

**Report of the State Board of Education
Committee on School Finance/Permanent School Fund
July 17, 2014**

The State Board of Education Committee on School Finance/Permanent School Fund met at 10:25 a.m. on Thursday, July 17, 2014, in Room #1-100 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

Non-Committee Members Present: Barbara Cargill; Geraldine “Tincy” Miller

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 received no presentations of public testimony.

CONSENT ITEM

1. Adoption of Review of 19 TAC Chapter 109, Budgeting, Accounting, and Auditing

(Adoption of Review)

(Board agenda page III-1)

[Consent agenda item #(3)]

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. David Marx, director of financial compliance, 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. Mr. Marx gave the committee an overview of the subchapters in 19 TAC Chapter 109 and stated that no public comments were received regarding the review.

Mr. Marx responded to committee members’ questions about school district accounting practices and the independent audits that school districts are required to have completed annually. Mr. Bradley asked whether current Chapter 109 rules limit the number of years that a school district may use the same independent auditor, and Mr. Marx stated that they do not. Mr. Bradley and Ms. Hardy asked whether this type of provision could be added to the rules in Chapter 109. David Anderson, general counsel, stated that it could be added to the rules in Chapter 109 or to the *Financial Accountability System Resource Guide*, which is adopted by reference through Subchapter C of Chapter 109.

Committee members directed agency staff members to bring a discussion item before the committee at a future committee meeting to initiate the rule amendment or new rule necessary to add the requested provision.

MOTION AND VOTE: *It was moved by Mr. Bradley, seconded by Mr. Allen, and carried unanimously to recommend that the State Board of Education adopt the review of 19 TAC Chapter 109, Budgeting, Accounting, and Auditing, Subchapter A, Budgeting, Accounting, Financial Reporting, and Auditing for School Districts; Subchapter B, Texas Education Agency Audit Functions; Subchapter C, Adoptions by Reference; and Subchapter D, Uniform Bank Bid or Request for Proposal and Depository Contract.*

ACTION ITEM

2. Per Capita Apportionment Rate for the 2013-2014 School Year

(Board agenda page III-55)

[Official agenda item #10]

Al McKenzie, manager of Foundation School Program (FSP) support, presented this item. He asked the committee to recommend adoption of a final Available School Fund per capita apportionment rate of \$261.372 for the 2013-2014 school year based on a revised estimate of the amount available for expenditures from the fund (Attachment A).

MOTION AND VOTE: *It was moved by Mr. Bradley, seconded by Mr. Ratliff, and carried unanimously to recommend that the State Board of Education adopt a final per capita apportionment rate of \$261.372 for the 2013-2014 school year.*

DISCUSSION ITEM

3. Discussion of Proposed Amendment to 19 TAC Chapter 129, Student Attendance, Subchapter B, Student Attendance Accounting, §129.21, Requirements for Student Attendance Accounting for State Funding Purposes

(Board agenda page III-67)

Belinda Dyer, director of financial accountability, presented this item. She explained that the proposed amendment would update statutory references in the rule text to reflect changes from the 83rd Texas Legislature, Regular Session, 2013. Ms. Dyer also responded to committee members' questions concerning excused absences, the making up of school days when school cannot be held because of health or safety issues, and other attendance issues.

4. Report by the State Auditor's Office on the Certification of the Bond Guarantee Program for Fiscal Year Ending August 31, 2013

(Board agenda page III-75)

Hillary Eckford, audit manager, and Bill Morris, audit project manager, presented the results of the Certification of the Permanent School Fund's Bond Guarantee Program for Fiscal Year 2013. Mr. Morris stated that the amount of bonds guaranteed during FY2013 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. Morris also stated the approval process complied with all applicable laws and policies.

CONSENT ITEM

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

(Board agenda page III-57)

[Consent agenda item #(4)]

Holland 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, 2013.*

DISCUSSION ITEM

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

(Board agenda page III-77)

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 March 1, 2014 through May 31, 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 May 31, 2014, PSF transactions occurring in the reporting period, revenues and expenditures for the fiscal period September through May 31, 2014, the activity on the securities lending program for the fiscal period September 1, 2013 through May 31, 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, internal fixed income credit rating changes, broker commissions on both the internal and external equity portfolios for the period beginning January 1, 2013 through May 31, 2014, and short-term cash investments.

CONSENT ITEM

7. Ratification of the Purchases and Sales of the Investment Portfolio of the Permanent School Fund for the Months of March, April and May 2014

(Board agenda page III-59)

[Consent agenda item #(5)]

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 March, April and May 2014 in the amount of \$1,579,937,179 and \$1,723,094,646 respectively (Attachment B).*

DISCUSSION ITEM

8. First Quarter 2014 Permanent School Fund Performance Report (Board agenda page III-79)

Tom Heiner and Scott Berard with BNY Mellon Asset Servicing, presented the first quarter of 2014 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 first quarter 2014. He stated that the PSF returned 2.22% for the first quarter outperforming the target benchmark by 34 basis points. The Fund ranked in the 32nd percentile of the Mellon Universe of Public Funds greater than \$1.0 billion for the 3-month period ending March 31, 2014.

Mr. Heiner reviewed first quarter 2014 performance of the Permanent School Fund by asset class, stating that the total domestic equity composite returned 1.99% for the quarter, outperforming its benchmark by three basis points. He added that international equities returned 0.59% for the quarter, outperforming its benchmark by eight basis points. The fixed income portfolio returned 1.95% for quarter, beating its benchmark by 11 basis points. Mr. Berard stated that the Absolute Return composite returned 1.69% for the quarter, outperforming its benchmark by 140 basis points. Mr. Berard added that the Real Estate composite returned 2.76% for the quarter, exceeding its benchmark by 58 basis points. Mr. Berard added that Total Risk Parity Strategies returned 4.65% in the first quarter of 2014, beating its benchmark by 278 basis points. He further stated that the Real Return Asset class returned 4.34% for the quarter, falling short of its benchmark by 14 basis points. Finally Mr. Berard stated that private equity returned 9.29% for the quarter ending March 31, 2014.

The committee recessed at 12:31 p.m., and reconvened at 1:36 p.m.

CONSENT ITEMS

9. Decision on Real Estate Investments (Board agenda page III-61) [Consent agenda item #(6)]

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

Mr. Novick, Mr. Moore, and Mr. Rapalje presented recommendations for the Ares U.S. Real Estate Fund VIII, L.P.; the Carlyle Realty Partners VII, L.P.; and the Invesco Mortgage Recovery Fund II, L.P. Mr. Novick and Mr. Moore described the due diligence process conducted by both Courtland and PSF staff. Mr. Moore and Mr. Rapalje provided a brief overview of how each of the funds fits into the current real estate program and that each is in compliance with the real estate investment policy. Further, Mr. Moore and Mr. Rapalje explained the objectives, constraints, terms, fees, benefits and concerns of the investment.

MOTION AND VOTE: *By unanimous consent, the committee recommended to the State Board of Education approval to execute agreements with Ares Management necessary to make an investment commitment of up to \$75 million in Ares U.S. Real Estate Fund VIII, L.P.; approval to execute agreements with the Carlyle Group necessary to make an investment commitment of up to \$75 million in Carlyle Realty Partners VII, L.P.; and, approval to execute agreements with Invesco Advisers, Inc. necessary to make an investment commitment of up to \$75 million in Invesco Mortgage Recovery Fund II, L.P., each subject to continued due diligence and negotiation of fund terms.*

10. Decision on Private Markets Benchmarks

(Board agenda page III-63)

[Consent agenda item #(7)]

The PSF general consultant, NEPC, represented by Rhett Humphreys, partner, the PSF real estate consultant, Courtland Partners, represented by Steve Novick, Dan Moore, and Jarrod Rapalje, and John Grubenman, presented proposed changes to the PSF's Private Equity and Real Estate programs' benchmarks.

Mr. Humphreys discussed the current process for private equity benchmarking, a comparison of choices for an updated private equity benchmark and NEPC's recommendation for the proposed private equity benchmark and its implementation.

Mr. Humphreys then reviewed NEPC's recommendations:

- Adopt a database approach, using the Burgiss Group database, for computing a time-weighted private equity benchmark for total plan performance;
- Construct the private equity benchmark using only investments from 2010 to the most current period, reflecting the same time period in which PSF was investing in private equity;
- Adopt a one-quarter lagged reporting policy for PSF private equity returns and the private equity benchmark on the total plan reports, where the prior quarter's private equity program and benchmark returns are revised to reflect 'final' private equity valuations reported by the underlying fund managers;
- Approve a 'restatement' of the private equity benchmark used on total plan reports using the proposed private equity benchmark going back to inception of PSF's private equity program; and
- Adopt a since inception IRR benchmark that will be separately used to assess the effectiveness of the PSF private equity program, using the Burgiss database private equity investments, reflecting the vintage year weightings of the PSF's private equity program.

Mr. Grubenman stated that staff had also reviewed available benchmarks and implementation alternatives and staff concurs with NEPC's recommendations.

Mr. Moore discussed the current process for real estate benchmarking, a comparison of choices for an updated real estate benchmarks and their recommendation for the proposed real estate benchmarks and its implementation.

Mr. Moore then reviewed Courtland's recommendations:

- Adopt the NFI-ODCE Index, Equal Weight, Net of Fees as the benchmark for core real estate or, if available, the NFI-ODCE Ex-81-100 Group Trust Index, Equal Weight, Net of Fees;
- Adopt the Burgiss Private iQ non-core database to compute time-weighted returns for purposes of total fund benchmark performance, using only those funds beginning in 2010 to the most current period, reflecting the same period in which PSF has been investing in real estate;
- Adopt the Burgiss Private iQ non-core database to compute a Since Inception IRR benchmark, reflecting the vintage year weightings of the PSF non-core real estate investments, to assess the performance of the PSF non-core real estate program; and
- Adopt a one-quarter lagged reporting policy for PSF real estate returns and the real estate benchmarks, where the prior quarter's real estate program and benchmark returns are revised to reflect 'final' real estate valuations reported by the underlying fund managers.

Mr. Grubenman stated that staff had also reviewed available benchmarks and implementation alternatives and staff concurs with Courtland's recommendations.

MOTION AND VOTE: *By unanimous consent, the committee recommended to the State Board of Education approval of the recommendations made by NEPC and Courtland and to amend the Investment Policy Manual for the Private Equity and Real Estate benchmarking policies (Attachment C).*

11. Decision on Absolute Return Investments

(Board agenda page III-65)

[Consent agenda item #(8)]

Mr. Timmins commented on the strong performance experienced by the Absolute Return Program since its inception in 2008 and how pleased he was with the strength of the Strategic Relationships with Grosvenor Capital Management (GCM) and Blackstone Alternative Asset Management (BAAM).

Jim Hubbard, director and portfolio manager for global risk control strategies, and portfolio managers Carlos Castro, Andriy Mysyk and Marc Leavitt, with the PSF Absolute Return team, gave a presentation to the committee on the Absolute Return portfolios and the Strategic Relationships with Blackstone Alternatives Asset Management (BAAM) and Grosvenor Capital Management (GCM). Their presentation provided an overview on the history of the portfolios managed for the benefit of the PSF ARS program and on the milestones accomplished by the strategic partnership structures managed jointly with staff.

Mr. Humphreys and Timothy Bruce, partner with NEPC, gave a presentation on the current state and performance of the Absolute Return Program and provided a review of the Strategic Relationships with the PSF.

Mr. Timmins and Mr. Humphreys presented the committee members with their views and recommendations on ways to optimize the management of the Absolute Return Program and on ways to minimize costs. Mr. Humphreys recommended extending contracts for Grosvenor, Blackstone and Mesirov. Mr. Timmins recommended contract extensions only for Grosvenor and Blackstone.

MOTION AND VOTE: *It was moved by Mr. Bradley and seconded by Mr. Allen and carried to recommend to the State Board of Education to approve NEPC's recommendation to maintain investments with Mesirow Advanced Strategies (Raven 2) and with the Strategic Relationships with Grosvenor Capital Management (Ravens 1, 3, and 6) and Blackstone Alternatives Asset Management (BAAM) (Ravens 4, 5 and 7) and to extend the contracts for a period of two years. Mr. Allen, Mr. Bradley and Mr. Mercer voted yes. 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-81)

Mr. Anderson described three bond guarantee issues to the committee. He recommended an Attorney General request be filed to seek clarity on issues related to charter capacity. He also recommended that the board adopt rules to clarify specific standards within the Bond Guarantee Program.

The meeting of the Committee on School Finance/Permanent School Fund adjourned at 4:40 p.m.