

**Report of the State Board of Education
Committee on School Finance/Permanent School Fund
April 10, 2014**

The State Board of Education Committee on School Finance/Permanent School Fund met at 10:12 a.m. on Thursday, April 10, 2014, 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., vice chair; David Bradley; Ken Mercer; Thomas Ratliff

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=25769804094> or in the information section (yellow pages) of the agenda.

The Committee on School Finance/Permanent School Fund heard public testimony on agenda item #3. Information regarding the individuals who presented public testimony is included in the discussion of that item.

DISCUSSION ITEM

1. Review of 19 TAC Chapter 109, Budgeting, Accounting, and Auditing
(Board agenda page III-57)

The Texas Government Code, §2001.039, establishes a four-year rule review cycle for all state agency rules, including State Board of Education (SBOE) rules. Lisa Dawn-Fisher, chief school finance officer and associate commissioner for school finance, presented this item 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. Dr. Dawn-Fisher pointed out that proposed amendments to Subchapter D of Chapter 109 were being considered for second reading and final adoption in item 2 on the committee agenda. She also stated that, at a future meeting, agency staff members planned to present proposed changes to Subchapters A-C to clarify language and terminology and update Texas Education Code references. Dr. Dawn-Fisher said that she would bring any comments received regarding the review to the July committee meeting.

ACTION ITEM

2. Proposed Amendments 19 TAC Chapter 109, Budgeting, Accounting, and Auditing, Subchapter D, Uniform Bank Bid or Request for Proposal and Depository Contract

(Second Reading and Final Adoption)

(Board agenda page III-1)

[Official agenda item #14]

Dr. Dawn-Fisher presented this item. She explained that the proposed amendments would reduce paperwork and streamline the process by which a school district selects a depository bank. Dr. Dawn-Fisher stated that the agency had not received any public comments on the rule and that agency staff members have recommended no changes since the rule was approved for first reading and filing authorization. In response to a question from Mr. Ratliff, Dr. Dawn-Fisher stated that the amended rule would allow for school districts to submit items electronically.

MOTION AND VOTE: *It was moved by Mr. Ratliff, seconded by Mr. Allen, and carried unanimously to recommend that the State Board of Education approve the proposed amendments to 19 TAC Chapter 109, Budgeting, Accounting, and Auditing, Subchapter D, Uniform Bank Bid or Request for Proposal and Depository Contract, §109.51, Uniform Depository Bank Bid or Proposal Form, and §109.52, Uniform Depository Bank Contract and Surety Bond Forms, for second reading and final adoption, with an effective date of 20 days after filing as adopted with the Texas Register.*

DISCUSSION ITEMS

3. Discussion of 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, §33.65, Bond Guarantee Program for School Districts

(Board agenda page III-73)

The following individuals provided public testimony:

NAME: Larry A. Garza

AFFILIATION: San Antonio Independent School District (San Antonio ISD)

NAME: Humberto Aguilera

AFFILIATION: Self

NAME: Ricardo Villasenor

AFFILIATION: Self

NAME: Lisa Pepi

AFFILIATION: San Antonio ISD

Dr. Dawn-Fisher presented this item, which provided an opportunity for the Committee on School Finance/Permanent School Fund to discuss 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, §33.65, Bond Guarantee Program for School Districts, at the request of a board member, Marisa Perez.

Dr. Dawn-Fisher explained that Ms. Perez had asked the committee to discuss amending the rule to explicitly make notes, including commercial paper notes, eligible for guarantee under the Bond Guarantee Program (BGP). Dr. Dawn Fisher stated that agency staff members, including the general counsel, had concerns about amending the rule to allow for the guarantee of these short-term debt instruments. She stated that the primary concern was that this change could cause credit rating agencies to reconsider the AAA rating of the Permanent School Fund (PSF).

David Anderson, general counsel, stated that while the proposed amendment was problematic, it did highlight the need for a definition of the word “bond” in the rule. He stated that, regardless of whether the committee opted to allow for the guarantee of notes, it would be helpful for the rule to define “bond” and specify in that definition a minimum term for a debt instrument to be considered a bond. Mr. Anderson explained that a universal definition of “bond” does not exist and thus defining the word and specifying a minimum term for a debt instrument to be considered a bond are policy considerations. Mr. Anderson recommended that the rule also be amended to specify whether attorney general approval is required for each issuance of debt.

Mr. Ratliff asked how allowing for notes to be guaranteed would affect BGP capacity. Dr. Dawn-Fisher stated that it was her understanding that the BGP administrator would be required to set aside capacity for the full amount that a school district had been authorized to issue under the district’s note program, even if the district did not intend to issue notes in that amount in the near future. She also explained that that rule already allows for the guarantee of bonds that refund notes. Mr. Ratliff asked if allowing notes to be guaranteed would help a district avoid the need to refund notes with a bond, and she stated that it would not.

Mr. Allen and Mr. Mercer asked whether notes are riskier financial instruments than bonds are. Dr. Dawn-Fisher said yes. Mr. Anderson added that notes present more risk because they are of a shorter term than bonds and so necessarily must be continually rolled over into a new debt instrument. He explained that a district faces risk whenever a debt instrument matures and that notes are riskier than bonds because notes will become due repeatedly over a given period of time.

Mr. Mercer asked whether credit rating agencies would be concerned if the PSF were to guarantee notes, and Dr. Dawn-Fisher stated that the agency believed so.

Ms. Hardy invited public testimony from those who had registered to speak.

Mr. Garza, chief financial officer for San Antonio ISD, stated that issuing commercial paper notes instead of bonds resulted in significant savings in debt service costs for the district. He also stated that BGP capacity should not be a consideration since the same amount of capacity would need to be set aside regardless of whether a district consumed capacity by issuing a bond in a large amount or consumed capacity by having its note program approved for the guarantee and issuing smaller amounts of debt up to the note program’s limit over time.

Mr. Villasenor, a managing director at Cabrera Capital, stated that having the guarantee for commercial paper notes would save school districts in debt service costs for the notes.

Ms. Hardy asked Dr. Dawn-Fisher what it would cost her department to add personnel to handle the guarantee of notes. Dr. Dawn-Fisher said that was difficult to determine without more information.

Carlos Veintemillas, deputy chief investment officer for the PSF, stated that what makes commercial paper notes problematic is the frequency with which they must be rolled over. He stated that, in 2008 and 2009, the inability of firms to roll their notes over had caused serious financial problems for the firms and some had gone bankrupt. He also stated that the benefit of the guarantee was supposed to be the increased credit rating it offered but that San Antonio ISD already had the highest rating possible for notes. Mr. Veintemillas said that, in terms of the PSF's own rating, he did not think that credit rating agencies would look at the PSF's guaranteeing notes favorably.

Mr. Villasenor stated that San Antonio could issue up to \$300 million in debt in the future and that the BGP capacity consumed by that potential debt would be the same regardless of the debt instrument used. He stated that issuing that debt incrementally over time using notes would save the district significantly in debt service costs.

Mr. Ratliff asked if it was legal to allow the PSF to guarantee notes.

Mr. Anderson stated that the issue to consider was what voters had understood "bond" to mean when they approved the constitutional amendment permitting the PSF's guarantee of bonds.

Mr. Ratliff asked if the agency could seek guidance on this issue from the attorney general, and Ms. Hardy asked agency staff members to bring proposed rule language that included a definition of "bond" back to the committee in July. Mr. Anderson and Dr. Dawn-Fisher said that agency staff members would do those things.

Mr. Aguilera, a bond counsel, asked to speak briefly and stated that he agreed a definition of "bond" was needed. He also stated that San Antonio ISD issued its notes pursuant to the Texas Education Code (TEC), Chapter 45, which is the TEC chapter that authorizes school building bonds.

Ms. Pepi, director of cash and treasury management for San Antonio ISD, asked to speak briefly and stated that allowing for the guarantee of notes would benefit all districts, not only San Antonio ISD.

Ms. Hardy stated it was important to safeguard the health of the PSF by not jeopardizing its AAA rating. Mr. Ratliff asked if the savings that would be realized by districts whose notes were guaranteed contemplated a drop in the PSF's rating. Mr. Veintemillas stated that a greater number of districts would be harmed by a drop in the PSF's rating than would benefit by the PSF guaranteeing notes. Dr. Dawn-Fisher pointed out that if the AAA rating were threatened, the board would be required to adjust the PSF's multiplier to maintain that rating and that that would result in decreased capacity.

After presenting the three school finance items on the committee agenda, Dr. Dawn-Fisher asked if she could provide a brief status update on the BGP for charter schools, and Ms. Hardy approved her request. Dr. Dawn-Fisher told committee members that nine charter schools had applied for the guarantee in March and that staff members were reviewing those applications now. She stated that if all nine applications were approved, that would leave an estimated \$213 million in capacity for the guarantee of new money issues and an estimated \$112 million in capacity for refunding issues. Dr. Dawn-Fisher emphasized that actual remaining capacity would depend on whether each application was approved and the most-current PSF data. Mr. Anderson stated that relatively minor modifications to the rule for the BGP for charter schools might be needed in the future with regard to applications for bond proceeds that were meant to be used for campuses not yet approved.

4. Review of Permanent School Fund Securities Transactions and the Investment Portfolio
(Board agenda page III-87)

Catherine Civileto, deputy executive administrator, provided a summary on the status of the Permanent School Fund portfolio. Reports presented to the committee were for the reporting period December 1, 2013 through February 2014 unless otherwise noted. Ms. Civileto's report included reporting on the current fair market value of the Fund, the asset allocation mix as of February 28, 2014, PSF transactions occurring in the reporting period, revenues and expenditures for the fiscal period December 1, 2013 through February 1, 2014, 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, broker commissions on both the internal and external equity portfolios for the period beginning January 1, 2013 through February 28, 2014, and short-term cash investments.

CONSENT ITEM

5. Ratification of the Purchases and Sales of the Investment Portfolio of the Permanent School Fund for the Months of December 2013, January and February 2014
(Board agenda page III-47)
[Consent agenda item #(1)]

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 2013, January and February 2014 in the amount of \$1,606,907,309 and \$1,105,593,237 respectively (Attachment A).*

DISCUSSION ITEMS

6. Report by the State Auditor's Office on the Audit of the Permanent School Fund's Financial Statements for Fiscal Year Ending August 31, 2013
(Board agenda page III-89)

Verma Elliott, audit manager, and Matthew Byrnes, audit project manager for the PSF audit, presented the results of the annual audit of the Permanent School Fund for the year ending August 31, 2013. Mr. Byrnes stated that the State Auditor's Office (SAO) issued an unqualified opinion on the financial statements audited for the period. Mr. Byrnes briefly reviewed the SAO's audit process and parts of the report that were subject to limited inquiries but on which SAO did not express an opinion. Mr. Byrnes reported that staff provided access to all records and information requested by the audit team and that no evidence of fraud was noted for the Fund. One internal control weakness was noted pertaining to control between the development and production environments of the TEA ISAS accounting system.

Holland Timmins, Executive Administrator and Chief Investment Officer, introduced Ms. Martha Reesing, director, TEA Information Technology Services, and asked her to speak to the SAO internal control finding that resulted from the TPSF fiscal year 2013 financial statement audit. Since the finding pertained to the TEA ISAS accounting system, TEA staff could speak knowledgeably about management's response to the audit finding and any changes made to mitigate the audit finding. Ms. Reesing explained that an intermediate step had been taken prior to

November 30, 2013, as committed in the management response and that a new piece of software has been purchased to improve the control environment between development and production in the ISAS system. The new software is expected to be implemented and functioning by August 31, 2014.

7. Fourth Quarter 2013 Permanent School Fund Performance Report
(Board agenda page III-91)

Tom Heiner, client relationship manager and Scott Berard, regional manager, both with BNY Mellon Asset Servicing, presented the fourth quarter of 2013 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 2013. He stated that the PSF returned 4.90% for the fourth quarter underperforming the target benchmark by 25 basis points. The Fund ranked in the 50th percentile of the Mellon Universe of Public Funds greater than \$1.0 billion for the 3-month period ending December 31, 2013. Mr. Heiner attributed the Fund's underperformance to the Risk Parity asset class.

Mr. Heiner reviewed fourth quarter 2013 performance of the Permanent School Fund by asset class, stating that the total domestic equity composite returned 10.16% for the quarter, outperforming its benchmark by four basis points. He added that international equities returned 4.84% for the quarter, outperforming its benchmark by seven basis points. The fixed income portfolio returned -0.01% for quarter, beating its benchmark by 13 basis points. Mr. Berard stated that the Absolute Return composite returned 3.65% for the quarter, outperforming its benchmark, the HFRI Fund of Funds Composite Index, by two basis points. Mr. Berard added that the Real Estate composite returned 2.64% for the quarter, underperforming its benchmark by 18 basis points. Mr. Berard added that Total Risk Parity Strategies returned 1.32% in the third quarter of 2013, underperforming its benchmark by 485 basis points. He further stated that the Real Return Asset class returned -1.35% for the quarter outperforming its benchmark by 16 basis points. Finally Mr. Berard stated that private equity returned 2.80% for the quarter ending September 30, 2013.

CONSENT ITEMS

8. Decision on Real Estate Investments
(Board agenda page III-49)
[Consent agenda item #(2)]

There were no real estate investments presented to the committee.

9. Overview of the Real Estate Asset Class
(Board agenda page III-51)
[Consent agenda item #(3)]

The PSF real estate consultant, Courtland Partners, was represented by Ben Blakney, managing director, and was joined by John Grubenman, Director of Private Markets for the PSF.

Mr. Blakney discussed that, as part of the continual review of the PSF real estate program's policies, Courtland and PSF staff recommend a review of performance benchmarks. The committee directed Courtland and PSF staff to proceed and to present recommendations at the July meeting.

10. Authorization to Issue a Request for Proposals for Emerging Market Equity Investment Managers

(Board agenda page III-53)
[Consent agenda item #(4)]

Mr. Timmins presented the key points relevant to the issuance of this Request for Proposals for Emerging Market Equity Investment Managers. Data presented included studies that over longer time periods, active emerging market equity fund managers failed to add value over passive benchmarks after considering fees.

MOTION: *It was moved by Mr. Ratliff and seconded by Ms. Hardy to recommend to the State Board of Education approval to strike language allowing manager tracking error ranges of 50-200 and greater than 200 basis points from the Request for Proposals for Emerging Market Equity Investment Managers.*

MOTION AND VOTE: *It was moved by Mr. Ratliff, seconded by Mr. Allen, and carried unanimously to recommend to the State Board of Education approval to amend language in the RFP to exclude managers with tracking error ranges greater than 200 basis points, amend the performance objective on page five to “meet or exceed” the benchmark return, amend firm track record from ten years to seven years and amend the dates of the oral presentations to the committee for final selection to meet the timeline of the selection process.*

VOTE: *By unanimous consent, the committee recommended that the State Board of Education approve the issuance of a Request for Proposals for Emerging Market Equity Investment Managers with amendments.*

11. Presentation on the Absolute Return Portfolios Managed for the Permanent School Fund and Decision on Absolute Return Investments

(Board agenda page III-55)
[Consent agenda item #(5)]

Representatives from Blackstone Alternatives Asset Management and Grosvenor Capital Management made presentations to the committee with updates on the portfolios they manage for the PSF and the Strategic Partnership Structures managed jointly with staff.

The following two firms gave presentations by their respective representatives:

Blackstone Alternatives Asset Management

Brian Gavin, Chief Operating Officer, Senior Managing Director
Stephen W. Sullens, Head of Portfolio Management, Senior Managing Director
Patrick Cronin, Vice President Client portfolio Advisory and Technology Services

Grosvenor Capital Management, L.P.

Stephen Brewster, Managing Director, Business Development
Brad Meyers, Managing Director, Head of Portfolio Management
Andy Preda, Vice President, Portfolio Management

Mr. Timmins discussed the need to address contracts for existing Raven Absolute Return Managers. Mr. Timmins explained to the committee that all of the Absolute Return Fund of Funds Managers have existing contracts expiring during the month of August 2014. The committee discussed the options of extending or terminating various contracts.

MOTION AND VOTE: *It was moved by Mr. Bradley, seconded by Mr. Allen, and carried to recommend to the State Board of Education approval to amend and extend the terms of all Raven operating agreements for a two year period. All operating agreements including Ravens 1-7 will receive two year extensions beginning September 1, 2014 through August 31, 2016. Ms. Hardy and Mr. Ratliff voted no.*

DISCUSSION ITEM

12. Report of the Permanent School Fund Executive Administrator and Chief Investment Officer
(Board agenda page III-93)

Mr. Timmins informed the committee that Moody's had affirmed the AAA rating for the PSF Bond Guarantee Program.

The meeting of the Committee on School Finance/Permanent School Fund adjourned at 3:04 p.m.