

**Report of the State Board of Education
Committee on School Finance/Permanent School Fund
July 15, 2009**

The State Board of Education Committee on School Finance/Permanent School Fund met at 8:57 a.m. on Wednesday, July 15, 2009, in Room #2-195 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: Pat Hardy, Mavis B. Knight, 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 ITEMS

**1. Review of the Request for Proposals for a Private Equity Discretionary
Separate Account Manager for the Permanent School Fund**
(Board agenda page III-39)

Holland Timmins, Executive Administrator and Chief Investment Officer, introduced the discussion. A brief outline of the evaluation process leading up to this discussion clarified that 24 responses had been received; 22 responses were deemed 'responsive' and evaluated and scored; and that the top eleven respondents based on that scoring were invited to Austin for interviews. Both staff and the consultant scored the eleven respondents subsequent to the interviews, and a combined ranking was brought to the committee by Mr. Timmins. Mr. Timmins asked the committee for direction as to which respondents should be engaged in on-site due diligence visits by staff.

The committee requested further clarity on the process and the respondents that survived to make the list of eleven. Each of the 11 respondents on the list was briefly characterized with the results of the evaluation to facilitate the committee discussion in preparation for giving direction to staff. The committee then directed staff to conduct on-site due diligence visits with the top five in the list and directed staff to add the ninth ranked firm in the list. The goal was to continue to evaluate as many as were prudent in order to give the committee and ultimately the board an adequate review of the best possible firms for the mandate.

The managers selected for on-site due diligence visits were Credit Suisse, NB Alternatives, Hamilton Lane, Partners Group, Portfolio Advisors and Pathway Capital. Staff will update the committee on the RFP evaluation process at the August meeting.

2. Report by the State Auditor's Office on the Certification of the Bond Guarantee Program for Fiscal Year Ending August 31, 2008
(Board agenda page III-41)

Tony Rose, Managing Senior Auditor and Project Manager for the Bond Guarantee Program (BGP) Audit presented the audit report from the State Auditor's Office to the committee. Also attending from the State Auditors Office was Ms. Verma Elliott, Audit Manager.

Mr. Rose stated that an annual audit of the BGP is required by the Texas Education Code to ensure that total bonds guaranteed are within the limits of State Statute. Mr. Rose noted that the audit included verification of the value of the Fund, the outstanding bonds guaranteed and an assessment of program controls.

Mr. Rose stated that as of August 31, 2008, the capacity of the program was \$57.3 billion, there were 2,596 issues totaling \$49.9 billion and available capacity of \$7.4 billion. The program was within the limits of both the State Statute, which is up to 5 times the cost and IRS limits, which remains at 2.5 times the lower of cost or market as established by an IRS letter ruling. He also noted the approval process complies with state laws.

Mr. Rose stated that the report included information regarding the change in market value of the Permanent School Fund since August 31, 2008 which has resulted in limiting approvals of new bond guarantees to September and October, 2008, and that the program was temporarily shut down on March 16, 2009.

Mr. Rose thanked the staff for their cooperation during the audit.

CONSENT ITEM

3. Adoption of an Annual Report on the Status of the Bond Guarantee Program
(Board agenda page III-7)
[Consent agenda item #(2)]

Mr. Timmins stated the requirement to present an annual report of the Bond Guarantee Program and asked the committee to review the report included in the committee agenda book. Mr. Timmins requested that the committee adopt the report as presented.

MOTION AND VOTE: *By unanimous consent, the committee recommended to the State Board of Education adoption of an annual report on the status of the Bond Guarantee Program as of August 31, 2008.*

ACTION ITEMS

4. Approval of the Selection of a Firm(s) to Provide Global Custody and Securities Lending Services for the Permanent School Fund and Authorization for Contract Execution by the Commissioner of Education

(Board agenda page III-19)

[Official agenda item #17]

Mr. Timmins introduced this item by providing the committee members with a handout of best and final fees received from each of the three finalists for the Request for Proposal for Global Custody and Securities Lending Services for the Permanent School Fund. Mr. Timmins recommended that the committee authorize the staff to negotiate with the current custodian, The Bank of New York Mellon (BNY Mellon).

MOTION AND VOTE: *It was moved by Ms. Lowe, seconded by Ms. Dunbar, and carried unanimously to recommend to the State Board of Education approval of a contract with The Bank of New York Mellon to provide global custody and securities lending services for the Permanent School Fund and authorization for contract execution by the commissioner of education. Staff was further directed to negotiate the custodian's payment to a third party performance analytic provider if the board elects not to have the custodian provide performance reporting to the board. It was recommended to place this item on the consent agenda of the State Board of Education meeting of July 17, 2009. Mr. Agosto was absent for the vote.*

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

(Board agenda page III-21)

[Official agenda item #18]

Mr. Bradley briefly reviewed the process in the selection of a firm to provide investment counsel services stating that the RFP has been pending for six to eight months and action has been further postponed from the meeting in May. Mr. Bradley further stated that since the RFP responses were first received, Ennis Knupp had withdrawn their proposal, leaving R.V. Kuhns and NEPC as the only applicants. Mr. Timmins stated that Ennis Knupp were reticent about providing reasons for their withdrawal. It also was noted that while R.V. Kuhns' contract did not expire until December 2010, all contracts were cancellable.

Both Mrs. Lowe and Ms. Dunbar expressed discomfort at there only being two firms being considered.

Mr. Bradley stated that he had some concerns with communications between board members, staff and the consultant. Mrs. Hardy stated that she always found open and positive lines of communication with R. V. Kuhns.

In response to a question about business and organizational strengths of NEPC, Mr. Timmins highlighted apparent changes that had occurred between their initial presentation and their interview whereby they had originally referenced the importance of portable alpha, which focused on

leveraged equity bets, but made no mention of this strategy in the interview. Notably the significant declines in the equity markets had occurred between initial presentation and interview.

MOTION AND VOTE: *It was moved by Mr. Nunez, seconded by Ms. Dunbar, and carried to recommend to the State Board of Education approval to contract with NEPC, LLC to provide investment counsel services for the Permanent School Fund and authorization for contract execution by the commissioner of education. Mr. Bradley, Mr. Nunez and Ms. Dunbar voted yes. Mrs. Lowe abstained. Mr. Agosto was absent for the vote.*

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

(Board agenda page III-23)

[Official agenda item #19]

Given the previous discussion and motion made on Item #5, Mr. Bradley suggested that the recommendation in this item should stand and be presented to the board on Friday for possible inclusion as an agenda item for the September meeting.

DISCUSSION ITEMS

7. 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-43)

David Anderson, legal counsel, participated in a brief discussion of the Attorney General Opinion. The committee decided to defer further discussion until the August committee meeting. At that time, preliminary draft language for inclusion in the Investment Procedures Manual will be brought to the committee.

8. Discussion of Permanent School Fund Rebalancing Procedures

(Board agenda page III-53)

Mr. Timmins introduced this item. He stated that the PSF has a formal automatic rebalancing policy. He added that it is a very powerful mechanism wherein the Fund sells assets that have outperformed and buys assets that have underperformed. Mr. Timmins addressed a chart that depicts a history of recent rebalancing performed by staff plotted against the fair value of the PSF. He showed the stages at which overvalued assets were rebalanced to undervalued assets having effectively added value to the Fund. Mr. Timmins added that in some instances rebalancing occurs when funds are needed for distribution to the Available School Fund and funded from asset classes that are overweight.

Jim Voytko of R. V. Kuhns Associates stated that this was a classic example of the best way at the institutional level to execute a rebalancing program. He added that rebalancing programs tend to work well when they are consistently adhered to. Mrs. Lowe asked whether the possibility that there will be no distributions to the ASF next fiscal year would cause the Fund to rebalance more often. Mr. Timmins stated that it all depended on the volatility of financial markets.

**9. Report of the Permanent School Fund Executive Administrator
and Chief Investment Officer**

(Board agenda page III-55)

Mr. Timmins updated the committee on the schedule and timing of the RFQ for real estate investment managers.

The meeting of the Committee on School Finance/Permanent School Fund adjourned at 11:35 a.m.