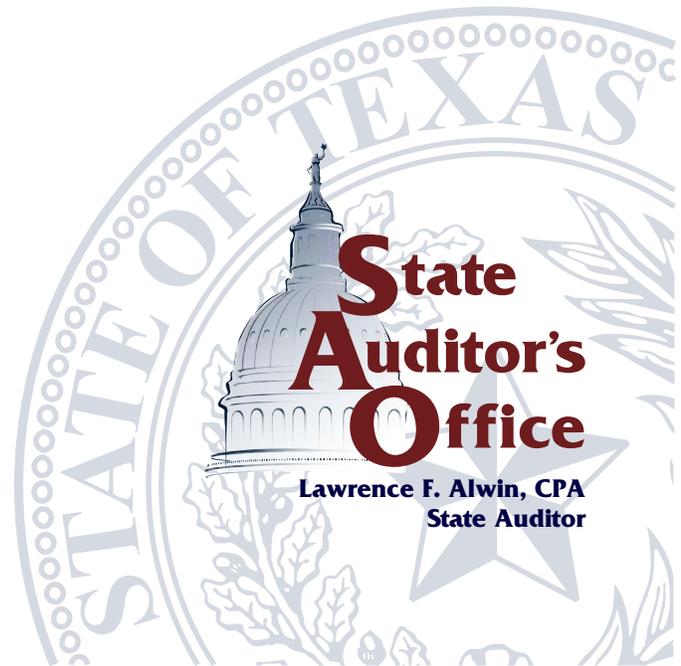


An Audit Report on

Controls over Permanent School Fund Real Estate and Collection of Oil and Gas Revenue at the General Land Office

June 2004

Report No. 04-040



**State
Auditor's
Office**

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State Auditor**

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Overall Conclusion

House Bill 3558 (HB 3558) significantly increased the funds available to the School Land Board's (Board) and General Land Office's (Office) real estate investment program (program) for the Permanent School Fund (PSF) (see text box). The Office had experience in buying, selling, and managing real estate for the PSF and for state agencies. However, although Office management acknowledged that the increase in funds available under HB 3558 called for an investment program of an entirely different scope, the Office and the Board did not implement certain key real estate investment controls that represent "best practices" used by most large institutional real estate investors. Most significantly, they did not initially retain an investment consultant or hire external portfolio managers and continued to operate the program in-house. The Office's controls over land holdings and over revenue collections for oil and gas leases that support the PSF are generally adequate.

In response to HB 3558, the Board and Office worked to comply with legislative requirements to sell at least \$150 million of state real property to be purchased by the PSF. In addition, they developed and generally adhered to reasonably comprehensive investment policies and procedures. However, because the Board and Office did not implement investment controls that represent best practices among institutional real estate investors, the following resulted:

- A lack of ongoing access to external expert advice in designing and implementing the program's policies and strategies.
- A slower-than-forecasted pace of investment. The Board and Office invested \$77 million (17 percent) of the more than \$453 million that was available for investment between September 1, 2001, and November 30, 2003. This led to the program's retaining high cash balances (more than \$318 million as of November 30, 2003), forgoing the opportunity to earn higher overall return, and earning less than the \$11.7 million the

Background Information

House Bill 3558, 77th Legislature (HB 3558), which became effective September 1, 2001, authorized the School Land Board (Board) to invest the proceeds from mineral leases and royalties from Permanent School Fund (PSF) land in "fee or lesser interests in real property" for the PSF. Prior to that, the Board was permitted to purchase such real estate only with proceeds from the sale of other PSF land; the PSF's mineral income was invested by the State Board of Education. The real estate portion of the PSF portfolio that the Board oversees represents only one asset class within the entire \$18.6 billion PSF.

Expanded Real Estate Program

In the first 27 months after HB 3558 became effective, more than \$453 million (on average, about \$200 million per year, mostly from mineral income) was available to the Board to invest in real estate for the PSF. In the 16 fiscal years before HB 3558 took effect, General Land Office (Office) reports indicate that the Office purchased about \$33 million (on average, about \$2 million per year) in PSF real estate on the Board's behalf.

The increase in funds available for investment and the Board's own long-term investment targets suggest that HB 3558 expanded the Board's and Office's role as land trust administrator to encompass the development, implementation, and oversight of an investment approach similar to that of institutional real estate investors such as large pension and endowment funds.



Office had anticipated earning for the Available School Fund during the 2002-2003 biennium.

- Performance reporting that did not fully demonstrate investment results.
- Targets for the real estate investment portfolio's value and rate of return that might be overly optimistic and geographic limitations on investments that could cause the Board to accept higher risk without an expectation for increased return.

During our audit, the Board was in the process of hiring an external consultant. If the Board procures all of the services it has requested, this should help to eliminate most of the above issues.

In addition, the Board could improve documentation of its decisions by ensuring that Board meeting minutes consistently demonstrate the Board's determination that each real estate investment it makes is in the PSF's best interest, which is required by statute. The Office's investment files also do not document that staff consistently provide the Board with certain information, such as expected investment return, that would help it document this determination.

Controls in other aspects of the program, record keeping for all PSF land and mineral interests, certain automated information systems, and royalty collections are generally operating effectively. However, the Office should improve certain aspects of these controls.

During the course of our audit, we became aware of some possible issues within the statutory language and appropriation patterns related to PSF real estate investments. Addressing these issues could enable the Board and Office to manage PSF real estate investments as other institutional real estate investors manage such investments.

Summary of Management's Response

The Office generally agrees with our recommendations.

Summary of Information Technology Review

We audited the Office's Electronic Production Reporting System, Clearance System, Energy Lease Management System, GLOBase, and PSF Land database. Overall, results of our testing indicated that these systems' computer-related controls are effective to ensure that system processing is complete, accurate, timely, and authorized. The Office has procedures in place to authenticate users who access these systems, restrict processing output to authorized users, protect external access points against unauthorized logical access, and protect systems from unauthorized physical access.

However, the Office should prepare a system security plan for its major information systems. This plan would formally establish responsibility for overall network security and for specific applications.

Summary of Objectives, Scope, and Methodology

Our objectives were to determine whether the Office's:

- Controls over investment practices associated with HB 3558 are adequate.
- Controls over land holdings and over revenue collections for oil and gas leases that support the PSF are adequate.

Our scope included reviewing relevant policies, procedures, strategies, historical records, leases, and reports. We also reviewed real estate investment transactions and cash balances during the 27-month period ending November 30, 2003. Our scope did not include an attempt to locate any land or mineral interests owned by the PSF for which the Office had no historical hard copy or electronic records.

Our methodology consisted of conducting interviews with the Office's management and staff, collecting information and documentation, performing selected tests and other procedures, and analyzing and evaluating the results of the tests.

Table of Results and Recommendations

The Board and Office developed reasonably comprehensive policies and procedures, but they did not structure the program like most institutional real estate investment programs. (Page 1)

Obtaining all of the consulting services described in the invitation for offer (IFO) the Office issued in February 2004 should help enable the Board and Office to address our concerns about the lack of ongoing advice related to the design and implementation of the expanded program. Therefore, the Board and Office should:

- Continue their efforts to procure the services of a real estate consultant that has considerable experience advising large institutional real estate investors such as government pension and endowment funds. We further recommend that the Board engage its consultant on an ongoing advisory basis rather than only to complete specific tasks. The Office should budget funds for this purpose on an annual basis.
- Work with the consultant the Board engages to develop a performance report that follows industry standards and that clearly distinguishes and evaluates the results of investments made since HB 3558 became effective.
- Ensure that the Board identifies any information about the PSF's other real property assets that it needs, and ensure that it works with the consultant and/or the Office to determine the appropriate reporting process for such information. In addition, the Office should exercise greater care in ensuring the accuracy of the data it provides to the consultant or the Board and ensure that results from mineral activities are not inadvertently included in a performance report on surface real estate.
- Consider using external real estate managers or advisors to help locate, evaluate, and, if necessary, manage new investments so that the pace of investments can better match the rate at which funds are available for investment. If the Board hires external managers, it should work with the consultant to clearly define the Office staff's role in the investment function. If the Board chooses not to use external managers, it should request the consultant's advice on any strategy changes needed to minimize the opportunity cost of holding large cash balances.
- Ensure that the Board works with the consultant to determine whether (1) the Board's preferred investment approach is consistent with its long-term portfolio goals, (2) its current strategy of investing only in properties within Texas and avoiding many of the property types in which other institutional investors invest could be revised to enhance the program's risk/return profile, and (3) a benchmark exists or can be created that more closely reflects the Board's actual investment approach.
- Ensure that they implement all requirements of Senate Bill 1059 (SB 1059, 78th Legislature, Regular Session) prior to hiring outside financial advisors or service providers. SB 1059 requires the Board to establish standards of conduct and specific, periodic disclosure requirements for such advisors and providers.

The Board could improve documentation demonstrating whether and how investments are in the PSF's best interest. (Page 13)

The Board should consistently document that it complied with statutory requirements to determine that each approved investment is in the PSF's best interest. In addition to documenting this determination, the Board could better serve the program's and the public's interest by:

- Formally adopting criteria that it will use consistently to make the determination that each investment is in the PSF's best interest. The Board might wish to specify that it will use as its criteria the requirements of the investment policy in effect at the time of the investment.
- Documenting the specific reasons it believes that each approved investment meets those criteria.
- Coordinating with the Office to adopt procedures to ensure that the Office publicly disseminates information about approved investments that is accurate and that does not conflict with information the Board documents in the public record.

The Office should ensure that it consistently documents in its files investment staff's compliance with all policies and procedures requiring them to provide the Board with information (including expected income, appreciation, total return, risk, and exit strategy) to use in documenting how the Board determined that each investment is in the PSF's best interest.

The Board and/or Office should request clarification in statute of how the Board should make its best interest determination by requesting that the Legislature consider specifying the investment standard of care to guide the Board's investment decisions. If the Legislature chooses to impose a standard of care equivalent to the "prudent investor" standard, the Board should modify its investment policy accordingly.

Table of Results and Recommendations

Although controls in several of the Office's functional areas are generally operating effectively, the Office should improve certain aspects of those controls. (Page 17)

The Office should:

- Consider acquiring an investment accounting system designed for real estate investments. An experienced real estate consultant will likely be familiar with a variety of software products used by its other institutional clients and could help the Office identify a system that will best meet its objectives.
- Ensure that it includes all acquisition and disposition costs for each property in the property's cost basis. The Office's Asset Management and Accounting Divisions should coordinate in this regard to ensure that appropriate accounting entries are made when other funds pay for some of these real estate costs for PSF investments. (In Chapter 4, we also suggest that the Office work with the Legislature to explore the possibility of requiring the PSF to pay for all such costs.)
- If the Board and Office anticipate acquiring more mineral interests in the future, the Office should inventory purchased mineral interests separately from surface land investments. To prepare accurate performance reports for these investments, the Office will need to identify mineral income arising from these properties separately from income earned on the PSF's other mineral interests.
- In connection with the planned hiring of a real estate consultant, request that the consultant specifically consider the appropriate distinction between core and specialized investments, the internal consistency of the policy's stated diversification and performance targets, and the appropriateness of explicitly stating a long-term goal or upper limit for the real estate portfolio's value in relation to the PSF's entire investment portfolio.
- Improve its documentation of compliance with its real estate control procedures by ensuring that investment staff retain required checklists in the archive or other property files.
- Formally document a security plan for major information systems that includes identification of responsibility for overall network security and for security of specific applications.

Consideration of certain statutory issues could enhance the Board's and Office's ability to operate like other institutional real estate investors. (Page 22)

The Board and Office, with the assistance of their future consultant and the Office's legal staff, should consider working with the Legislature regarding the potential statutory enhancements outlined in Appendix 3 of this report and any other statutory enhancements related to investment strategies they may pursue in the future.

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Detailed Results

Chapter 1

The Board and Office Developed Reasonably Comprehensive Policies and Procedures, but They Did Not Structure the Program like Most Institutional Real Estate Investment Programs

House Bill 3558 (HB 3558) significantly increased the funds available to the School Land Board's (Board) and General Land Office's (Office) real estate investment

Background Information

House Bill 3558, 77th Legislature (HB 3558), significantly expanded the ability of the School Land Board (Board), which is assisted by the General Land Office (Office), to acquire real estate for the Permanent School Fund (PSF) by making available for investment all of the mineral income the Office receives from PSF land.

Expanded Real Estate Program

In the first 27 months after HB 3558 became effective, more than \$453 million (on average, about \$200 million per year, mostly from mineral income) was available to the Board to invest in real estate for the PSF. In the 16 fiscal years before HB 3558 took effect, General Land Office (Office) reports indicate that the Office purchased about \$33 million (on average, about \$2 million per year) in PSF real estate on the Board's behalf.

Expected Benefits from HB 3558

Legislative testimony from 2001 indicates that the expected benefits from HB 3558 included:

- Enhancing the PSF's overall value.
- Providing greater flexibility to the Board in making real estate purchases.
- Ensuring more income flowing to the Available School Fund (ASF) (a 2003 constitutional amendment now directs such current income to the State Board of Education's control).
- Increasing the Office's ability to help the State dispose of surplus real property.

The bill's sponsor stated that the expanded real estate program represented "the logical next step in how we invest for the benefit of the PSF."

program (program) for the Permanent School Fund (PSF) (see text box). The Office had experience in buying, selling, and managing real estate for the PSF and for state agencies. However, the increase in funds available for investment and the Board's own long-term investment targets suggest that the Board's and Office's role as land trust administrator was expanded to encompass the management of an investment approach similar to that of institutional real estate investors such as large pension and endowment funds.

Although Office management acknowledged that the increase in funds available under HB 3558 called for an investment program of an entirely different scope, the Office and the Board did not implement certain key real estate investment controls that represent "best practices" used by most large institutional real estate investors. Most significantly, they did not initially retain an investment consultant or hire external portfolio managers and continued to operate the program in-house.

In response to HB 3558, the Board and Office worked to comply with legislative requirements to sell at least \$150 million of state real property to be purchased by the PSF. In addition, immediately after the passage of HB 3558, the Office drafted a framework for a strategic plan to guide the implementation of the program. The Board and Office later adopted a more comprehensive investment policy that addresses many important issues that a real estate investment policy

should include. They also developed and generally adhered to detailed procedures to guide investment acquisitions. However, we identified certain aspects of those policies and of compliance with procedures that should be improved. (The results of our tests of compliance with investment policies and procedures are discussed in detail in Chapters 2 and 3.)

HB 3558 had several expected benefits (see text box). However, if the Board and Office had structured the program to obtain the level of external expertise that most

large institutional real estate investors commonly obtain, they would have improved their ability to achieve those benefits. Most large institutional real estate investors (pension and endowment funds) retain a consulting firm to provide expert assistance in designing key controls and processes that represent investment fund best practices. Such controls and processes include:

- Designing policy and strategy.
- Obtaining expert advice on issues such as the structure of specific transactions or other investment decisions.
- Selecting and overseeing any external investment managers, which most institutional investors rely on to help find, analyze, negotiate, and/or manage desirable investments. (Although using external managers increases the cost of investing, it increases the investor's ability to invest funds quickly and with diversification.)
- Evaluating investment performance.

The Board's and Office's decision not to initially retain an investment consultant or hire external portfolio managers and, instead, operate in-house resulted in a lack of ongoing access to expert advice, a slower-than-forecasted pace of investment, performance reporting that did not fully demonstrate investment results, and overly optimistic targets for portfolio value and rate of return.

Chapter 1-A

The Board and Office Did Not Obtain Continuous Access to Expert Real Estate Advice to Help Design and Implement the Program

Real Estate Consultants Provide Expert Assistance in a Variety of Areas

Real estate consultants typically assist institutional investors in areas such as:

- Designing investment policy and strategy.
- Providing expert advice on issues such as the structure of specific transactions and other investment decisions.
- Measuring and evaluating investment performance (see Chapter 1-C for additional details).

Real estate consultants can also assist in the selection and oversight of external investment managers that can:

- Help locate, analyze, negotiate, and manage desirable real estate investments (see Chapter 1-B for additional details).
- Bring a greater diversity to the real estate investment portfolio by increasing access to potential deals across the United States (see Chapter 1-D for additional details).

Although the Office budgeted \$175,000 to hire a real estate consultant in fiscal year 2002, the Board and Office did not hire this consultant and, instead, designed and implemented the program internally. In February 2004, during the course of our audit, the Office issued an invitation for offer (IFO) in an attempt to contract with such a consultant.

Obtaining ongoing assistance from a real estate consultant is a typical practice among large real estate investors. In addition, because of the unique nature of real estate investments, many institutional investors maintain continuous access to a specialized real estate consultant even when they already retain a general investment consultant for their entire portfolio of stocks, bonds, and real estate (see text box for additional details).

The Office acknowledged that implementing the program would require it to make significant changes to its investment function.

Although the Office had experience in buying, selling, and managing real estate for the PSF and for state agencies, Office management acknowledged that the increase in funds available called for an investment program

of an entirely different scope. An Office strategy document and a procedures guide concluded that the following changes, among others, would be necessary:

- Possible reorganization of the Office's existing Asset Management Division
- Adoption of best-practices criteria for acquiring institutional-type investments
- Establishment of return objectives and risk constraints
- Development of real estate disposition criteria
- Future development of procedures to analyze multitenant properties

Without the assistance of a real estate consultant, the Office developed a real estate investment policy and implementation strategy that differ in some important ways from the policies and strategies of most large institutional real estate investors.

Acting without the assistance of a real estate consultant, the Office developed an investment policy (which the Board adopted in April 2003) and internal policies and procedures for property acquisitions and dispositions. The Board's policy addresses many important issues that a real estate investment policy should include. For example, it discusses the relationship of risk and return and the importance of diversification (however, as discussed below and in Chapter 1-D, the policy adopts limitations that offset some of the benefits of diversification). The policy also establishes expected returns, benchmarks, and minimum investment criteria for the allowable investment types, and it specifies the information that Office investment staff must provide to the Board prior to the Board's approval of each investment.

However, the Board's policy differs significantly from the policies or strategies of other large investment funds we reviewed, particularly in two fundamental respects:

- The Board's policy does not address the use of external real estate managers to locate investments.
- The Board's policy has unusually restrictive policy limits on investment diversification, both by geographic location and by property type. (The policy limits investments to within Texas, and the Board's implementation of this policy has limited investment types to those involving only single-tenant properties).

The Office contracted with a real estate consultant to assist with one acquisition, but the way in which it worked with the consultant did not maximize the effectiveness of this process.

In January 2004, the Office contracted with a real estate consultant to provide analyses related to the contemplated \$80 million acquisition of the program's largest investment to date. However, the way in which the Office worked with this consultant prevented it from obtaining the maximum benefit from hiring a consultant. It is possible that the problems discussed below would not have occurred if the Office had engaged a consultant that had more frequent and ongoing contact with the program.

The Office asked the real estate consultant to conduct and report on its analysis within a very short timeframe, and it did not provide the consultant with up-to-date contract provisions affecting long-term risk and specifying the lease payments. It also did not detect that the consultant's evaluation assumed that the Board's investment policy called for a minimum annual return of 5 percent; the policy actually states that the Board expects its investments to earn at least a 5 percent *real* return which, when adjusted for inflation, is a target return that is considerably higher than 5 percent. Conversely, the real estate consultant did provide the Office with helpful information about the structure of similar real estate acquisitions and suggested improvements to contract terms and to certain of the Office's financial analysis techniques.

The Board's February 2004 IFO that was issued to obtain real estate consulting services appears to request proposals that would enable the Board and Office to obtain on an ongoing basis all the assistance that we cite above and in the other chapters in this report. If the Board procures all of the services the IFO requests, including the IFO's descriptions of the development and implementation phases, this should help to eliminate most weaknesses we have identified in the program. See Appendix 2 for a detailed description of the scope of work specified in the IFO.

Chapter 1-B

The Board and Office Did Not Invest Funds as Rapidly as They Forecasted

Using in-house investment staff, the Board and Office did not invest the funds available under HB 3558 as rapidly as they had forecasted. For example, the Office's forecast of month-end cash balances during fiscal year 2003 projected the purchase of 21 properties for \$122 million during fiscal year 2003. However, four properties, costing about \$22 million, were actually purchased during that time.

The Office had a reasonable forecasting methodology to project future cash balances. However, between September 1, 2001, and November 30, 2003, the Board and Office closed six transactions through which they invested \$77 million (17 percent) of the more than \$453 million that was available for investment. Because the Office's cash forecasts called for higher levels of investment than were achieved, its ending cash balances were higher than it had forecast. Holding most of the remainder in cash caused the Board and Office to forgo the opportunity to earn higher returns and caused them to earn less current income for public education than anticipated.¹ The Board's investment policy projects that its real estate investments should earn at least 4 percentage points above the return on cash (the policy presumes cash will earn a 1 percent return after adjustment for inflation).

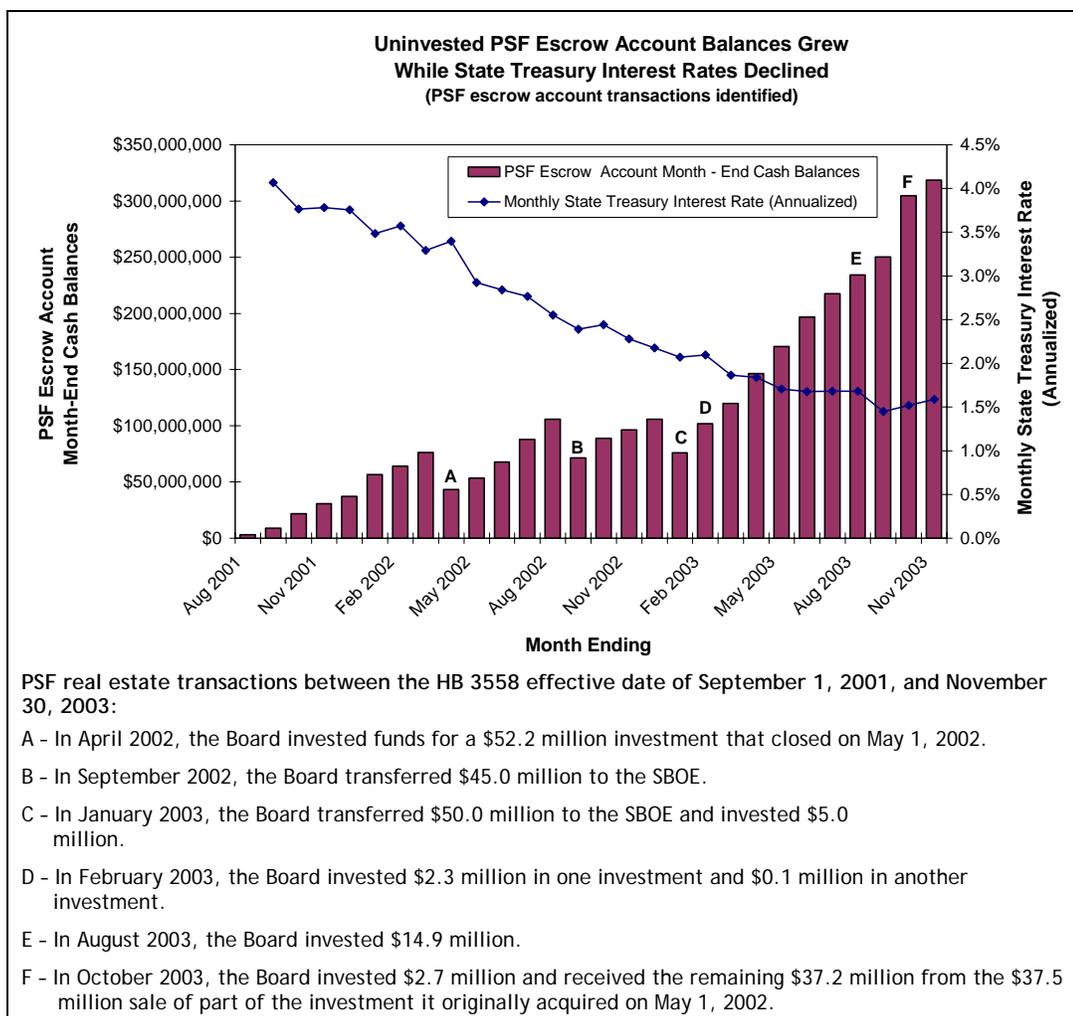
The Board's and Office's inability to invest funds and meet forecasts is partially understandable given the significant increase in funds available to the program due to HB 3558 and the need to focus on General Appropriation Act riders. Specifically, the Board and Office were working to comply with Rider 10.22 (General Appropriations Act, 77th Legislature, page IX-87), which required them to sell at

¹ Prior to the September 2003 passage of a constitutional amendment, all current income earned from Permanent School Fund investments flowed to the Available School Fund. With the passage of the new amendment, this income now flows to the State Board of Education for long-term investment rather than directly to the Available School Fund.

least \$150 million of state real property to be purchased by the PSF; additional riders required them to comply with certain other requirements regarding real estate investment.² In addition, during fiscal year 2003, the Board took some steps to minimize the effect of holding more cash than it could invest by transferring \$95 million in excess cash to the State Board of Education (SBOE) to invest in stocks and bonds.

As Figure 1 shows, the program’s uninvested cash balances in the State Treasury (referred to as the PSF Escrow Account) grew from about \$3 million on September 1, 2001, to almost \$319 million on November 30, 2003. During that same time, however, the interest rate the State Treasury paid on deposits steadily declined, from 4.1 percent (annualized) in September 2001 to 1.6 percent (annualized) in November 2003.

Figure 1



Sources: Cash balances and transaction information are from the Office; State Treasury interest rates are from the State Treasury Safekeeping Trust Company.

² See Riders 10.25 through 10.28, pages IX-88 and IX-89, the General Appropriations Act (77th Legislature).

The program earned less current income for public education than the Office anticipated.

The slow pace of investments resulted in the program's generating no current income from leases or rents during its first two years. In a briefing paper in support of its presentation before the SBOE in September 2001, the Office anticipated that the program would generate at least \$11.7 million for the 2002–2003 biennium from interest and lease income. However, the program generated only about \$4.7 million during that time, all from interest on cash deposits in the State Treasury.

Chapter 1-C

The Office Did Not Develop an Adequate Investment Performance Reporting Process

During the first 27 months after HB 3558 became effective, the Office did not develop an adequate investment performance reporting format or methodology. Institutional investors typically rely on the expertise of an outside consultant to

develop and implement this process (see text box for additional details). In the absence of this external expertise, the Office's lack of familiarity with generally accepted investment performance reporting methods impaired its ability to fully demonstrate the program's results.

Other State Investment Funds Obtain External Expertise to Report Investment Performance

State statutes currently require the State Board of Education and the boards of the Teacher Retirement System and Employees Retirement System to employ outside performance measurement services. The statutes further require those services to compare the funds' performance with the performance of other public or private funds.

Obtaining external expertise to report investment performance is beneficial because it:

- Generally adds to the objectivity and reliability of this important information.
- Provides access to the necessary expertise for proper performance reporting. This helps to ensure the timely and periodic computation and reporting of investment performance in a manner consistent with the performance reporting methods that other funds use.
- Enables decision makers to compare investment performance of a particular program with the performance of other real estate investment programs.

If the Office had presented performance information for its real estate and cash balances in a manner similar to standard industry performance reports, it could have demonstrated (1) performance of the investments the Board had made and (2) the effect that holding large cash balances had on the program's overall performance. For example, while the value of the program's first and largest investment (which represented about two-thirds of the \$77 million the Board invested during the program's first 27 months) increased by 46 percent in the 16 months following its acquisition, the program's cash holdings earned low returns.

In July 2002, the Office presented to the Board a summarized performance report covering most of fiscal year 2002. In January 2004, the Office presented to the Board its real estate report for fiscal year 2003, the first comprehensive real estate report it has presented since HB 3558 took effect. However, it is significant that neither report clearly portrayed the results of the program because they did not:

- Separate the performance of investments made after HB 3558 became effective from the performance and balances for the more than 700,000 acres of real estate the PSF owned prior to the passage of HB 3558. This is important because much of the reported income and asset balance on the reports were associated with real estate owned prior to the passage of HB 3558.
- Measure and report investment performance according to a methodology that is customary in the investment industry. This is important because using a standard

methodology allows more meaningful comparisons with benchmarks, investment policy expectations, and the performance of similar investment funds.

The Office's fiscal year 2003 performance report omitted key information and contained numerous errors.

The Office's fiscal year 2003 performance report also omitted key information that a standard industry performance report typically would include. For example, the report omitted:

- Total portfolio return on market value, as well as the separate return components arising from current income and price appreciation.
- Total return for the entire investment portfolio (including cash), as well as a separate presentation of real estate performance and cash performance.
- Investment returns for the prior year and cumulative returns for the program's first two years.
- Comparisons of the program's performance to its established benchmarks.
- The allocation of the real estate investment portfolio according to the investment policy's major categories (such as the lower risk "core" investments and higher risk "specialized" investments) and subcategories (including institutional or commercial sale/leasebacks, farm and ranch, timberland, and other property types).

The fiscal year 2003 report also contained numerous errors, one of which might have significantly impaired the proper evaluation of the reported results. The number and types of errors in this report suggest that the Office's internal reporting process lacks adequate review. For example, the report's narrative summary suggested that it included only the performance results for surface land holdings and excluded any mineral-related performance. However, the report included a \$3.36 million item related to mineral lease income (and also excluded a small amount of interest income on land sales). As a result, the report overstated land income by \$3.25 million (72 percent) and overstated the income return percentage on the market value of the land to the same extent (current income return on market value should have been reported as 2.1 percent rather than 3.5 percent).

Chapter 1-D

The Board's Targets for the Real Estate Portfolio's Value and Rate of Return May Be Overly Optimistic; Its Limited Diversification Accepts Higher Risk without an Expectation for Increased Return

The Board's slow pace of investment and limitations on diversification suggest that the Board's targets for the real estate investment portfolio's value might be overly optimistic. Further, the Board's conservative approach to individual investments suggests that the Board's targets for the portfolio's overall rate of return also might be overly optimistic. As a result, it appears that the Board's goals are not consistent with its investment approach. In addition, limiting investments to properties within Texas is likely to result in higher overall portfolio risk without an expectation for higher return.

The Board's growth targets for portfolio dollar value appear to be overly optimistic.

The investment policy projects that the investment portfolio will grow to \$3.5 billion during the next 10 fiscal years. However, the program's initial results and our hypothetical models of potential portfolio growth both suggest that the following would need to occur to meet that goal:

- Investable income levels during the next 10 years would need to be considerably higher than they have averaged over the previous 10 years.
- The Board and Office would need to invest funds much faster than they have invested them so far. This may be made even more difficult because the Board's current strategy is to invest only in properties within Texas.

In the future, any funds the Board transfers to the SBOE (instead of investing in real estate) would make the stated growth target even less attainable.

Returns for the Board's Real Estate Investments Since HB 3558 Became Effective Might Be Relatively Modest

Although the Office could not provide us with documents that projected total rates of return for all completed or proposed long-term investments (see Chapter 2 for additional details), the following examples suggest relatively modest total return expectations for the Board's HB 3558 investments to date:

- A recent large investment commitment is projected to earn a nominal annual return of about 7.1 percent over a 30-year term.
- A recent 20-year installment sale will return less than 7 percent annually.
- A completed investment called for initial lease payments equal to approximately 5 percent of the investment's market value (equivalent to the property's initial investment yield), with periodic increases of just below 1 percent per year on a compound basis during the lease's 30- to 40-year term.
- A structure contemplated for a 30-year lease under consideration called for initial lease payments of 6.5 percent of the investment's market value.

The Board's growth targets for long-term rate of return appear to be overly optimistic.

The Board's goal for future rate of return is significantly higher than historical, industry-wide real estate returns. The Board's policy calls for the portfolio's "real" rate of return to be 9.8 percent by the end of the program's twelfth fiscal year. The 9.8 percent real rate of return could equate to a nominal return of 12.5 percent.³ However, according to the Board's investment policy, industry-wide real estate returns averaged only a 7.6 percent nominal return over the past 21 years.

In addition, the investment policy's expected long-term rate of return might not be consistent with the Board's actual investment approach. Its initial investments generally appear to involve very low risk to the PSF. Therefore, given the direct relationship assumed between risk and return, these investments would be expected to have a modest rate of return (see text box for additional details regarding these investments). While these investments generally expect initial net lease income (yield) ranging from 5.0 to 6.5 percent of market value,

real estate survey data indicate that other real estate investors demand initial yields ranging from 8.0 to 10.0 percent. Office management suggested that these higher initial yields, which might produce higher long-term total return, were likely the result of the other investors' accepting a higher level of risk.

³ Nominal Return = (1 + Real Return) x (1 + Inflation) – 1. Therefore, assuming inflation is 2.5 percent in fiscal year 2013, the portfolio would need to earn a 12.5 percent nominal return to produce a 9.8 percent real return.

The Board's policy restriction to invest within Texas could result in higher risk without an expectation for higher return; its implementation of this policy has further limited investments by property type.

The Board's investment policy limits investments to within Texas, and its implementation of this policy has limited investment types to those involving only single-tenant properties. We reviewed investment reports and/or investment policies of the government pension funds that compose the top 10 U.S. pension fund real estate investors. We also reviewed several other government pension funds and one large endowment fund with multibillion-dollar real estate portfolios. All of these funds diversify across the United States (some also invest internationally) and across common property types that normally encompass numerous multitenant properties. Such diversification can help minimize long-term exposure to risk because an economic downturn in a particular geographic region or property type could be offset by good economic conditions experienced in another region or property type. Modern portfolio theory assumes that investors expect to be compensated for assuming risk.

The Board's real estate investment policy itself acknowledges that its restriction to invest only in properties within Texas greatly limits the Board's ability to reduce overall portfolio risk. Our discussions with Office management suggest that the Board's and Office's historical role of acquiring and managing properties only within Texas may have contributed to the decision to restrict investments to within Texas.

The Board has chosen an investment benchmark with underlying investments that do not match the composition of its portfolio.

The Board has adopted the National Council of Real Estate Investment Fiduciaries (NCREIF) Index as its benchmark, but the composition of that index does not resemble the composition of the Board's real estate investment portfolio. The NCREIF Index includes properties broadly diversified across the United States, includes certain property types in which the Board does not invest, and excludes certain property types in which the Board does invest.

When the investment policies or annual reports of other major institutional real estate investors provided benchmark and diversification information, we observed that most of these investors benchmarked their portfolios on some variant of the NCREIF Index, and their portfolios included geographic and property type diversification reasonably similar to the NCREIF Index's diversification. Because the Board's policy and strategy result in its real estate portfolio's departing from its benchmark to such a great extent, the benchmark the Board has selected might not be a useful standard against which to measure the portfolio's performance. In connection with its plan to hire a consultant to redesign the investment policy, the Board has requested that the consultant reassess the appropriateness of using the NCREIF Index as the benchmark.

Recommendations

Obtaining all of the consulting services described in the IFO the Office issued in February 2004 should help enable the Board and Office to address our concerns

about the lack of ongoing advice related to the design and implementation of the expanded program. Therefore, the Board and Office should:

- Continue their efforts to procure the services of a real estate consultant that has considerable experience advising large institutional real estate investors such as government pension and endowment funds. We further recommend that the Board engage its consultant on an ongoing advisory basis rather than only to complete specific tasks. The Office should budget funds for this purpose on an annual basis.
- Work with the consultant the Board engages to develop a performance report that follows industry standards and that clearly distinguishes and evaluates the results of investments made since HB 3558 became effective.
- Ensure that the Board identifies any information about the PSF's other real property assets that it needs, and ensure that it works with the consultant and/or the Office to determine the appropriate reporting process for such information. In addition, the Office should exercise greater care in ensuring the accuracy of the data it provides to the consultant or the Board and ensure that results from mineral activities are not inadvertently included in a performance report on surface real estate.
- Consider using external real estate managers or advisors to help locate, evaluate, and, if necessary, manage new investments so that the pace of investments can better match the rate at which funds are available for investment. If the Board hires external managers, it should work with the consultant to clearly define the Office staff's role in the investment function. If the Board chooses not to use external managers, it should request the consultant's advice on any strategy changes needed to minimize the opportunity cost of holding large cash balances.
- Ensure that the Board works with the consultant to determine whether (1) the Board's preferred investment approach is consistent with its long-term portfolio goals, (2) its current strategy of investing only in properties within Texas and avoiding many of the property types in which other institutional investors invest could be revised to enhance the program's risk/return profile, and (3) a benchmark exists or can be created that more closely reflects the Board's actual investment approach.
- Ensure that they implement all requirements of Senate Bill 1059 (SB 1059, 78th Legislature, Regular Session) prior to hiring outside financial advisors or service providers. SB 1059 requires the Board to establish standards of conduct and specific, periodic disclosure requirements for such advisors and providers.

Management's Response

Historically, the Permanent School Fund real property assets that the Board oversees have been managed and reported separately from assets managed by TEA, and they are not part of the investment portfolio TEA manages. The Board and Office have been, and will continue, implementing the real estate program according to the delegated authority granted by the Legislature and by legislative intent as provided through statutory language, riders, and appropriation authority. The Office

currently may not have the legal or statutory authority to engage in some of the activities identified in the audit report. We have not engaged in investment activities for which we do not have clear statutory or appropriation authority, such as investing outside of Texas or in commingled funds. We have taken great care to make only prudent investments that are in the best interest of the PSF.

The Board and Office do not have control over the rate earned on the cash balance, which is invested at the State Treasury. The interest rate declined while deposits of mineral revenues were higher than expected due to historically high prices for natural gas and crude oil. However, in addition to the amounts mentioned in the report, we have also sent \$6.5 million per month to TEA since January 2004. Due to total return, program expenses are now funded out of the PSF as appropriated to the GLO by the Legislature. The GLO will implement the audit recommendations as described in our responses to the extent that appropriated funds are available.

As mentioned in the report, investing some of the additional revenues the program received has been delayed in part due to the appropriation riders for agencies scheduled to sell real property. Delays also occurred due to requested changes in the closing dates of some transactions for state budgetary reasons. It should also be noted that with real estate activities, there often is a delay between the time a transaction is initiated and the time revenues are actually received. In addition to the transactions mentioned in the report, during fiscal year 2003, the Board and Office initiated transactions that resulted in lease agreements being signed during fiscal year 2004. These agreements have increased PSF lease revenues from a historical average of roughly \$3 million per year to \$4.5 million per year. Another lease currently in process will more than double PSF lease revenue, increasing it to approximately \$9.5 million per year. The Office also made a \$35 million sale that generated a return of \$9.7 million for the PSF. In doing so, for fiscal year 2004 the Office has met the targeted asset mix in our board-approved investment strategy.

Although the Office has considerable real estate expertise on staff, we have hired a real estate fund advisor that has the appropriate knowledge and experience to help with the expanded funding available for the real estate program. The fund advisor was hired on an ongoing basis to assist in refining the investment policy and strategy, performance targets, rates of return, and benchmarks. Since the Constitutional amendment passed in September 2003, all expenses for activities associated with the real estate program, including the fund advisor, are now funded out of the PSF. The Office will continue to retain the services of a fund advisor, as needed, to the extent sufficient funds are appropriated by the Legislature.

We agree that all real estate purchases made as investments need to be reported and that their performance should be measured. However, the PSF real estate program is different from industry both constitutionally and statutorily, which must be considered in the performance reporting. Since the Board oversees all GLO-related PSF activity, and the real estate program made investments prior to the passage of HB3558, we disagree that investments made after HB3558 became effective should be reported separately from previous investments. The Natural Resources Code governs all GLO real estate activities, and the PSF real property assets are all part of the same fund. We find no legal grounds for reporting the post-HB3558 investments separately. However, we believe that performance reporting should address all PSF activities, differentiate between sovereign and acquired properties,

and follow industry benchmarking strategies as applicable. The scope of work for the fund advisor addresses this issue.

We believe the performance report the Office prepared and presented to the Board was a very good effort that contained useful information. The Office will continue its efforts to ensure the Board receives the information it needs for making effective business decisions that are in the best interest of the PSF. The Office hired the fund advisor with the understanding that the firm will help develop recommendations for improving our performance reporting.

The Office would consider using external real estate managers if there is clear legal authority and sufficient funding to do so. We have asked the fund advisor to help identify the most cost-effective and productive strategy for managing the real estate investments.

The scope of work for the fund advisor includes providing recommendations for improving our investment policy and strategy. Since the program is unlike any other real estate investment program, there is no single existing benchmark that correlates with the PSF portfolio. Therefore, we have requested the assistance of the fund advisor in helping to re-evaluate our benchmarking strategy.

Currently, it is not clear whether the Board and Office have the authority to invest outside of Texas or to implement other audit recommendations that would make our program more comparable to other large institutional real estate funds. We have historically been a state land trust that derives our authority from the Legislature. These and other issues must be resolved before the Board can implement the recommendations to make the PSF like other real estate funds.

The requirements of SB 1059 were incorporated into the Invitation for Offer (IFO) for the real estate fund advisor. In order to prevent potential situations that might create conflicts of interest, the Office selected a fund advisor that does not also function as a fund manager.

Auditor's Follow-Up Comment

The State Auditor's Office has not recommended that the Board and Office act in violation of their statutory authority. Management's responses indicate that the statutes are unclear as to whether the Board and Office are prohibited from implementing some of our recommendations. We agree that the statutes do not specifically grant authority to implement certain aspects of the audit recommendations. However, it is also not clear that existing statutes necessarily prohibit implementation of those recommendations.

The Board Could Improve Documentation Demonstrating Whether and How Investments Are in the PSF's Best Interest

The Board could improve documentation of its decisions by ensuring that Board meeting minutes consistently demonstrate the Board's determination that each real estate investment it makes is in the PSF's best interest. Texas Natural Resources Code, Section 51.402 (b), requires the Board to determine that each real estate investment it makes is in the PSF's best interest. However, for the investments we reviewed, Board minutes or resolutions rarely contained a statement indicating that the Board had made this determination. In addition, according to Office management, the Board has not, by rule, established criteria to follow in making this determination. Principles of good governance suggest that outside parties should be able to understand the basis for a governing board's decisions. However, to maintain the PSF's competitive advantage, the law permits the Board to conduct much of its investment deliberations in executive sessions. Therefore, when the Board takes final action on an investment (which it must do in public in an open meeting), it is important that it document the basis for that action.

Investment decisions regarding real estate might be more subject to criticism than decisions about other types of investments, in part because real estate deals can be complex, highly visible, long-term, and more expensive and can have a greater potential for the appearance of conflicts of interest. Unfounded criticism might be reduced if outside parties had access to accurate information about the Board's key expectations at the time it made each investment (to the extent the Board can publicly disclose such information without compromising its competitive position in a pending investment).

For the investments we tested, Board minutes or resolutions rarely contained a statement indicating that the Board had determined that the investment was in the PSF's best interest.

We tested four of the six initial real estate investments made since HB 3558 became effective, and the Board explicitly put in writing its determination that the investment was in the PSF's best interest in only one of those cases. In a few instances, Board resolutions and/or staff memos (to which the Board's minutes sometimes refer when documenting the approval of an investment) asserted that the investment was in the *State's* best interest. However, the PSF's best interest and the State's best interest may not always align. For example, the best interest of the PSF and the State might conflict if the other party to a transaction is a state agency or if an investment in a property within Texas is expected to produce secondary economic benefits to the geographic area where the investment property is located. One or both of these conditions existed in several of the Board's initial real estate investments made since HB 3558 became effective.

Public information about expected investment performance could reduce misunderstanding on the part of the public.

If the Board does not provide a written, public record of its correct return expectation, outside parties could erroneously conclude later that the investment was unsuccessful. For example, apparently based on imprecise information the Office provided, a newsletter reported that the Board expected an annual return of 7.8

percent on an \$80 million investment commitment. While the 7.8 percent figure accurately represented the average annual lease payment as a percentage of the investment's initial cost (or average *yield*), that figure is considerably higher than the 7.1 percent *total investment return* the Office informed us it actually expected for this investment.⁴ Therefore, if the \$80 million investment commitment's actual annual return fell between 7.1 percent and 7.8 percent, outside parties could erroneously conclude that the investment was unsuccessful when, in fact, it exceeded the Board's expectations.

The Office's investment files do not document that staff consistently provide the Board with certain information that would help the Board document its "best interest" determination.

Three of five investment files we tested lacked documentation indicating that, prior to the Board's approving these investments, staff had calculated and provided to the Board (1) the investment's expected total return or (2) the specific exit strategy for disposing of the property at the end of any existing or contemplated long-term lease. The Board's investment policy and the Office's procedures mandate that the Office present this information to the Board before requesting final purchase approval. The information in the file for one of those three investments demonstrated that, several months after the acquisition, Office staff prepared analyses of expected total return and then submitted the relevant information to the Board. If the Board lacks information concerning the specific expected return before it makes an investment decision, it is unable to document quantified information that might help explain its determination that the investment is in the PSF's best interest.

Statute Tells the Board What Types of Real Estate It Can Buy with PSF Funds but Not How to Determine Whether Each Purchase Is in the PSF's Best Interest

Section 51.402, Acquisition of Interest in Real Property, Texas Natural Resources Code, states the following:

(a) The board may use the money designated under Section 51.401 of this subchapter to acquire property for any of the following purposes:

- (1) to add to a tract of public school land to form a tract of sufficient size to be manageable;
- (2) to add contiguous land to public school land;
- (3) to acquire, as public school land, property of unique biological, commercial, geological, cultural, or recreational value; or
- (4) to acquire mineral and royalty interests for the use and benefit of the permanent school fund.

(b) Before acquiring property under Subsection (a) of this section, the board must determine that the acquisition is in the best interest of the permanent school fund.

Statute does not provide guidance to the Board on how it should determine whether an investment is in the Board's best interest, but the Board could adopt its own criteria.

For the State's other major investment funds, the Texas Constitution or statute typically provide an investment standard of care that broadly defines the parameters within which the board or staff of those funds must make investment decisions. Typical examples include language commonly referred to as the "prudent person" or, more recently, "the prudent investor" standard. In contrast, however, the statute permitting the Board to invest PSF funds in real estate does not provide any guidance to the Board on the criteria it should use in making its best interest determination, nor does it expressly establish that there must be an investment purpose for every acquisition (see text box).

Absent further legislative guidance, the Board's decision-making process could be enhanced if it formally adopted, by rule, its own criteria. The Board already has the

⁴ An investment's *total return* is dependent on both the amount and timing of cash inflows. The average annual lease payment percentage (*average yield*) is dependent only on the amount of the cash flows and, therefore, is a less meaningful way to measure an investment's potential value.

Permanent School Fund Real Estate Portfolio Strategy, a document we refer to in this report as its investment policy. Therefore, it could consider demonstrating its determination that an investment is in the PSF's best interest simply by providing specifics on how a proposed investment will comply with the major requirements (for example, expected return, risk, and geographic and property type diversification targets) of that policy.

The 77th Legislature Authorized Investment Standards of Care Equivalent to Prudent Investor Language for Several State Investing Entities

The following language in Section 51.0031(d), Deposits and Investments, of the Texas Education Code, applies to all investments of higher education institutions that have endowment funds with a book value of at least \$25 million. It is similar to constitutional language that governs the investment of the Permanent University Fund:

As used in this section, "prudent person standard" is the standard of care described in Article VII, Section 11b, of the Texas Constitution, and means that standard of judgment and care that prudent investors, exercising reasonable care, skill, and caution, would acquire or retain in light of the purposes, terms, distribution requirements, and other circumstances of the fund then prevailing, taking into consideration the investment of all the assets of the fund rather than a single investment.

In addition, the Board's policy states that investment decisions will be guided by the provisions of the prudent *person* rule. However, certain other entities that manage investment funds have been required to move toward the use of the more contemporary prudent *investor* rule. Specifically, the 78th Legislature adopted the Uniform Prudent Investor Act (UPIA), codified in the Texas Property Code, to guide the investment behavior of trustees. The UPIA contains a standard of care with guidance that is somewhat different from the much older prudent person language. It appears that recent Legislatures have generally considered prudent investor guidance preferable to the older prudent person guidance, at least for some state entities (see text box; although the statute cited in the text box uses the phrase "prudent person standard" as a label for this language, it actually refers to "prudent investors" and uses language that parallels the standard of care language in the UPIA).

Recommendations

The Board should consistently document that it complied with statutory requirements to determine that each approved investment is in the PSF's best interest. In addition to documenting this determination, the Board could better serve the program's and the public's interest by:

- Formally adopting criteria that it will use consistently to make the determination that each investment is in the PSF's best interest. The Board might wish to specify that it will use as its criteria the requirements of the investment policy in effect at the time of the investment.
- Documenting the specific reasons it believes that each approved investment meets those criteria.
- Coordinating with the Office to adopt procedures to ensure that the Office publicly disseminates information about approved investments that is accurate and that does not conflict with information the Board documents in the public record.

The Office should ensure that it consistently documents in its files investment staff's compliance with all policies and procedures requiring them to provide the Board with information (including expected income, appreciation, total return, risk, and exit

strategy) to use in documenting how the Board determined that each investment is in the PSF's best interest.

The Board and/or Office should request clarification in statute of how the Board should make its best interest determination by requesting that the Legislature consider specifying the investment standard of care to guide the Board's investment decisions. If the Legislature chooses to impose a standard of care equivalent to the "prudent investor" standard, the Board should modify its investment policy accordingly.

Management's Response

The Office will work with the Board to develop criteria for determining and documenting that each investment is in the best interest of the PSF. We will ensure that all briefing memos specifically state for each acquisition that it is in the best interest of the PSF. We will also develop a resolution to that effect for each acquisition, have it signed by the Board or its designee, and retain a copy in the records for the transaction.

By statute the Board may make investments not only for financial returns but also for biological, commercial, geological, cultural, or recreational purposes. Therefore, when the Board is using its investment authority to make a purchase, it will document the criteria required by the investment policy. For other acquisitions of interest in real property, it will document the specific reason the acquisition is in the best interest of the PSF.

The Office will continue to disseminate accurate information about approved investments and will document procedures to ensure this occurs. It should be noted that the Office does not have control over all information reported by outside parties.

The Legislature has delegated to the Office its authority to acquire and sell real property, and we will continue to follow the standard established by the Legislature. A change in statute may be required for the Board and Office to adopt a "prudent investor" standard. The Office will work with the fund advisor to address the investment standard.

Although Controls in Several of the Office's Functional Areas Are Generally Operating Effectively, the Office Should Improve Certain Aspects of Those Controls

Other controls in Office functional areas that we audited are generally operating effectively. Those functional areas included other aspects of the program, record keeping for all PSF land and mineral interests, certain automated information systems, and royalty collections. However, the Office should improve certain aspects of controls in the following areas:

- Specific program record keeping procedures and investment policy provisions
- Information retained for the entire portfolio of PSF land and mineral interests
- Information technology security planning

Improving controls in these areas will help enhance the Office's ability to properly account for and manage the PSF's assets and ensure the security of its major information systems.

Although the Office is generally following procedures and policies for the program, certain aspects of those procedures and policies should be improved.

The Office Generally Follows Internal Operating Procedures and Policies for Real Estate Investments

The Office is generally following its procedures and policies for HB 3558 real estate investments. The results of our tests of four of the six HB 3558 real estate purchase transactions made during the program's first 27 months indicate that the Office complied with procedures requiring that:

- The Office use a structured evaluation process that includes two or more levels of review by staff, senior management, and the Board prior to approval.
- The Board not pay more than market value for any investment.
- Office senior management approve all contracts.
- The PSF not pay brokers' commissions for acquisitions.
- The Office create archive files after transactions close.

With the exception of the documentation issues discussed in Chapter 2, the Office is generally following internal operating procedures and policies established to guide real estate investments (see text box for additional details). However, we identified several weaknesses that should be addressed:

- The Office lacks a formal, automated real estate investment accounting system. Using software specifically designed for real estate investing would help the Office ensure that it can track complete and accurate cost, income, expense, and other property-specific information at the individual property level. This, in turn, would aid in accurate performance and management reporting.
- The Office did not always "capitalize" various investment-related costs (such as option fees; closing costs; and appraisal, surveying, and environmental site assessment fees) in the investment's total cost, usually because they were paid for with non-PSF funds. However, proper accounting for real estate investments requires that *all* costs incurred in acquiring (or selling) a property be included in the property's cost basis. Although these investment-related

costs were typically minimal in relation to the investment's total cost, omitting them will result in a slight overstatement of investment return and an overstatement of gain (or an understatement of loss) on the investment's eventual sale.

- The Office did not separately inventory mineral interests it purchased in conjunction with a land investment it made after HB 3558 became effective. In the case we identified in which this occurred, the mineral interests represented less than 1 percent of the combined investment’s total cost. However, if the Office continues to purchase mineral interests when it acquires the related land but does not separately inventory such investments, future investment reports will not accurately reflect the extent of the portfolio’s diversification. In addition, without separately tracking mineral interests acquired with funds that became available for investment after HB 3558 became effective, the Office is more likely to omit from future investment performance reports the associated mineral income from these investments, thereby slightly understating the program’s performance.
- The Board’s investment policy is not consistent with how other institutional real estate investors categorize investments according to risk, includes some internally inconsistent assumptions, and does not explicitly document the Board’s and Office’s expectations for the program’s relationship to the PSF as a whole:
 - ♦ The policy uses what appears to be an industry-standard term—“core” investments—to refer to its relatively low-risk investments. However, the Board’s policy considers undeveloped land to be a core investment, while other institutional investors generally appear to require their core investments to consist of income-producing properties.
 - ♦ The policy specifies a 9.8 percent long-term real return expectation that is inconsistent with the expected long-term percentage mix between its core and “specialized” (higher risk/higher return) investments. Based on the policy’s expected long-term percentage mix of core and specialized investments and its expected long-term return for each of those investment types, the long-term real return of the portfolio would be 7.45 percent.
 - ♦ Office management indicates that it believes that real estate investments should not exceed about 10 percent of the total size of the entire PSF investment portfolio (including the SBOE’s investments in stocks and bonds). However, the current policy neither acknowledges this principle nor addresses how to ensure compliance with it.

We communicated to the Office’s management several other suggestions to improve real estate investment procedures and policies.

Information in the Office’s databases on the PSF’s ownership of surface land and mineral interests is substantially correct, but some documentation supporting that information should be improved.

Internal controls in the Office’s two computerized inventory databases that record the PSF’s ownership of land and mineral interests are generally adequate to ensure the accuracy of those databases. The databases correctly include only land and mineral interests that belong to the PSF, and the property descriptions and historical cost information they contain generally agree with supporting documentation.

However, we noted that the Office typically does not retain in its property files completed checklists to document that staff have complied with review and approval

processes or other control procedures. Office staff indicated that, after they complete the archive file for a property, they discard the completed checklist. Although we did not note significant omissions in the contents of these archive files, it is sound business practice to retain such checklists to provide an audit trail and to demonstrate compliance with internal controls. Office procedures also require the use of other checklists (such as land sale, land trade, and preclosing checklists); however, we were not provided with evidence that Office staff retain these checklists after they use them.

We communicated to the Office's management several other suggestions to improve controls over record keeping for PSF land and mineral interests.

Controls over information systems are operating effectively, but the Office has not developed a system security plan for its major information systems.

Controls over several of the Office's major information systems are operating effectively to prevent unauthorized access and ensure complete, accurate, timely, and authorized data processing. However, for the information systems we reviewed, the Office has not documented a system security plan that encompasses defining security levels and completing risk assessments. In addition, the Office has not fully developed its security objectives and standards and does not have a formal process to do so.

The purpose of a system security plan is to provide an overview of the security requirements of the system, to describe the controls in place or planned, and to define the responsibilities and expected behavior of all individuals who access the system. The system security plan documents the process of planning adequate, cost-effective security protection for a system. It should reflect input from various managers with responsibilities concerning the system, including information owners, the system operator, and the system security manager.

Certain control procedures appear to be operating effectively to ensure that the PSF receives the royalties due to it.

The Office's Royalty Audit Division has processes and controls that appear to provide reasonable assurance that the Office identifies and collects the funds owed to the PSF from royalties earned on PSF oil and gas interests. The Royalty Audit Division operates according to its documented processes for conducting a combination of desk audits (reconciliations of amounts the PSF should receive based on mineral production reported by lessees) and field audits (more extensive reviews of the records maintained by individual lessees to determine whether they have paid the correct amounts to the PSF). Reconciliations generally include evidence of supervisory or quality control reviews. In addition, to help ensure that lease operators accurately report mineral production, the Office's procedures include comparisons of mineral production information that lease operators reported to the Office with production reports the operators file with the Railroad Commission. We communicated to the Office's management some suggestions to improve its royalty audit process.

Instead of receiving royalties in cash, the Office can elect to receive "in-kind" royalties in the form of actual commodities (oil or gas). Results of our tests indicate that the Office's procedures are operating effectively to ensure that the Office pays

the correct expense amounts incurred in connection with taking royalties in-kind and subsequently selling the commodities. The Office also is in the process of strengthening its accounting controls for in-kind royalty activities by acquiring and implementing a more sophisticated automated accounting system to replace the numerous spreadsheets that the Office was using during our audit.

In addition, we noted that the current versions of the mineral leases the Office uses include the terms and provisions required by statute.

Recommendations

The Office should:

- Consider acquiring an investment accounting system designed for real estate investments. An experienced real estate consultant will likely be familiar with a variety of software products used by its other institutional clients and could help the Office identify a system that will best meet its objectives.
- Ensure that it includes all acquisition and disposition costs for each property in the property's cost basis. The Office's Asset Management and Accounting Divisions should coordinate in this regard to ensure that appropriate accounting entries are made when other funds pay for some of these real estate costs for PSF investments. (In Chapter 4, we also suggest that the Office work with the Legislature to explore the possibility of requiring the PSF to pay for all such costs.)
- If the Board and Office anticipate acquiring more mineral interests in the future, the Office should inventory purchased mineral interests separately from surface land investments. To prepare accurate performance reports for these investments, the Office will need to identify mineral income arising from these properties separately from income earned on the PSF's other mineral interests.
- In connection with the planned hiring of a real estate consultant, request that the consultant specifically consider the appropriate distinction between core and specialized investments, the internal consistency of the policy's stated diversification and performance targets, and the appropriateness of explicitly stating a long-term goal or upper limit for the real estate portfolio's value in relation to the PSF's entire investment portfolio.
- Improve its documentation of compliance with its real estate control procedures by ensuring that investment staff retain required checklists in the archive or other property files.
- Formally document a security plan for major information systems that includes identification of responsibility for overall network security and for security of specific applications.

Management's Response

The Office currently operates an information system that tracks the basis in each real property asset. We will work with the fund advisor to determine whether acquiring an investment accounting system is necessary and cost-effective.

Since the passage of the total return Constitutional amendment in September 2003, the Office is required to include all acquisition and disposition costs for each property in the cost basis. We are doing so in a manner that ensures appropriate accounting entries are made when other funds pay some of the real estate costs for PSF investments.

Although the Office does not intend to report pre-HB3558 investments separately from investments made after the bill was passed, we will continue keeping our records in accordance with our statutory requirements and appropriation authorities. We believe it is important to be consistent in our treatment of acquisitions. The Information Systems Division of the Office is adding a new field called "Minerals Only Acquired" to the information system. If the Board acquires mineral interests alone without the surface interest, the Office will record the acquisition in its information systems as such and report on its performance accordingly.

Because the GLO real estate investment function is a real estate trust, our core investments differ from those of other large institutional investors. The scope of work for our fund advisor includes assisting the Office by making recommendations for improving our investment policy and strategy.

The checklists are intended for internal purposes to ensure all necessary documents are put into the archive files. As the audit report mentioned, no documents were identified as being missing from the files. Each file contains a Table of Contents, which is used to ensure this is the case. We believe the checklists are not archival and should not be included in the archive files, but we will retain them in the property files according to the agency records retention schedules.

Although the Information Systems Division has a security plan that relates to all of our systems, and all of our systems are implemented on the same architecture and platform so one system security plan covers all of them, we agree that the documentation of the plan could be improved. We will develop a template for an information security plan that can be used for all systems and will make modifications based on the unique characteristics of each application once it is placed into production. We will also incorporate it into our software development life cycle.

Consideration of Certain Statutory Issues Could Enhance the Board's and Office's Ability to Operate like Other Institutional Real Estate Investors

With the significantly expanded investment scope permitted by HB 3558 (\$200 million per year has been available to invest since the passage of HB 3558, compared with an average annual investment level of \$2 million before the passage of HB 3558), we became aware of some possible issues within the statutory language and appropriation patterns related to PSF real estate investments. Appendix 3 presents the specific potential statutory enhancements we identified.

Recommendation

The Board and Office, with the assistance of their future consultant and the Office's legal staff, should consider working with the Legislature regarding the potential statutory enhancements outlined in Appendix 3 of this report and any other statutory enhancements related to investment strategies they may pursue in the future.

Management's Response

Legislative recommendations for the Office are strictly the purview of the Commissioner. Some legislative changes may be requested, but until they are granted, the Board and Office will continue to follow the existing laws.

Appendices

Appendix 1

Objectives, Scope, and Methodology

Objectives

Our objectives were to determine whether the General Land Office's (Office):

- Controls over investment practices associated with House Bill 3558, 77th Legislature (HB 3558), are adequate.
- Controls over land holdings and over revenue collections for oil and gas leases that support the Permanent School Fund (PSF) are adequate.

Scope

Our scope included:

- Policies, procedures, and reports associated with the School Land Board's (Board) and Office's implementation of their real estate investment program for the PSF since HB 3558 became effective on September 1, 2001.
- Real estate investment transactions and cash balances during the 27-month period ending November 30, 2003.
- Certain real estate investment strategies the Office developed in advance of or shortly after HB 3558's passage.
- Historical records (including those maintained by the Office in hard copy and electronic form) regarding the PSF's ownership of surface and mineral interests.
- Policies, procedures, and amounts for mineral income collections the Office receives in cash or in-kind (by taking possession of the PSF's share of oil or gas).
- Recent versions of oil and gas leases.

Our scope did not include an attempt to locate any land or mineral interests owned by the PSF for which the Office had no historical hard copy or electronic records.

Methodology

The audit methodology consisted of conducting interviews with the Office's management and staff, collecting information and documentation, performing selected tests and other procedures, and analyzing and evaluating the results of the tests.

Information collected included the following:

- Interview responses from Office management and staff
- Policy documents and procedure manuals
- Automated data from land and mineral holdings databases and from mineral income and lease information databases
- Reports prepared by Office management and staff
- Documents supporting information reported by the Office
- Interest rate data from the State Treasury Safekeeping Trust Company
- Investment policies, reports, and data from other institutional investors

Procedures and tests conducted included the following:

- Tests of samples of real estate investment purchase transactions for compliance with Board and Office policies and procedures
- Comparison of the Board's and Office's real estate investment policy and program structure with the real estate investment policies and program structures used by large governmental funds outside Texas
- Comparison of samples of electronic records of land and mineral holdings with supporting documents
- Comparison of certain school land and submerged land file number sequences on hard copy with electronic records to test for completeness of records
- Recalculation of various Office calculations
- Tests of samples of Office reconciliations of royalty collections for compliance with required control procedures
- Review of risk-based procedures the Office used to select royalty collections for such verification processes as desk reviews and field audits
- Review of Office calculations of and support for expenses and customer billings related to oil and gas royalties taken in-kind
- Comparison of provisions in current mineral leases with existing statutory requirements
- Review of security and processing controls of major automated systems supporting oil/gas royalty payments and PSF land and mineral holdings

Criteria used included the following:

- Relevant sections of the Texas Constitution and statutes

- Board real estate investment policy
- Office policies and procedures
- Investment policies and reports of governmental investment funds outside Texas that have large real estate investment portfolios
- Standards for reporting real estate investment performance established by the Association for Investment Management and Research
- Statewide regional land valuations provided by Texas A&M University

Other Information

We conducted fieldwork from August 2003 through March 2004. This audit was conducted in accordance with generally accepted government auditing standards.

The following members of the State Auditor's staff performed the audit work:

- Roger Ferris, CPA (Project Manager)
- John Swinton, CGFM, MPAff (Assistant Project Manager)
- Rodney Almaraz, MBA, CPA, CISA
- Carla Kleinwachter, CIA
- Ron Zinsitz, CPA
- Worth Ferguson, CPA (Quality Control Reviewer)
- Hugh Ohn, CPA, CFA (Quality Control Reviewer)
- Carol Smith, CPA (Audit Manager)
- Frank Vito, CPA (Audit Director)

Scope of Work in the School Land Board's Invitation for Offer

The following is the scope of work the School Land Board (Board) specified in its Invitation for Offer (IFO) No. 41198-DF dated February 6, 2004:

SCOPE OF WORK

2.1 **ENGAGEMENT OF ADVISOR.** The purpose of this IFO is to identify and engage a qualified real estate investment consulting firm. The Board will select a real estate consultant (Advisor) based on the qualifications and selection criteria set forth in Articles IV and V. Under the direction of the Board, the selected Advisor will provide the Board with the real estate investment consulting services described herein in order to reevaluate, revise and implement the Board's Strategic Plan (attached hereto as Exhibit A) through an appropriate comprehensive real estate investment framework. The Board is seeking consulting assistance to include, but not limited to, the following services, which will take place in two phases:

2.2 PHASE I – DEVELOPMENT

2.2.1 **Development of Real Estate Policy.** Advisor shall consult with the Board and its asset management staff to develop and document an appropriate real estate investment policy statement, investment guidelines and procedures for the PSF. Consideration should be given to the asset allocation of the PSF's total investment portfolio, asset class correlation, current real estate investments, expected and required returns, relevant risks, liquidity preferences, diversification preferences and required cash flows.

2.1.1. **Design & Structure of Real Estate Portfolio.** Advisor shall: (1) provide an analysis of potential real estate investment alternatives and recommend an optimal investment structure for the PSF's real estate allocation; (2) evaluate real estate investment strategies including but not limited to core, value, enhanced, and opportunistic strategies; (3) propose an appropriate benchmark(s) for use in measuring performance; (4) propose an appropriate investment performance measurement and evaluation mechanism; (5) develop audit and accounting oversight procedures; and (6) recommend a schedule for implementing investment decisions.

2.3 PHASE II – IMPLEMENTATION.

2.3.1 **Policy Implementation & Procedures.** Advisor shall: (1) propose procedures and design request for proposals regarding the selection of real estate investment managers; (2) develop operating guidelines for real estate investment managers; (3) establish due diligence criteria; (4) provide advice and assistance in contract negotiations with real estate investment managers and/or funds; and (5) assist in evaluation, negotiation and hiring of external real estate investment managers.

2.3.2 **Reporting Requirements.** Advisor shall: (1) provide ongoing quarterly review and analysis of the portfolio performance by real estate investment managers, and individual property (reports should include return

attribution characteristics and risk analyses comparable to appropriate indices); (2) review and identify any potential underperforming assets and recommend appropriate action; (3) provide ongoing annual reviews of the PSF's real estate guidelines, policies and procedures in relation to the total investment portfolio and real estate investment strategies; (4) monitor investment manager(s) (if any) for compliance with contractual guidelines, recommending any remedial actions as appropriate; (5) on a periodic basis, reconcile holdings (cost and market) and cash flows; (6) on a quarterly basis, provide a narrative discussion of the state of the major real estate markets and how any anticipated market changes may impact the PSF's existing real estate investments and potential future investments; and (7) annually, provide a written comprehensive analysis of the PSF's real estate portfolio, its goals and objectives and its current strategy.

2.3.3 Education. Advisor shall: (1) apprise the Board and its asset management staff of new investment strategies, vehicles and techniques as well as major changes in existing practices within the industry; (2) upon request, prepare comprehensive analyses and recommendations regarding such opportunities; and (3) educate staff on specific issues, as requested.

2.3.4 Other Responsibilities. Advisor shall attend meetings with the Board and asset management staff, as requested, to provide advice and counsel on investment matters.

Consideration of Certain Statutory Issues Could Enhance the Board's and Office's Ability to Operate like Other Institutional Real Estate Investors

With the significantly expanded investment scope permitted by HB 3558 (\$200 million per year has been available to invest since the passage of HB 3558, compared with an average annual investment level of \$2 million before the passage of HB 3558), we became aware of some possible issues within the statutory language and appropriation patterns related to PSF real estate investments. The Board and Office may wish to work with the Legislature to address the following:

- Office management indicated that the current statutory language, which requires the Board and Office to make real estate investments by acquiring “fee or lesser interests in real property,” might preclude the Board and Office from directly making certain routine or essential improvements, such as building a sewer line, which would add value to PSF real estate.
- Statute is unclear about whether the Board and Office may invest in commingled real estate funds, an investment form that is common to many institutional real estate investors.
- Investment accounting and performance measurement is more difficult because certain investment-related costs are appropriated from state funds other than the PSF (see Chapter 3 for additional details). Rather than placing a fixed limit on appropriations for this purpose, it could be beneficial for the Office to consider working with the Legislature to establish (1) estimated appropriations for this purpose and (2) performance measures specifying the desired upper limits on investment acquisition and management expenses as a percentage of total new or ongoing investments.
- Statute does not address whether PSF funds may be placed in an escrow account outside the State Treasury, if necessary, and whether these funds may remain in escrow longer than two years. Statute requires the Board to invest PSF funds within two years or transfer them to the SBOE's control. Placing funds in escrow, possibly for longer than two years, might be necessary when the Board contracts to purchase a building upon completion of construction by the other party to the contract.
- It could be useful to consider whether the statutory 1.5 percent fee paid by a buyer of PSF real estate should continue to be deposited to the General Revenue Fund now that the Legislature can appropriate PSF funds to cover the Office's investment management costs. If the General Revenue Fund retains this fee, the PSF would incur all administrative costs and would receive only 98.5 percent of the total amount (price plus fee) for its properties.
- It is unclear whether (1) the Office can use funds appropriated for administrative costs to pay fees to external real estate managers to help locate or manage investment properties, (2) the Office's existing appropriations would be sufficient to cover these expenses, and (3) the Office could net any ongoing property management costs against property income that it is otherwise statutorily required to transfer to the SBOE's control.

Copies of this report have been distributed to the following:

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The Honorable David Dewhurst, Lieutenant Governor, Joint Chair
The Honorable Tom Craddick, Speaker of the House, Joint Chair
The Honorable Steve Ogden, Senate Finance Committee
The Honorable Thomas “Tommy” Williams, Member, Texas Senate
The Honorable Talmadge Heflin, House Appropriations Committee
The Honorable Brian McCall, House Ways and Means Committee

Office of the Governor

The Honorable Rick Perry, Governor

General Land Office and School Land Board

The Honorable Jerry Patterson, Land Commissioner and Chairman
of the School Land Board
Mr. Todd Barth, Member of the School Land Board
Mr. David S. Herrmann, Member of the School Land Board



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