

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

The State Board of Education Committee on School Finance/Permanent School Fund met at 10:05 a.m. on Thursday, July 18, 2013, 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

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 individual who presented public testimony is included in the discussion of that item.

ACTION ITEM

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

(Board agenda page III-1)
[Official agenda item #10]

Lisa Dawn-Fisher, associate commissioner for school finance and chief school finance officer, presented this item. She asked the committee to adopt a final Available School Fund per capita apportionment rate of \$469.215 for the 2012-2013 school year based on a revised estimate of the amount available for expenditures from the fund (Attachment A). Dr. Dawn-Fisher explained that the amount available for distribution from the fund for 2012-2013 had increased as a result of the passage of Senate Bill 559 by the 83rd Texas Legislature, 2013. That bill repealed legislation of the 82nd Texas Legislature, First Called Session, 2011, that would have required the comptroller to delay the scheduled monthly July and August transfers of certain tax monies into the Available School Fund for the 2012-2013 fiscal year until September of the following fiscal year.

MOTION AND VOTE: *It was moved by Mr. Ratliff, seconded by Mr. Mercer, and carried to recommend that the State Board of Education adopt a final per capita apportionment rate of \$469.215 for the 2012-2013 school year and to place this item on the consent agenda of the State Board of Education meeting of July 19, 2013.*

DISCUSSION ITEMS

2. **Discussion of Proposed Amendment to 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, §33.65, Bond Guarantee Program**

(Board agenda page III-23)

Dr. Dawn-Fisher presented this item, a proposed amendment to 19 TAC §33.65, Bond Guarantee Program, for discussion. She explained that the proposed amendment would reorganize the rule for clarity and provide for a lower application fee that was better aligned with the current cost of administering the Permanent School Fund (PSF) Bond Guarantee Program. Dr. Dawn-Fisher stated that the amendment would also update the rule to refer to the recently implemented online application for the guarantee administered through the website of the Municipal Advisory Council of Texas and modify the rule's financial exigency provisions to reflect statutory and rule changes. The proposed amended rule text was distributed to the committee as a separate exhibit (Attachment B).

Dr. Dawn-Fisher answered questions about the proposed amendment from committee members. Mr. Ratliff asked if the setting of the program application fee could be delegated to agency staff. David Anderson, general counsel, stated that statute placed responsibility for setting the fee with the board.

3. **Discussion of Proposed New 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, §33.67, Bond Guarantee Program for Charter Schools**

(Board agenda page III-37)

Public testimony was provided by the following individual:

NAME: David Dunn
AFFILIATION: Texas Charter Schools Association

Dr. Dawn-Fisher presented this item, proposed new 19 TAC §33.67, Bond Guarantee Program for Charter Schools, for discussion. The proposed new rule would implement provisions of the Texas Education Code (TEC), Chapter 12, Subchapter D, and Chapter 45, Subchapter C, that were added by Senate Bill 1, Article 59, 82nd Texas Legislature, First Called Session, 2011. These provisions expand the PSF Bond Guarantee Program to allow for guarantee of bonds issued for the benefit of open-enrollment charter schools.

Dr. Dawn-Fisher and Mr. Anderson responded to several questions from committee members regarding the proposed new rule. Both explained that the agency is awaiting a ruling from the Internal Revenue Service permitting the guarantee of charter school bonds before bringing the rule before the board for first reading. Mr. Bradley asked if agency staff could bring draft rule language for discussion to the September board meeting. Dr. Dawn-Fisher responded that staff would do so.

4. Review of Permanent School Fund Securities Transactions and the Investment Portfolio
(Board agenda page III-47)

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 March 1, 2013 through May 31, 2013 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, 2013, PSF transactions occurring in the reporting period, revenues and expenditures for the fiscal period September 1, 2012 through May 31, 2013, 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 March 1, 2013 through May 31, 2013, and short-term cash investments.

Additionally, the committee discussed the bond guarantee program and recent legislative dialogue around capital appreciation bonds and the guarantees associated with such debt. The committee requested staff to bring back to the September 2013 meeting more detailed information about the usage of such bonds in guaranteed school district debt issuances.

CONSENT ITEM

5. Ratification of the Purchases and Sales of the Investment Portfolio of the Permanent School Fund for the Months of March, April and May 2013
(Board agenda page III-3)
[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 March, April and May 2013 in the amount of \$1,247,971,983 and \$1,145,888,109, respectively (Attachment C).*

DISCUSSION ITEM

6. First Quarter of 2013 Permanent School Fund Performance Report
(Board agenda page III-49)

Tom Heiner, with BNY Mellon Asset Servicing, presented the Permanent School Fund performance report for the first quarter of 2013. Mr. Heiner began with an overview of the U.S and foreign capital markets. Mr. Heiner then reviewed the performance of the Fund. He stated that the PSF returned 5.42% for the quarter, underperforming the target benchmark by four basis points. The Fund ranked in the 23rd percentile, or first quartile of the Mellon Universe of Public Funds greater than \$1.0 billion for the 3-month period ending March 31, 2013.

Mr. Heiner reviewed first quarter 2013 performance of the Permanent School Fund by asset class, stating that the total domestic equity composite returned 11.14% for the quarter, performing in line with its benchmark. He added that international equities returned 3.19% for the quarter, outperforming its benchmark by two basis points. The fixed income portfolio returned 0.10% for

the quarter, outperforming its benchmark by 22 basis points. Mr. Heiner stated that the Absolute Return composite returned 3.84% for the quarter, outperforming its benchmark, the HFRI Fund of Funds Composite Index, by 36 basis points. Mr. Heiner added that the Real Estate composite returned 2.41% for the quarter, outperforming its benchmark by 23 basis points. Mr. Heiner added that Total Risk Parity Strategies returned 5.56% in the fourth quarter of 2012, underperforming its benchmark by 368 basis points. He further stated that the Real Return Asset class returned -0.86% for the quarter underperforming its benchmark by 13 basis points. In conclusion, Mr. Heiner stated that private equity returned 10.64% for the quarter.

CONSENT ITEMS

7. Overview of the Real Estate Asset Class

(Board agenda page III-5)

[Consent agenda item #(3)]

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 the PSF.

Mr. Grubenman introduced the topic. Mr. Novick, Mr. Moore and Mr. Grubenman discussed recommended changes to select provisions in the *Real Estate Investment Policy Statement* including, clarification of the definitions of the real estate risk-return categories of “core”, “value-added” and “opportunistic” and delegation of SBOE authority allowing the PSF to execute real estate co-investments and secondary investments with existing manager relationships, subject to parameters and guidelines set forth in the *Real Estate Investment Policy Statement*. Mr. Novick and Mr. Moore explained the objectives, benefits and risks of the recommendations along with suggested guidelines included in the *Real Estate Investment Policy Statement*.

Following discussion among committee members, the *Real Estate Investment Policy Statement* was modified by PSF staff and redistributed to the committee.

MOTION AND VOTE: *By unanimous consent, the committee recommended that the State Board of Education approve the Real Estate Investment Policy Statement dated July 2013, as amended, including delegation of SBOE authority allowing the PSF to execute real estate co-investments and secondary investment with existing real estate managers, subject to the parameters and guidelines set forth in the Real Estate Investment Policy Statement, in order to enhance the risk-return profile of the PSF real estate investment program (Attachment D).*

8. Decision on Real Estate Investments

(Board agenda page III-7)

[Consent agenda item #(4)]

Mr. Novick, Mr. Moore and Mr. Grubenman presented the item. Mr. Grubenman provided an introduction to three real estate investment recommendations.

Mr. Novick and Mr. Moore presented the recommendations for DRA Growth and Income Fund VIII, LLC, GTIS U.S. Residential Strategies Fund, L.P., and the UBS Trumbull Property Fund.

Mr. Novick provided a brief overview of how each of the three funds fit into the current real estate program and are in compliance with the real estate investment policy.

Mr. Moore explained the objectives, constraints, terms, fees, benefits and concerns of each of the investments. 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 DRA Advisors LLC necessary to make an investment commitment of up to \$75 million in DRA Growth & Income Fund VIII, LLC.; approval to execute agreements with GTIS Partners necessary to make an investment commitment of up to \$50 million in GTIS U.S. Residential Strategies Fund, L.P.; and approval to execute agreements with UBS necessary to make an investment commitment of up to \$100 million in UBS Trumbull Property Fund, each subject to continued due diligence and negotiation of fund terms.*

The meeting recessed at 1:05 p.m. and reconvened at 1:56 p.m.

- 9. Selection of a Firm to Provide Real Estate Counsel Services for the Permanent School Fund and Authorization for Contract Execution by the Commissioner of Education**
(Board agenda page III-9)
[Consent agenda item #(5)]

The following two firms gave presentations by their respective representatives:

Courtland Partners

Dan Moore, Senior Consultant
Steve Novick, Principal/Chief Operating Officer

The Townsend Group

Dan Stenger, Principal
Steve Burns, Principal Assistant

The meeting recessed at 2:42 p.m. and reconvened at 2:48 p.m.

Following the presentations Mr. Grubenman summarized the RFP process. Staff recommended selecting Courtland Partners as the real estate investment counsel for the PSF.

MOTION AND VOTE: *By unanimous consent, the committee recommended to the State Board of Education approval to contract with Courtland Partners to provide real estate investment counsel services for the Permanent School Fund and authorization for contract execution by the commissioner of education.*

10. Proposed Amendment to 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, §33.25, Permissible and Restricted Investments and General Guidelines for Investment Managers

(First Reading and Filing Authorization)

(Board agenda page III-11)

[Consent agenda item #(6)]

Holland Timmins, executive administrator and chief investment officer, explained that the current guidelines restrict the fixed income team from making some investments in securities that could enhance the return of the Fund. Carlos Veintemillas, deputy chief investment officer, gave a presentation to the committee on the proposed change to 19 TAC Chapter 33. He stated that the current rule requires that a security be rated investment grade by at least two of the three nationally recognized rating agencies (Moody's, S&P, and Fitch). He further stated that the new language would retain the prohibition on purchasing securities below investment grade, but would require only one agency rating on the security. The proposed language would mandate:

- (1) If all three agencies rate the security, the two lowest ratings will be used;
- (2) If two agencies rate the security, the lowest rating will be used; and,
- (3) If only one agency rates the security that rating will be used.

Rhett Humphries, partner with NEPC, explained that this change would bring the policy in line with how bonds are selected for the fixed income benchmark. Mr. Humphries reported that NEPC supports the proposed change to Chapter 33.

MOTION AND VOTE: *By unanimous consent, the committee recommended that the State Board of Education approve the proposed amendment to 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, §33.25, Permissible and Restricted Investments and General Guidelines for Investment Managers for first reading and filing authorization, as amended, as follows:*

(b)(13) purchasing any publicly traded fixed income security not rated investment grade by Standard & Poor's (BBB-), Moody's (BBB), or Fitch (BBB-), subject to the provisions of the PSF Investment Procedures Manual and the following restrictions: [at least two of the following ratings agencies: at least BBB- by Standard & Poor's, Baa3 by Moody's, and BBB by Fitch, subject to the provisions in the PSF Investment Procedures Manual related to the fixed income portfolio mandates regarding quality and duration;]

(A) when ratings are provided by the three rating agencies, the middle rating shall be used;

(B) when ratings are provided by two ratings agencies, the lower rating is used; or

(C) when a rating is provided by one rating agency, the sole rating is used;

MOTION AND VOTE TO RECONSIDER: *The committee voted to reconsider the vote on the proposed amendment to 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, §33.25 in order to correct a rating shown in subsection (b)(13).*

MOTION AND VOTE: *By unanimous consent, the committee recommended that the State Board of Education approve the proposed amendment to 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, §33.25, Permissible and Restricted Investments and General Guidelines for Investment Managers for first reading and filing authorization, as amended, as follows:*

(b)(13) purchasing any publicly traded fixed income security not rated investment grade by Standard & Poor's (BBB-), Moody's (Baa3), or Fitch (BBB-), subject to the provisions of the PSF Investment Procedures Manual and the following restrictions: [at least two of the following ratings agencies: at least BBB- by Standard & Poor's, Baa3 by Moody's, and BBB by Fitch, subject to the provisions in the PSF Investment Procedures Manual related to the fixed income portfolio mandates regarding quality and duration;]

(A) when ratings are provided by the three rating agencies, the middle rating shall be used;

(B) when ratings are provided by two ratings agencies, the lower rating is used; or

(C) when a rating is provided by one rating agency, the sole rating is used;

11. Approval of an Extension of the Global Custody and Securities Lending Services Agreement with BNY Mellon and Authorization for Contract Execution by the Commissioner of Education

(Board agenda page III-19)
[Consent agenda item #(7)]

MOTION AND VOTE: *By unanimous consent, the committee recommended that the State Board of Education approve an extension of the global custody and securities lending services agreement with The Bank of New York Mellon through August 31, 2017 and authorization for contract execution by the commissioner of education.*

12. Selection of Qualified Respondents to the Request for Proposals for Emerging Market Debt Local Currency Discretionary Investment Managers and Authorization for Contract Execution by the Commissioner of Education

(Board agenda page III-21)
[Consent agenda item #(8)]

The following three firms gave presentations by their respective representatives:

Stone Harbor Investment Partners

Alan M. Fressle, Relationship Manager
David Oliver, Senior Portfolio Manager, Emerging Market Debt
Chris Mitrovich, Relationship Manager/Client Service

Ashmore Investment Management

Mark Weiller, Head of Product & Client Management – Americas
Jan Dehn, Global Head of Research & Portfolio Manager

Investec Asset Management

Melvin Lindsey, CFA, Director, North America Institutional
Thanos Papisavvas, Fixed Income and Currency Strategist

Prior to and following the presentations Rhett Humphries and Phil Nelson with NEPC, and Mr. Veintemillas provided information about each finalist, together with return and risk

information. Discussions with committee members focused on the risk profile of each manager, and the benefit of hiring more than one manager to obtain the benefit of both risk and style diversification.

MOTION AND VOTE: *By unanimous consent, the committee recommended that the State Board of Education approve contracts with Stone Harbor Investment Partners, Ashmore Investment Management and Investec Asset Management in equal allocations for emerging market debt local currency discretionary investment managers and provide managers with specific authorization to invest in fixed income securities not rated investment grade and authorization for contract execution by the commissioner of education.*

DISCUSSION ITEM

13. Report of the Permanent School Fund Executive Administrator and Chief Investment Officer
(Board agenda page III-51)

Mr. Timmins had no report.

The meeting of the Committee on School Finance/Permanent School Fund adjourned at 4:44 p.m.