

**Report of the State Board of Education
Committee on School Finance/Permanent School Fund
April 18, 2013**

The State Board of Education Committee on School Finance/Permanent School Fund met at 10:04 a.m. on Thursday, April 18, 2013, 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; Thomas Ratliff; Marty Rowley

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.

DISCUSSION ITEM

1. Review of Permanent School Fund Securities Transactions and the Investment Portfolio
(Board agenda page III-13)

Catherine Civiletto, 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, 2012 through February 28, 2013 unless otherwise noted. Ms. Civiletto's report included reporting on the current fair market value of the Fund, the asset allocation mix as of February 28, 2013, PSF transactions occurring in the reporting period, 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, 2013 through February 28, 2013, and short-term cash investments.

CONSENT ITEM

2. Ratification of the Purchases and Sales of the Investment Portfolio of the Permanent School Fund for the Months of December 2012, January and February 2013

(Board agenda page III-1)
[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 2012, January and February 2013 in the amount of \$2,062,508,886 and \$2,116,379,835 respectively (Attachment A).*

DISCUSSION ITEM

3. Report by the State Auditor's Office on the Audit of the Permanent School Fund's Financial Statements and the Certification of the Bond Guarantee Program for Fiscal Year Ending August 31, 2012

(Board agenda page III-15)

Verma Elliott, audit manager, and Michael Clayton, managing senior auditor and project manager for the PSF audit, presented the results of the annual audit of the Permanent School Fund for the year ending August 31, 2012. Mr. Clayton stated that the State Auditor's Office (SAO) issued an unqualified opinion on the financial statements audited for the period. Mr. Clayton briefly reviewed the SAO's audit process and those parts of the report that were subject to limited inquiries but on which SAO did not express an opinion. Mr. Clayton reported that staff provided access to all records and information requested by the audit team and that no material control weaknesses or evidence of fraud were noted for the Fund.

Angelica Ramirez, audit manager and Ben Carter, project manager, presented the results of the Certification of the Permanent School Fund's Bond Guarantee Program for Fiscal Year 2012. Mr. Carter stated that the amount of bonds guaranteed during FY2012 was within all regulatory limits established by the Texas Education Code (Section 45.053(a) and (d)), the Internal Revenue Service (Notice 2010-5 dated December 16, 2009) and the State Board of Education. Mr. Carter also stated the approval process complied with all applicable laws and policies.

CONSENT ITEM

4. Adoption of an Annual Report on the Status of the Bond Guarantee Program

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

Mr. Timmins, executive administrator and chief investment officer, presented the annual report of the Bond Guarantee Program as required by the Texas Education Code and 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 the annual report on the status of the Bond Guarantee Program as of August 31, 2012.*

DISCUSSION ITEMS

5. Fourth Quarter of 2012 Permanent School Fund Performance Report (Board agenda page III-17)

Tom Heiner and Scott Berard of BNY Mellon Asset Servicing, presented the fourth quarter of 2012 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 2012. He stated that the PSF returned 1.73% for the fourth quarter outperforming the target benchmark by 28 basis points.

Mr. Heiner reviewed performance of the Permanent School Fund by asset class stating that the total domestic equity composite returned 0.45% for the quarter, beating its benchmark by six basis points. He added that international equities returned 5.85% for the quarter, performing in line with its benchmark. The fixed income portfolio returned 0.58%, for quarter, outperforming its benchmark by 37 basis points. Mr. Berard stated that the Absolute Return composite returned 2.15% for the quarter, outperforming its benchmark, the HFRI Fund of Funds Composite Index, by 84 basis points. Mr. Berard added that the Real Estate composite returned 2.32% for the quarter, outperforming its benchmark by four basis points. Mr. Berard added that Total Risk Parity Strategies returned 1.63% in the fourth quarter of 2012, outperforming its benchmark by 177 basis points. He further stated that the Real Return Asset class returned 0.58% for the quarter outperforming its benchmark by nine basis points. Finally Mr. Berard stated that private equity returned 2.62% for the quarter.

6. Presentation on the Absolute Return Strategies Management Services Provided to the Permanent School Fund (Board agenda page III-19)

Representatives from Blackstone Alternatives Asset Management and Grosvenor Capital Management L.P. made presentations to the committee with updates on the portfolios they manage for the benefit of the PSF and on the strategic partnership structures managed jointly with the PSF staff.

The following representatives made presentations:

Blackstone Alternative Asset Management

Brian Gavin, Chief Operating Officer, Senior Managing Director
Stephen W. Sullens, Head of Portfolio Management, Senior Managing Director
Emily M. Reycroft, Head of Client Service, Managing Director

Grosvenor Capital Management, L.P.

Stephen Brewster, Managing Director
Brad Meyers, Vice President

CONSENT ITEMS

7. Authorization to Issue a Request for Qualifications (RFQ) for Investment Management Services for Real Estate

(Board agenda page III-5)

[Consent agenda item #(4)]

John Grubenman, director of private markets, stated that the existing procurement RFQs for investing in real estate expire on August 18, 2013. Mr. Grubenman stated that staff prepared RFQ#701-13-014, for real estate for the committee's consideration.

Chuck Campbell, fiduciary counsel with Jackson Walker LLP, discussed the opinion issued by the Texas Attorney General's Office on April 15, 2013 (Tex. Att'y Gen Op. No. GA-0998 (2013)).

MOTION AND VOTE: *By unanimous consent, the committee recommended that the State Board of Education table the requirement to issue a Request for Qualifications (RFQ) for Real Estate Investment Management Firms.*

8. Decision on Real Estate Investments

(Board agenda page III-7)

[Consent agenda item #(5)]

The PSF real estate consultant, Courtland Partners, represented by Steve Novick, principal/chief operating officer, Ben Blakney, managing director, and Dan Moore, senior consultant, was joined by Mr. Grubenman to present this item. Mr. Grubenman provided an introduction to the recommendation.

Mr. Novick and Mr. Moore presented the recommendation for Madison Realty Capital's Sullivan Debt Fund, L.P. Mr. Novick provided a brief overview of how the fund fits into the current real estate program.

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 Madison Realty Capital necessary to make an investment commitment of up to \$50 million in Madison Realty Capital's Sullivan Debt Fund, L.P., subject to continued due diligence and negotiation of fund terms.*

9. Authorization to Issue a Request for Proposals for Real Estate Consultant Services for the Permanent School Fund

(Board agenda page III-9)
[Consent agenda item #(6)]

Mr. Grubenman stated that the real estate investment counsel services contract with Courtland Partners, Ltd. expires on August 31, 2013. Mr. Grubenman presented RFP#701-13-015 for Real Estate Investment Counsel Services to the committee.

Rhett Humphreys, general consultant with NEPC, concurred with the terms of the RFP.

MOTION AND VOTE: *By unanimous consent, the committee recommended to the State Board of Education approval to issue the Request for Proposal for Real Estate Investment Counsel Services for the Texas Permanent School Fund.*

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

(Board agenda page III-11)
[Consent agenda item #(7)]

Mr. Grubenman presented a review of the Hybrid Private Equity Structure approved by the board at the January 2013 meeting and then reviewed the process conducted by staff and NEPC in reviewing pricing proposals for the program.

The following two firms gave presentations by their respective representatives:

Credit Suisse CFG

Kelly Williams, Managing Director and Group Head
Bernard Yancovich, Managing Director
Thomas Rest, Partner
Lee Brashear, Principal

NB Alternatives Advisors LLC

John Buser, Managing Director
Brien Smith, Managing Director
Kaci Boyer, Investment Associate

Mr. Humphreys provided a review of their assessment of the two firms and recommended entering into a Hybrid Private Equity program with NB Alternative Advisors LLC for \$900 million over 3 years. Mr. Grubenman stated that staff concurred with the conclusion and recommendation.

MOTION AND VOTE: *By unanimous consent, the committee recommended to the State Board of Education approval to execute agreements necessary to implement the Hybrid Private Equity Program with NB Alternative Advisors LLC as the single provider for \$900 million over 3 years.*

DISCUSSION ITEMS

11. Review of Permanent School Fund Governance

(Board agenda page III-21)

Mr. Campbell made a presentation on the operational structure of the Permanent School Fund related primarily to governance, fiduciary and legal considerations. Mr. Campbell gave an overview of the current governance structure, its benefits and short comings and what it can be done to correct it.

Mr. Campbell described to the committee three considerations related the structure of the PSF governance. Under the first consideration, TEA is the entity implementing the day to day investment functions of the PSF. He stated that the State Board of Education has oversight, sets policies, and approves transactions, but TEA through PSF staff is charged with implementation. He added that TEA is not specifically designed for investing assets and is subject to various state agency requirements not applicable to other Texas state investors. He added, however, that being a state agency has some benefits.

Mr. Campbell stated that under the second consideration the entire board is responsible for PSF investment activity. He added that the PSF committee does remove some of the burden from the board with respect to administration of the PSF, but the full board would still set the asset allocation, approve investment transactions, select outside investment consultants; and set many policies procedures and objectives.

Finally, Mr. Campbell described a third consideration where he stated that in most organizations, including Texas state institutional investors, the governing board has control over administration. He added that the board currently has complete control over investments and related operations but the commissioner, not the board, has control of administrative functions.

Mr. Campbell stated that the board may establish a non-profit corporation under Section 43.006 of the Education Code. A non-profit corporation would invest funds under control and management of the board. Corporation bylaws and other governing documents would provide governance structure and address state agency limitations and administrative control concerns. He emphasized that this would give the board full administrative control. He added that a non-profit corporation would not address board compositions issues, immunity issues and certain tax exemption issues.

He added that a better solution was the formation of a “government” corporation which would provide many of the advantages of a state agency and could be structured to avoid the disadvantages. This new government corporation could also address the board composition and administrative control issues. He added that this new structure would require statutory change or addition.

Mr. Ratliff stated that the considerations were something that should be studied carefully and brought to the board in July.

12. Report of the Permanent School Fund Executive Administrator and Chief Investment Officer
(Board agenda page III-23)

Mr. Timmins had no report.

The meeting of the Committee on School Finance/Permanent School Fund adjourned at 4:05 p.m.