

**Report of the State Board of Education
Committee on School Finance/Permanent School Fund
September 18, 2014**

The State Board of Education Committee on School Finance/Permanent School Fund met at 9:09 a.m. on Thursday, September 18, 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 #4. Information regarding the individuals who presented public testimony is included in the discussion of that item.

ACTION ITEMS

- 1. 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**
(First Reading and Filing Authorization)
(Board agenda page III-1)
[Official agenda item #9]

Lisa Dawn-Fisher, associate commissioner for school finance and chief school finance officer, presented this 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. The proposed amendment would amend the rule to update statutory references in the rule text to reflect changes from the 83rd Texas Legislature, Regular Session, 2013.

Dr. Dawn-Fisher explained that this is a routine item that adopts the *Student Attendance Accounting Handbook* as a rule by reference. It is important to schools because they receive funding from the state based on attendance. Dr. Dawn-Fisher responded to questions from Ms. Hardy about how schools take attendance and about how failure to maintain accurate attendance accounting for every school day can affect how much money a school district receives.

MOTION AND VOTE: *It was moved by Mr. Allen, seconded by Mr. Mercer, and carried unanimously to recommend that the SBOE approve for first reading and filing authorization the 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.*

2. Per Capita Apportionment Rate for the 2014-2015 School Year

(Board agenda page III-9)
[Official agenda item #10]

Dr. Dawn-Fisher presented this item. She asked the committee to recommend that the State Board of Education adopt a preliminary Available School Fund per capita apportionment rate of \$257.274 for the 2014-2015 school year based on an estimate of the amount available for expenditures from the fund (Attachment A). Dr. Dawn-Fisher responded to questions regarding the per capita apportionment rate.

MOTION AND VOTE: *It was moved by Mr. Allen, seconded by Mr. Bradley, and carried unanimously to recommend that the State Board of Education adopt a recommended per capita rate of 257.274 for the 2014-2015 school year (Attachment A) and to place this item on the consent agenda of the State Board of Education meeting of September 19, 2014.*

3. Proposed Amendment to 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, Subchapter A, State Board of Education Rules, §33.65, Bond Guarantee Program for School Districts

(First Reading and Filing Authorization)
(Board agenda page III-11)
[Official agenda item #11]

Dr. Dawn-Fisher presented this item, proposed amendment to 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, Subchapter A, State Board of Education Rules, §33.65, Bond Guarantee Program for School Districts. The proposed amendment would add a definition of *bond* to the rule to define more precisely the types of debt that are eligible for guarantee. The proposed amendment would also modify the rule to require that *each issuance* of bonds approved for the guarantee be approved by the attorney general. In addition, the proposed amendment would add a definition of *nationally recognized investment rating firm* to provide consistency with the charter school bond guarantee rules.

Dr. Dawn-Fisher commented that this item and the next one are proposing similar changes to rules that affect school districts and charter schools, and she responded to questions from committee members about the changes.

Mr. Bradley asked whether other ratings firms could be used, and Dr. Dawn-Fisher responded that the acceptable ratings firms are specified by name in the definitions section of the rules. Mr. Bradley proposed adding a reference in §33.65(f)(2)(D) to clarify that an applicant district is not eligible unless it is rated by one of the three firms named in the definition.

MOTION AND VOTE: *It was moved by Mr. Bradley, seconded by Mr. Mercer, and carried unanimously to recommend 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, Subchapter A, State Board of Education Rules, §33.65, Bond Guarantee Program for School Districts, for first reading and filing authorization with added wording as follows:*

- (D) An applicant school district is ineligible for consideration for the guarantee if its lowest credit rating from any nationally recognized investment rating firm as defined in subsection (b)(9) of this section [~~credit rating agency~~] is the same as or higher than that of the PSF.

4. Proposed Amendment to 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, Subchapter A, State Board of Education Rules, §33.67, Bond Guarantee Program for Charter Schools

(First Reading and Filing Authorization)

(Board agenda page III-25)

[Official agenda item #12]

Public testimony was provided by the following individuals:

NAME: Amanda List
AFFILIATION: Texas Charter Schools Association

NAME: James J. Butera
AFFILIATION: HR Ratings

Dr. Dawn-Fisher presented the item, proposed amendment to 19 TAC Chapter 33, Statement of Investment Objectives, Policies, and Guidelines of the Texas Permanent School Fund, Subchapter A, State Board of Education Rules, §33.67, Bond Guarantee Program for Charter Schools. The proposed amendment would add a definition of *bond* to the rule to define more precisely the types of debt that are eligible for guarantee. The proposed amendment would also add a definition of *nationally recognized investment rating firm*. In addition, the proposed amendment would modify the rule to require that *each issuance* of bonds approved for the guarantee be approved by the attorney general. Finally, the proposed amendment would clarify language regarding the treatment of charter schools that apply for the guarantee within 12 months of the date that their charter is due to expire.

The public testimony provided by Mr. Butera urged the committee to include other firms in addition to the three named in the rule definition for *nationally recognized investment rating firm*. Dr. Dawn-Fisher and Mr. Butera responded to questions from the committee about the process for a rating firm to be approved by the Securities and Exchange Commission.

The committee directed the staff to gather information about the process for further discussion at the November meeting. Mr. Bradley proposed adding a reference in §33.67(e)(3)(C) to clarify that an applicant charter is not eligible unless it is rated by one of the three firms named in the definition.

MOTION AND VOTE: *It was moved by Mr. Bradley, seconded by Mr. Allen, and carried to recommend 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, Subchapter A, State Board of Education Rules, §33.67, Bond Guarantee Program for Charter Schools, for first reading and filing authorization with added wording as follows:*

- (C) An applicant charter district is ineligible for consideration for the guarantee if its lowest credit rating from any ~~credit rating agency nationally recognized investment rating firm~~ **as defined in subsection (b)(16) of this section** is the same as or higher than that of the PSF.

Mr. Mercer was absent for the vote.

DISCUSSION ITEMS

5. Discussion of Proposed Amendment to 19 TAC Chapter 109, Budgeting, Accounting and Auditing, Subchapter B, Texas Education Agency Audit Functions, §109.23, School District Independent Audits and Agreed-Upon Procedures

(Board agenda page III-53)

Dr. Dawn-Fisher presented the item, discussion of proposed amendment to 19 TAC Chapter 109, Budgeting, Accounting, and Auditing, Subchapter B, Texas Education Agency Audit Functions, §109.23, School District Independent Audits and Agreed-Upon Procedures. The proposed amendment would clarify the requirements for a school district to hire an independent auditor to conduct an audit and give an opinion on the annual financial and compliance report of a school district, governmental charter school, open-enrollment charter school, not-for-profit service provider, county education district, or regional education service center. The proposed amendment would also move the auditors' requirements, which are currently dispersed in various locations in the *Financial Accountability System Resource Guide (FASRG)*, into a single location to make them easy to find. The existing provisions in the rule would be edited slightly for plain language. The new provisions would also state that a school district or other entity must send out a request for qualifications (RFQ) every five years for a new independent auditor, who may or may not be a different partner in the same firm, or as required by the Division of Financial Compliance if at any time the division finds a deficiency in a work paper review of the district's or entity's audit firm. The new provisions would also clarify requirements that a school district must include in its RFQ.

Mr. Bradley asked how the agency could enforce the requirements, and Dr. Dawn-Fisher responded that a school district could receive lower School FIRST ratings as a result of not meeting the requirements.

6. Texas Education Agency Administrative and Program Strategic Budget for Fiscal Year 2015 and the Proposed Legislative Appropriations Request for the 2016-2017 Biennium

(Board agenda page III-61)

Shirley Beaulieu, associate commissioner for finance and chief financial officer, presented the agency administrative and program budget for 2015 fiscal year. Ms. Beaulieu provided committee members with an exhibit comparing the budget for the 2014-2015 biennium to the Legislative Appropriations Request (LAR) submitted by the agency for the 2016-2017 biennium (Attachment B). The attachment also included a list of the exceptional items that were included in the 2016-2017 LAR.

Ms. Beaulieu presented an overview of the major components of the budget, and answered questions from committee members regarding these budget components.

DISCUSSION ITEM

7. Review of Permanent School Fund Securities Transactions and the Investment Portfolio
(Board agenda page III-63)

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 June 1, 2014 through July 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 July 31, 2014, PSF transactions occurring in the reporting period, revenues and expenditures for the fiscal period September 1, 2013 through July 31, 2014, the activity on the securities lending program for the fiscal period September 1, 2013 through July 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 July 31, 2014, and short-term cash investments.

CONSENT ITEM

8. Ratification of the Purchases and Sales of the Investment Portfolio of the Permanent School Fund for the Months of June and July 2014
(Board agenda page III-41)
[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 June and July 2014 in the amount of \$1,183,580,482 and \$918,230,165, respectively (Attachment C).*

DISCUSSION ITEM

9. Second Quarter 2014 Permanent School Fund Performance Report
(Board agenda page III-65)

Tom Heiner with BNY Mellon Asset Servicing, presented the second 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 second quarter 2014. He stated that the PSF returned 3.95% for the second quarter outperforming the target benchmark by 27 basis points. The Fund ranked in the 48th percentile of the Mellon Universe of Public Funds greater than \$1.0 billion for the 3-month period ending June 30, 2014.

Mr. Heiner reviewed second quarter 2014 performance of the Permanent School Fund by asset class, stating that the total domestic equity composite returned 4.94% for the quarter, outperforming its benchmark by one basis point. He added that international equities returned 5.13% for the

quarter, outperforming its benchmark by ten basis points. The fixed income portfolio returned 2.14% for quarter, beating its benchmark by 10 basis points. Mr. Heiner stated that the Absolute Return composite returned 2.07% for the quarter, outperforming its benchmark, the HFRI Fund of Funds Composite Index, by 60 basis points. Mr. Heiner added that the Real Estate composite returned 3.05% for the quarter, exceeding its benchmark by 17 basis points. Mr. Heiner added that Total Risk Parity Strategies returned 6.81% in the first quarter of 2014, beating its benchmark by 286 basis points. He further stated that the Real Return Asset class returned 2.14% for the quarter, exceeding its benchmark by 18 basis points. He added that Emerging Market Debt returned 3.48% for the quarter, underperforming its benchmark by 54 basis points. Finally, Mr. Heiner stated that private equity returned 2.38% for the quarter ending June 30, 2014.

CONSENT ITEMS

10. Determination as to Whether Transfers May be Made from the Permanent School Fund to the Available School Fund

(Board agenda page III-43)

[Consent agenda item #(3)]

Carlos Veintemillas, deputy chief investment officer, gave a presentation describing the two constitutional limits on distributions from the Permanent School Fund. The two limits require that an annual distribution cannot be greater than six percent of the value of the Fund assets and the total amount of distributions from the current and previous nine state fiscal years cannot exceed the total return on the Fund assets over the same time period. Mr. Veintemillas stated that both tests were satisfied, allowing for a distribution from the PSF to the Available School Fund in fiscal year 2015. Keith Stronkowsky, senior consultant with NEPC, PSF general consultant, stated that NEPC also did the same calculations as PSF staff and agreed that both tests were satisfied and a distribution would be permitted.

MOTION AND VOTE: *By unanimous consent, the committee recommended that the State Board of Education determine that a distribution of \$838.672 million for fiscal year 2015 is permitted under Texas Constitution Article VII, Subsection 5(a)(2).*

11. Proposed Amendments to the Investment Procedures Manual

(Board agenda page III-47)

[Consent agenda item #(4)]

Mr. Veintemillas reviewed the proposed amendment to the Investment Procedures Manual of the Permanent School Fund. The amendments reflect the changes to the asset allocation adopted by the Board in July 2014, a name change to the commodity index used in the real return allocation due to the acquisition of the index by Bloomberg, L.P. from Dow Jones-UBS, and a recognition of the different time horizons for open end and closed end real estate funds.

NEPC submitted a memo prior to the meeting that stated their agreement with the amendments.

MOTION AND VOTE: *By unanimous consent, the committee recommended to the State Board of Education adoption of the amendments to the Investment Procedures Manual (Attachment D).*

12. Decision on Real Estate Investments

(Board agenda page III-49)

[Consent agenda item #(5)]

The PSF real estate consultant, Courtland Partners, was represented by Ben Blakney, managing director, and Dan Moore, senior consultant, and joined by John Grubenman, director of private markets for PSF. Mr. Grubenman provided an introduction to two real estate investment recommendations.

Mr. Blakney and Mr. Moore presented the recommendation for a commitment to the Blackstone Property Partners, L.P. Mr. Moore described the due diligence process conducted by both Courtland and PSF staff, provided a brief overview including its objectives and strategy, and he also outlined the merits and considerations. Mr. Blakney and Mr. Moore presented the recommendation for an additional commitment to the Blackstone Real Estate Partners Europe IV, L.P. Mr. Moore described the diligence conducted by both Courtland and PSF staff, and provided a brief description of the process.

MOTION AND VOTE: *By unanimous consent, the committee recommended to the State Board of Education approval to execute agreements with Blackstone Real Estate necessary to make an investment commitment of up to \$100 million in Blackstone Property Partners, L.P., subject to continued due diligence and negotiation of fund terms; and, approval to execute agreements with Blackstone Real Estate to make an additional investment commitment of up to \$25 million in Blackstone Real Estate Partners Europe IV, L.P..*

DISCUSSION ITEMS

13. Presentation by The Bank of New York Mellon on the Custody and Securities Lending Services Provided to the Permanent School Fund

(Board agenda page III-67)

The Bank of New York Mellon (BNY Mellon) was represented by Catherine Wargo, vice president, relationship executive, Tom Heiner, vice president, senior consultant, global risk solutions and Ray Kronz, vice president, securities lending client service officer. Ms. Wargo reviewed BNY Mellon and Permanent School Fund (PSF) partnership milestones and accomplishments since being appointed as global custodian, reviewed the custodian services provided by BNY Mellon and also provided an overview of the BNY Mellon organization, including financial highlights and recent quality rankings.

Mr. Heiner reviewed services provided by the global risk solutions group which include performance measurement, compliance monitoring and reporting. Mr. Kronz presented an overview of the securities lending program.

14. Presentation on the Commodities Discretionary Investment Management Services Provided to the Permanent School Fund

(Board agenda page III-69)

Holland Timmins, chief investment officer and executive administrator, introduced the item to the committee.

The following two firms then gave presentations from their respective representatives:

PIMCO

Nic Johnson, Executive Vice President and Real Return Portfolio Manager
Rick Fulford, Executive Vice President and Head of Public Practice

Credit Suisse Asset Management, LLC

Chris Burton, Managing Director and Senior Portfolio Manager
Charlie Shaffer, Managing Director and Global Head of Distribution

Representatives from PIMCO and Credit Suisse Asset Management discussed recent commodity market conditions and provided the committee with updates on the PSF Commodities portfolio strategy and performance.

CONSENT ITEM

15. Presentations by Finalist Candidates for Emerging Market Equity Discretionary Investment Managers for the Permanent School Fund and Authorization for Contract Execution by the Commissioner of Education

(Board agenda page III-51)

[Consent agenda item #(6)]

Blackrock Institutional Trust, N.A.

Obie McKenzie, Managing Director, Relationship Manager
Jeff Shen, Managing Director, Head of Emerging Markets and Co-head of Investments for Blackrock's Scientific Active Equity
Jamie Lee, Managing Director, Portfolio Manager

State Street Global Advisors

Dave Schiller, Vice President, Senior Relationship Manager
Lynn Black, Senior Managing Director, Global CIO, Global Equity Beta Solutions
Tom Coleman, Vice President, Senior Portfolio Manager, Head of Passive Emerging Markets, Global Equity Beta Solutions

Quantitative Management Associates

Jacob Pozharney, Managing Director, Head of Non-US Core Equity Team
Brad Allinson, Managing Director, Head of Institutional Client Relations

Robeco Institutional Asset Management US, Inc.

Michael Strating, Executive vice president, Portfolio Manager
Michael McCune, Client Portfolio Manager
David Gullen, Relationship Manager

Prior to and following the presentations Rhett Humphreys and Keith Stronkowsky with NEPC, and Karim Hirani, director of equities for PSF, provided information about the search process. 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 Quantitative Management Associates and Blackrock Institutional Trust, in equal allocations for emerging market equity discretionary investment managers for contract execution by the commissioner of education.*

DISCUSSION ITEM

16. Report of the Permanent School Fund Executive Administrator and Chief Investment Officer (Board agenda page III-71)

Mr. Timmins directed the committee members to the quarterly compliance report on transactions between service providers for the 2nd quarter of 2014.

The meeting of the Committee on School Finance/Permanent School Fund adjourned at 3:30 p.m.