to the Permanent School Fund (Board agenda page III-41)

The following four firms gave presentations by their respective representatives:

AQR Capital Management, LLC

Mike Mendelson, Principal and Co-Portfolio Manager of Risk Parity Strategies

Bridgewater Associates, LP

Paul Podolsky, Senior Portfolio Strategist

Alan Bowser, Senior Client Advisor

Mesirow Advanced Strategies, Inc.

Thomas Macina, President

Erik Barefield, Managing Director

Linda Jordan, Managing Director

GAM USA Inc.

Anthony Lawler, Portfolio Manager

Arvin Soh, Investment Manager

Joseph F. Gieger, Managing Director

Kristin Hovencamp, Director

The meeting recessed at 11:08 a.m. and reconvened at 11:27 a.m.

CONSENT ITEM

13. Decision on the Private Equity Structure of the Permanent School Fund

(Board agenda page III-21)

[Consent agenda item #(6)]

Mr. Grubenman gave a presentation on the private equity asset class. He described the current structure of the asset class and answered questions from the committee. The committee directed staff to provide additional information regarding the private equity program structure at a future meeting.

The meeting recessed at 12:15 p.m. and reconvened at 1:26 p.m.

ACTION ITEM

14. Decision on Absolute Return Investments

(Board agenda page III-23)

[Official agenda item #9]

Mr. Timmins made a presentation covering the history of the absolute return asset class that addressed the structure, fees, performance, and management of the investments. He stated that over the history of the Fund's investment in the absolute return asset class, from March 2008 through September 2012, over \$87 million has been paid in management fees, representing 45% of the gross returns (86 basis points).

Mr. Timmins then discussed the recent history of the board's decisions to reduce the number of external managers and enter into strategic relationships. As the board continues its review of this asset class, Mr. Timmins presented four scenarios for management of the asset class.

Mr. Craig asked Mr. Timmins if the PSF would benefit under scenario three because of lower fees. Mr. Timmins responded that scenario three offered the best value.

Mr. Humphreys stated his understanding that the board wants to move forward with the strategic relationship structure and the only question is the timeframe of how quickly that would occur. The committee discussed various issues related to the implementation of the strategic relationship.

MOTION AND VOTE: *It was moved by Mr. Craig, seconded by Mr. Ratliff, to recommend to the State Board of Education to terminate Mesirow Advanced Strategies, Inc., and GAM USA, Inc., as absolute return managers and distribute the net assets between Raven 6 and Raven 7. Mr. Craig, Ms. Hardy and Mr. Ratliff voted yes. Mr. Bradley and Mr. Allen voted no.*

MOTION AND VOTE: *It was moved by Mr. Ratliff, seconded by Mr. Craig, and carried unanimously to recommend to the State Board of Education ratification of the modifications of ten contract matters with existing absolute return managers.*

DISCUSSION ITEMS

15. Education on Emerging Market Debt (Board agenda page III-43)

Discussion of this item was postponed until the January 2013 meeting.

16. Report of the Permanent School Fund Executive Administrator and Chief Investment Officer (Board agenda page III-45)

Mr. Timmins reported that during 2012, ten new staff members had been hired and that eight positions were currently in various stages within the hiring pipeline.

David Anderson, TEA general counsel, reported that as previously discussed, the PSF was a participant in litigation against BNY Mellon Bank, the Fund's current securities custodian and securities lending agent regarding this matter. The pertinent class action case is *CompSource Oklahoma v. BNY Mellon, N.A.*, No. 08-469 (E. D. Okla.). Pursuant to the board's authorization at its July 2012 meeting, staff decided to participate in the settlement, after consultation with the Attorney General's Office, and with the approval of the chairs of the SBOE and the PSF subcommittee. The PSF is expected to receive approximately \$27 million in early January 2013 after payment of attorney fees and administrative expenses in the settlement of this matter.

The meeting of the Committee on School Finance/Permanent School Fund adjourned at 4:17 p.m.