



A Fiduciary Review of Key Governance &  
Investment Functions of the  
Texas Permanent School Fund

SAO Report No. 03-026  
Part A  
(Main Body of Review Report)

Prepared Under Contract to the Texas State Auditor's Office

March 2003

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## **CORTEX APPLIED RESEARCH INC.**

Cortex Applied Research Inc. is a leading practitioner in the development and enhancement of governance practices, fiduciary risk management, fiduciary education and strategic planning for North American public and private pension plans and endowment funds. We are also a leading provider of independent fiduciary audits and governance reviews. We help to clarify the roles and responsibilities of boards, committees, and senior management with respect to their fiduciary obligations, so that they can more efficiently and prudently manage large institutional funds.

We have focused on governance and fiduciary decision-making because of the tremendous impact they have on the overall success of retirement systems and endowment funds. Studies have found that effective governance and decision-making can significantly improve long-term investment performance and the quality of plan administration. Our own work and experience lend support to such studies. Governance systems that incorporate clear decision-making structures, sound policy setting processes, tailored fiduciary education, and relevant and timely reporting systems will better position fiduciaries to make prudent decisions and provide effective oversight.

In its 12-year history, Cortex and its team of experienced professionals has helped to enhance the governance practices of more than 75 pension plans and endowment funds in the United States and Canada.

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## Executive Summary

1. The pioneers of Texas had hoped that the creation of a large fund to finance public education would relieve the State of having to levy taxes for this purpose. Since its inception, however, the revenues of the Permanent School Fund (PSF) have never been sufficient to fully support public education, and the taxpayers, as represented by the Legislature, have been ultimately responsible for ensuring the financing of public education and for bearing the financial risk associated with the PSF.
2. Because the Legislature bears the risk associated with the PSF, the PSF's governance structure, guiding parameters, spending policy, and asset allocation policy should reflect the interests of the Legislature. These same mechanisms should also protect the PSF from short-term considerations that may be detrimental to the long-term health of the PSF.
3. At present, the PSF's governance structure, guiding parameters, spending policy and asset allocation policy do not adequately reflect the interests of the Legislature:
  - a) The governance structure does not allow the Legislature any representation in the fiduciary decision-making process of the State Board of Education (SBOE).

### Sponsors and Fiduciaries

A sponsor is a party that establishes and maintains a public trust fund such as an endowment or pension fund. The sponsor generally establishes the purpose of the fund and designates a party to administer it, who is the fiduciary. The fiduciary is responsible for managing the assets of the fund within parameters set by the sponsor. The fiduciary, unlike the sponsor, must carry out its duties in accordance with strict fiduciary standards established in law, including acting exclusively in the interests of the beneficiaries. In the case of the PSF, the Legislature is the sponsor and the SBOE is the fiduciary.

Instead, the composition of the SBOE is determined by elections, with no guarantee that the resulting governing board will have the investment or related qualifications to make effective fiduciary decisions and properly consider the interests of the Legislature.

b) The Legislature, as the sponsor of the PSF, has not established parameters that guide the SBOE in carrying out the purpose of the PSF as set forth in the Constitution. Clear parameters would allow the development of a more effective investment program for the PSF and provide benchmarks by which the Legislature could evaluate the SBOE's management of the PSF. We believe that the most important parameter should be to ensure intergenerational equity; that is ensure that the value of the PSF and the distributions from the PSF keep pace with appropriate measures of inflation and growth in the student population. This parameter is consistent with generally accepted principles of endowment fund management.

- c) The current income-based spending policy severely limits the range of asset allocation policies the SBOE may adopt. This makes it difficult for the SBOE to accommodate the income needs of the State without adversely affecting the PSF. An asset-based spending policy, which most endowment funds use, could accommodate the needs of the State more effectively.
4. In attempting to manage its own risk exposure, the Legislature has imposed an organizational structure on the PSF in which the SBOE is unable to hold PSF staff accountable. This structure, combined with the inherent limitations in the SBOE's qualifications, has hampered the SBOE's ability to manage the PSF,

and has arguably made the SBOE vulnerable to third parties offering to serve as informal advisors to individual board members. Informal advisors may have financial interests that are in direct conflict with the interests of the PSF.

5. In many instances, the fiduciary practices of the SBOE have been inconsistent with generally accepted standards of fiduciary conduct. We believe that the constraints imposed on the SBOE by the governance structure, the organizational structure, and the spending policy have to some extent contributed to the shortcomings in the SBOE's fiduciary practices.
6. The SBOE has demonstrated an inability to establish, implement, and enforce a comprehensive code of ethics that effectively addresses issues of ethical conduct and conflict of interest.

## **Recommendations to the Legislature**

We have made a number of recommendations to the Legislature and to the SBOE designed to enhance the governance and management practices of the PSF. Below are recommendations for consideration by the Legislature.

- 1.1 We recommend that, as sponsor of the PSF, the Legislature should clarify the parameters within which the PSF is to achieve its Constitutional purpose. The parameters should incorporate the principle of intergenerational equity, which can be satisfied by growing the PSF and its distributions at a rate that keeps pace with the student population growth and appropriate measures of inflation. In addition, the Legislature should communicate the parameters to all interested parties including the PSF's governing board. We believe that by clarifying and communicating the guiding parameters, the Legislature will greatly enhance the potential for effective, long-term management of the PSF.
- 1.2 We recommend that the Legislature, by constitutional amendment, create a governing board for a state-sponsored, quasi-independent investment management organization created to administer the PSF. The composition of the new governing board should appropriately balance the Legislature's legitimate interests with the need for protecting the PSF from non-fiduciary considerations. The composition of the new governing board should accomplish the following:
  - a) Be sufficiently independent to ensure that fiduciary decisions affecting the PSF are not unduly influenced by non-fiduciary considerations that may be detrimental to the long-term financial integrity of the PSF.
  - b) Reflect the fact that the Legislature has important and legitimate interests in the performance and activities of the PSF.
  - c) Include a sufficient number of individuals with relevant investment or related qualifications to help ensure that adequate technical knowledge is brought to bear on all fiduciary decisions involving the PSF.
  - d) Be the right size to balance the need for efficient and effective decision-making with the need to sufficiently represent all interested parties.

Consistent with the above principles, we offer the following recommendations concerning the composition of the new governing board:

- i) The size of the new governing board should be limited to 9 members, the majority of whom should be independent of state government and school districts. Such a size would be large enough to allow sufficient perspectives and expertise to be brought to bear on all decisions, would facilitate the meeting of quorum requirements, and would support the use of committees. At the same time, such a board would be small enough to ensure effective and efficient deliberations.
- ii) The board should contain five qualified individuals appointed by the Governor, with the advice and consent of the Senate, from a list of candidates submitted by the SBOE, but not to include SBOE members. No fewer than two candidates should be submitted by the SBOE to the Governor for each open board position. This recommendation reflects the need for independent board members possessing investment and related qualifications relevant to the administration of the PSF.
- iii) The board should contain one qualified individual appointed by the Lieutenant Governor, reflecting the fact that the State Senate has a legitimate interest in the activities of the PSF.
- iv) The board should contain one qualified individual appointed by the Lieutenant Governor from a list of candidates submitted by the Speaker of the House of Representatives, reflecting the fact that the House of Representatives has a legitimate interest in the activities of the PSF.
- v) The board should contain one qualified individual appointed by the Governor to reflect checks and balances that are customary in government.
- vi) The board should contain one qualified individual appointed by the Commissioner of Education from a list of candidates recommended by a representative number of school districts, to reflect the fact that the school districts are the direct recipients of funding from the Available School Fund (ASF), which is partially funded by the PSF.
- vii) All individuals appointed to the new board should be required to possess relevant qualifications and be free of inherent conflicts of interest. Ruling out individuals who face inherent conflicts of interest will admittedly reduce the pool of potential candidates significantly. Nevertheless, we believe that independent and qualified candidates could be drawn, for example, from the ranks of academics, independent investment consultants, former chief executives of public or private investment funds, former senior executives of insurance companies, former government officials, and professionals in the fields of law, accounting, or auditing. To ensure a diversity of informed views and perspectives, there should not be a concentration of individuals on the board from any one field or discipline.
- viii) Consideration should be given to establishing a process whereby any member of the new governing board could be removed for cause relating to the improper discharge of a fiduciary duty.

- ix) The PSF's governing board should have the authority to select its own chair from amongst its members.
- 1.3 If, and only if, the composition of the PSF's governing board is modified as recommended above, we would recommend that the PSF's governing board be granted greater authority by the Legislature to administer the PSF. At a minimum, such expanded authority should include the ability to appoint the Executive Administrator of the PSF. This would result in a more traditional organizational structure in which management and operating staff are directly accountable to the governing board. This in turn would ensure an alignment between the governing board's fiduciary duties and its authority to carry out its duties. This would also reduce any perceived need by members of the governing board to seek advice from informal advisors. We also believe this recommendation would facilitate recruitment of future Executive Administrators because the current organizational structure is a likely deterrent to qualified candidates.
- 1.4 We recommend that the Constitution be amended to provide for an asset-based spending policy that sets distributions from the PSF by applying a percentage rate to the market value of the PSF. The percentage rate should be determined from time to time by the PSF's governing board, and appropriate smoothing mechanisms should be established as part of the spending policy to minimize fluctuations in annual distributions from the PSF. Other suggested spending policy provisions include the following:
- a) The percentage rate established by the PSF's governing board should ensure that, given reasonable capital market assumptions, the assets of the PSF and the distributions from the PSF will, in the long run, grow in line with growth in the student population and appropriate measures of inflation.
  - b) The PSF's governing board should review the percentage rate at least every three years, using the services of an experienced investment advisor. The review should be based on generally accepted principles of endowment fund management and reasonable and appropriate capital market assumptions.
  - c) If the Legislature is reluctant to allow the PSF's governing board full discretion in setting the above distribution percentage rate, the Legislature may wish to consider establishing in statute a corridor of acceptable rates, based upon the recommendations of an independent, experienced investment advisor. As the outlook for investment returns changes, so too should the corridor. Accordingly, if the Legislature establishes a corridor, we would suggest that the Legislature review the corridor once every 10 years. While a corridor may put interested parties at ease, it is not without risk. A corridor is likely to have an upward bias. That is, during periods of high investment returns the Legislature will have ample incentive to shift the corridor upwards because this may lead to higher distributions. However, during periods of low investment returns the Legislature will have little incentive to shift the corridor downward because this may lead to lower distributions.
- 1.5 We recommend that the Legislature, by statute, should require that the Legislative Audit Committee periodically commission a review to evaluate the PSF's investment practices and performance. This review should be performed by an independent firm with substantial experience in conducting such reviews. The costs of this review should be payable out of the PSF's administrative budget. This

requirement has already been established for the Teacher Retirement System of Texas. The findings of the reviews should be submitted to both the Legislative Audit Committee and the governing board of the PSF.

- 1.6 We recommend that the Legislature require that the PSF's governing board report annually to the Legislature on its investment performance and fiduciary practices. Investment reporting and benchmarks should be consistent with generally accepted standards of performance measurement. At a minimum, reporting on fiduciary practices should include confirmation of compliance with appropriately stringent codes of ethics and/or conflict of interest policies. The report should include a plain-language summary.

Implementation of the above recommendations would require Constitutional or statutory amendments. Section 10 of this report contains additional recommendations, beginning on page 44 that may be implemented by the SBOE or by a new governing board, without amendments to the Constitution or to legislation. These additional recommendations are intended to enhance the governance and management of the PSF, regardless of whether a new investment management organization is established to administer the PSF.

Beginning on the bottom of page 46 we provide minimum recommendations for consideration in the event that Recommendations 1.1 and 1.2 above are not implemented.

## Comments by Cortex to Responses Received From Members of The State Board Of Education

The members of the State Board of Education (SBOE) in their responses to the Cortex report raised numerous issues. (The responses are set out in full starting on page 51.) The responses were in some cases fairly lengthy and detailed. There were a few issues raised by more than one SBOE member. We have chosen to comment on the major issues only, rather than on each and every issue raised. The fact that we do not comment on an issue does not mean that we necessarily agree with the response. We have provided below a short summary of the responses, followed by our comments, on an issue-by-issue basis rather than commenting separately on the responses from each SBOE member. The major issues raised were as follows:

### **Independence**

#### **1. Independence of Cortex**

*Summary of SBOE Responses:* Some SBOE members questioned Cortex's independence and felt that the fiduciary review reflected the views of the State Auditor's Office, including, according to one member, the use of the term "informal advisor".

Comment by Cortex: We feel that these comments are an unfair attack on our professionalism, honesty and integrity. The recommendations that we have made are based on principles and standards of fiduciary conduct and decision-making that we believe are appropriate for the management of large public funds, and which we clearly state in our report. They are consistent with recommendations that we have made in similar situations for our other pension and endowment fund clients such as the California State Teachers Retirement System, the Virginia Retirement System, and the Alberta Heritage and Savings Trust.

We use the term "informal advisor" not only because it was used in the previous reports by the State Auditor's Office and the House Committee on General Investigating, and would thus be familiar to readers, but also because it defines accurately and succinctly persons providing advice to individual SBOE members on a regular basis who have not been formally appointed and authorized to do so by the SBOE.

### **Spending Policy**

#### **2. Asset-based versus Income-only Spending Policy**

*Summary of SBOE Responses:* There were a number of comments on spending policy. Some SBOE members criticized the report for ignoring the findings of other studies done by Callan Associates, Cambridge Associates and Deutsche Bank. Others claimed that an asset-based spending policy that we recommend has not been tested in a prolonged period of declining markets, that it would not improve the performance of the PSF, and that it would simply provide the Legislature with the means of extracting more revenue at the expense of intergenerational equity. One SBOE member questioned our selection of 1990 as the starting year for measuring the performance of the PSF. The same member observed that the six drawbacks of the current income-only spending policy that

*we point out in our report are either not drawbacks at all or apply equally to an asset-based spending policy.*

Comment by Cortex: Our recommendation that the PSF governing board use an asset-based spending policy rather than an income-only spending policy is not based on a study of either historical or expected future performance. We do not claim anywhere in the report that an asset-based spending policy would necessarily result in a higher rate of return. Studies that focus only on the projected return from different types of spending policies are not really helpful. The performance of the PSF will ultimately depend on the returns provided by capital markets, the asset allocation of the PSF, and the value added by the investment managers. An income-only spending policy and an asset-based spending policy could both project the same average level of spending over time. Our reason for proposing an asset-based spending policy is that an income-only spending policy suffers from certain drawbacks that an asset-based spending policy does not, namely:

- i) Using an asset-based policy, the governing board is free to choose from a range of asset allocation alternatives, depending on its tolerance for investment risk. If it has a high tolerance for risk, it could choose a fairly aggressive asset allocation (more stocks, less bonds) with a high expected return, and accordingly set a high spending rate (as a percentage of assets). If its risk tolerance were low, it could choose a conservative asset allocation with a lower expected return, and accordingly a lower spending rate. Of course, the spending rate and the asset allocation would have to be consistent with each other. Under the income-only policy, which requires that all income earned be spent, there is only one asset allocation that will provide the growth in assets and spending necessary to ensure intergenerational equity.
- ii) Using an asset-based policy, if the governing board wanted to increase the level of spending it would raise the spending rate. This would require that the board also change the asset allocation to invest more in stocks and less in bonds to increase the expected return of the PSF. Under the income-only policy, the only way to increase the level of spending is to increase income, which requires investing more in bonds and less in stocks (as the SBOE discovered in 2001). This would lower the expected future return of the PSF, which we maintain is not only unreasonable but also goes against the principle of intergenerational equity.
- iii) Using an asset-based policy, the governing board can control the level of spending to a large extent by choosing the spending rate that it applies to the value of assets. Under the income-only policy, the level of spending depends on interest rates and dividend yield which the board has no control over. Of course, the governing board has no control over changes in the value of assets resulting from movements in capital markets under either type of spending policy.
- iv) The income-only spending policy, combined with a perceived requirement to meet the Biennial Revenue Estimate (BRE), creates an incentive not to rebalance the asset allocation because that might: (a) reduce investment income (by moving assets from bonds to stocks) below the current BRE; or (b) increase investment income (by moving from stocks to bonds) and thus make it difficult to meet a future BRE. An asset-based spending policy would create no such incentive to interfere with the prudent rebalancing of the asset allocation.

- v) Under an asset-based policy, the governing board can choose the investments of the PSF based on a prudent consideration of their risk-return tradeoff. There would be no incentive to invest in high income, low growth assets (such as high-yield bonds) to meet a BRE target, as there is under the income-only policy. It would not necessarily lead the board to invest in riskier assets, unless the board felt that such investments were prudent and justified by their higher expected return.
- vi) One of the arguments put forward in support of the income-only policy is that it protects the value of the PSF. However, since the policy requires that all of the income earned must be spent, it protects only the principal value. It does not necessarily protect the corpus. The corpus must grow to cover inflation and student enrollment. The asset-based policy does not guarantee future growth in the value of the corpus either, but by allowing the governing board to re-invest a portion of the income when it is greater than the desired level of spending, or to reduce the spending rate when necessary, such as during a long period of declining markets, it can better protect the value of the PSF. In doing so, and by allowing the PSF to be managed more effectively, an asset-based policy may result in better performance.

The studies by Cambridge Associates and Deutsche Bank project the expected outcome of different spending rates under various assumptions. We have not put forward any suggestion as to what a prudent spending rate should be under an asset-based spending policy, whether it should be 5% or 4% or even 3%. That would be for the PSF governing board to decide, based on a careful study using realistic expectations of the future long-term rate of return in capital markets, as well as estimates of future inflation and increases in student enrollment. In the last fiscal year 2002, the PSF distributed \$764 million on an average asset value of \$18 billion, which works out to a spending rate of 4.2%.

The reason we looked at the performance of the PSF since 1990 was because Task Area 6 of the CPR specifically asked us to “analyze the PSF’s ability to maintain inflation-adjusted and per-capita-adjusted spending over the past ten years.” If we had confined our analysis to the ten-year period from 1993 to 2002, it would not have changed our conclusions in the slightest. The reason we decided to extend the analysis back to 1990 was not only because the data on asset value and spending was readily available, but more importantly, because the regular performance reports provided to SBOE also measure performance from fiscal year 1990. The reports, in fact, indicate August 31, 1989 as the “inception date” for performance measurement purposes.

Finally, in response to the argument that an asset-based spending policy would simply allow the Legislature to extract more revenue from the PSF, we would point out that even the income-only policy did not prevent this from happening in 2001. Furthermore, it resulted in a change in the asset allocation (towards more bonds and less stocks) that – instead of increasing the expected rate of return to provide for the extra spending – is, in fact, likely to reduce the expected future growth of the PSF, and thus may fail to ensure intergenerational equity. On the other hand, under an asset-based spending policy, an increase in spending could be accommodated by an increase in the spending rate. It would also allow for a change in the asset allocation towards more stocks and less bonds, thus increasing the expected return of the PSF, consistent with the need to maintain intergenerational equity.

## **Governance**

### **3. Separation of Powers between the SBOE and the Legislature**

*Summary of SBOE Responses:* A few SBOE members claimed that the Constitution of 1876 established a “separation of powers” between the SBOE and the Legislature, and that the “independence” of the SBOE had been maintained for the last 127 years. One member observed that providing the Legislature with greater control over the governance of the PSF would not promote intergenerational equity. Another member stated that the Constitution gives the management of the PSF to the SBOE while the Legislature controls the spending of PSF income, and that there would be a conflict of interest if the same party were to control both spending and investment decisions.

Comment by Cortex: The facts do not support the above assertion. The history of the governance of the PSF, according to the *House Research Organization Report* dated January 3, 2000, shows the following:

- For the first 52 years from 1876 to 1928 the SBOE consisted of the governor, the comptroller and the secretary of state.
- For the next 21 years it was a 9-member body appointed by the governor.
- For 35 years from 1949 to 1984, the SBOE was an elected body.
- From 1984 to 1989 the members of the SBOE were appointed by the governor.
- Since 1989 it has again been an elected body.

In other words, there has not been a “separation of powers” for the last 127 years, and an independent SBOE has existed for less than half that time.

The State is responsible for providing public education for the school children of Texas. The distributions from the Permanent School Fund are part of the total expenditure on public school education in Texas. The State, as represented by the executive and legislative branches, therefore, has a legitimate interest in the management and performance of the PSF, and should have a voice in deciding how the PSF should be governed. We feel that interest is best represented not through the imposition of riders to appropriation bills, but by the authority to appoint members to an independent governing board responsible for the management of the PSF. Our recommendation is that the majority of the members of the proposed board be appointed by the SBOE. We believe a sufficiently independent and qualified governing board is key to establishing appropriate spending and investment policies, which in turn are critical to ensuring intergenerational equity.

The Legislature currently does not control the level of spending from the PSF; the SBOE does this, under the income-only spending policy, by choosing the proportion of assets that are invested in dividend-paying stocks and interest-paying bonds. Spending and investment decisions have effectively resided with the SBOE all along and have not been separated. Consistent with the recommendation contained in our report, we do not believe that the spending and investment policy decisions should be separated. To ensure intergenerational equity, spending policy and investment policy, including asset allocation, need to be consistent with each other. We propose that the PSF governing board should establish both the spending policy (within broad guidelines set out in the Constitution) and the investment policy for the prudent management of the PSF.

#### **4. Fiduciary Duty to Act Exclusively in the Interest of Beneficiaries**

*Summary of SBOE Responses:* One SBOE member noted that the fiduciary of a fund has a duty to act exclusively in the interests of the beneficiaries, and not the sponsor of the fund.

Comment by Cortex: While the school children of Texas are often referred to as the beneficiaries of the PSF, it is more accurate to say that in fact the parents of the school children are the beneficiaries, because if there were not a system of public education in Texas, parents would have to pay for their children's education directly. Given that Texas does offer public education, one can make the case that, broadly speaking, taxpayers are also beneficiaries of the PSF because if the PSF does not meet its performance objectives, taxpayers must ultimately make up the difference.

The Legislature is not a beneficiary of the PSF, but it does have a legitimate interest in the success of the PSF, because it represents the taxpayers of the State. Accordingly, we believe its interests must be reflected in the governance structure of the PSF. When fiduciaries act exclusively in the interests of the beneficiaries, they necessarily also act in accordance with the legitimate interests of the Legislature. Fiduciaries have a duty however to resist acting in support of any interests the Legislature may have that are not legitimate; that is, they may not support actions that are contrary to the principle of intergenerational equity.

#### **5. Riders to the Appropriation Bill**

*Summary of SBOE Responses:* Two SBOE members commented at some length on the riders to the appropriation bills, noting their history through the nineties. They felt that the riders demonstrate that the Legislature is strongly represented on PSF matters. One member observed that the Cortex review provides little opinion on the appropriateness of the riders.

Comment by Cortex: We do not believe that riders to appropriations bills are an appropriate mechanism by which the Legislature should have its interests represented on PSF matters. The Legislature, however, is forced to resort to using such indirect mechanisms to protect its legitimate interests, because it lacks more appropriate and traditional means of doing so. That is, it does not have a role in determining the composition of the PSF governing body.

If the governance structure were modified to properly reflect the interests of the Legislature, we would recommend that the Legislature no longer impose riders to appropriation bills, but rather should allow the proposed governing board to oversee the PSF with due regard to all parties having legitimate interests in the PSF.

#### **6. Accountability of an Appointed vs. Elected Governing Body**

*Summary of SBOE Responses:* Some SBOE members suggested that an appointed board would not be sufficiently independent of the Legislature. It was asserted that even the current SBOE has trouble maintaining its independence, as some SBOE members may want to please current legislators. It was also pointed out that, in fact, several current board members have received significant financial support from an influential State Senator.

Comment by Cortex: We believe that the above assertions only provide support to our recommendation to establish an appointed governing board to manage the PSF, in which a majority of the members are appointed by the SBOE.

We believe, as reflected in our report, that the single greatest value the SBOE can bring to the PSF is independence from the Legislature. We believe that the SBOE can best achieve this by appointing a majority (that is, five) of the members of the governing board, and by ensuring that these five individuals are fully independent, free of inherent conflicts of interest, and committed to acting solely in the best interests of the beneficiaries of the PSF, i.e., the schoolchildren and taxpayers of Texas. Identifying the individuals to serve on the governing board will require considerable thought and effort on the part of the SBOE, but we are confident that the SBOE will be successful in carrying out this important task.

Under our recommended structure, should one or two SBOE members be “dependent on pleasing state leadership” they will have great difficulty influencing the activities of the PSF, because they will be one step removed from the fiduciary decision-making process. That is, they will represent only one of fifteen votes involved in appointing five of the nine members of the PSF governing board.

Furthermore, given that we have recommended that the remaining four members of the PSF governing board are to be appointed by four different constituency groups within state government and the school districts, it is unlikely that all four would consistently be sufficiently dependent on pleasing state leadership as to ignore the best interests of the PSF in their decisions. This will further help to ensure the independence of the PSF from undue influence.

While no structure is perfect, we continue to believe that our recommended structure is most likely to result in a governing board that is able to act in the best interests of the PSF beneficiaries.

## **7. Investment Expertise**

*Summary of SBOE Responses:* One SBOE member stated that the review makes the assumption that because SBOE members are elected they may not have the investment expertise necessary to oversee the management of the PSF. The member noted that the same argument would apply to members of the Legislature.

Comment by Cortex: We recognize that neither SBOE members nor members of state government are necessarily versed in investment matters. Accordingly, we have recommended that the SBOE and various areas of state government appoint qualified individuals to the PSF governing board. We stipulated in our report that the governing board would not only benefit from having investment expertise, but also expertise in related fields, such as law, finance, accounting, and government.

## **8. Committee of the Whole**

*Summary of SBOE Responses:* Some SBOE members proposed that all PSF matters be brought before a Committee of the Whole rather than the PSF Committee. One member felt that this would ensure that a few members do not control the decision-making process, that informal advisors would have less sway over the SBOE, and the entire 15-member body would more properly exercise its fiduciary responsibilities as a unit.

Comment by Cortex: We believe that the PSF suffers from fundamental deficiencies relating to the governance structure, organizational structure, and spending policy of the PSF which threaten the long-term success of the PSF. A Committee of the Whole would not in any way alleviate these fundamental deficiencies.

## **Operational Structure**

### **9. Appointment of the Executive Administrator**

*Summary of SBOE Responses:* A few SBOE members criticized our report for recommending that only a new independent governing body be given the authority to appoint the Executive Administrator. One member identified the SBOE's lack of authority over the Executive Administrator as "the key structural governance flaw of the PSF."

Comment by Cortex: We agree that it is important for a governing body to have the authority to appoint management and staff, and we have recommended that the new PSF governing board be given that authority. However, in the absence of a new independent governing board, simply changing the reporting relationship of the Executive Administrator would not correct the more fundamental structural flaw we see in the PSF governance structure – namely, that the Legislature, as the representatives of the taxpayers of Texas (who are directly affected by the management and performance of the PSF), has no voice in the governance of the PSF.

## **Code of Ethics**

### **10. Adoption of Recommendations from other Studies**

*Summary of SBOE Responses:* One SBOE member stated that Cortex was unfair in commenting that the SBOE had not adopted most of the recommendations regarding SBOE ethics policies and procedures made by the House Committee on General Investigating in its November 2000 report<sup>1</sup>, since a vast majority of the recommendations were not given to the SBOE but to the Legislature.

In its report, the House Committee made fourteen recommendations aimed to help restore prudence and public trust in the management of the PSF. The SBOE member is correct that about half of those recommendations were directed to the Legislature. However, the recommendations from the report were later incorporated into Senate Bill 512, which was vetoed by the Governor. In his veto, the Governor pointed out that "the Chair of the SBOE and the Commissioner of Education had the constitutional and statutory authority necessary to enact many of the provisions in the Senate Bill." The Governor indicated that those were the proper means for such changes to be made. The veto went on to direct the Chair of the SBOE and the Commissioner of Education to adopt ethics provisions similar to those set out in the Senate Bill.<sup>2</sup>

Given that the Governor, in his veto, redirected a majority of the recommendations directly to the SBOE and the Commissioner, we do not believe our statement to be unfair. Furthermore, although we did not agree with all of the recommendations, in light of the types of conflicts and problems faced by the SBOE in recent years, on the whole,

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<sup>1</sup> House Committee on General Investigation, Texas House of Representatives, *A Report to the House of Representatives, 77<sup>th</sup> Texas Legislature, Interim Report 2000*.

<sup>2</sup> Proclamation by the Governor of the State of Texas, June 17, 2001.

the majority of the recommendations in the House Committee report appeared to be reasonable.

## **Scope**

### **11. Scope of the Fiduciary Review**

*Summary of SBOE Responses: One SBOE member observed that the review exceeded the guidelines of the Consultant Proposal Request (CPR) by going into a detailed investigation of individual allegations or occurrences.*

Comment by Cortex: The CPR does state in a general Statement of Purpose that the fiduciary review is not intended to be a conclusive investigation of individual allegations and occurrences. It does, however, set out seven very specific Task Areas to be addressed in the review, one of which, Task Area 5, required the consultant to “present a detailed exposition as to what, in the [consultant’s] professional opinion, constitutes generally accepted principles and standards of fiduciary conduct as regards managing investment matters in a public setting.” Task Area 5 required the consultant to “compare and contrast the SBOE’s management process of the below listed investment matters against the principles and standards presented.” It then went on to list nine “investment matters”. (Note: the Plan of Work from the CPR is included as Appendix 10.)

In Appendices 3, 4 and 4(A) through 4(I), we did exactly what Task Area 5 of the CPR required us to do. We reviewed the management process of the SBOE and compared it against the fiduciary principles and standards we identified as appropriate for the management of public funds. In our review, we relied mainly on the minutes of the SBOE and PSF Committee meetings and any supporting reports or documents provided to the PSF Committee or the SBOE. We did not undertake any “investigation” of individual allegations or occurrences, to determine the accuracy or validity of the different views and perceptions of the parties involved.

In conducting our review, we focused on assessing the fiduciary decision-making process of the PSF, and on identifying the underlying structural causes of any problems, rather than individual issues or actions, which in our opinion are only symptoms of underlying structural problems.

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## Section 1 — Background and Methodology

Cortex Applied Research was retained in August 2002 by the State Auditor’s Office under the supervision of the Legislative Audit Committee and at the request of the SBOE to conduct a fiduciary review of the Permanent School Fund and provide a report of findings.

In performing our review of the fiduciary practices of the PSF, Cortex Applied Research employed the following research methods:

### *Interviews*

- Interviews with various state officials and/or their staff
- Interviews with members of the SBOE and the Investment Advisory Committee (IAC)
- Interviews with senior staff within the Texas Education Agency
- Interviews with service providers of the SBOE
- Interview with representatives of the Texas Association of School Boards

### *Documentation Review*

- Review of documentation pertaining to the PSF
- Review of constitutional, statutory, and administrative provisions pertaining to the PSF
- Review of public information pertaining to large public retirement and endowment funds
- Review of reports and investigations concerning the PSF and the SBOE prepared by various state agencies
- Review of model legislation pertaining to large public investment funds

### *Analysis*

- Review and evaluation of minutes of meetings of the SBOE and the PSF Committee
- Analysis of the PSF’s investment performance, distributions, and fund values

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## Section 2 — What is the Permanent School Fund?

The Legislature established the Permanent School Fund (PSF) in 1854 to help fund public education for present and future generations of Texans. The Texas Constitution describes the PSF as permanent and perpetual. It also provides that the SBOE will administer the PSF, and, as such, will be a fiduciary subject to fiduciary standards of conduct. PSF staff, located within the Texas Education Agency (TEA), is responsible for the day-to-day management of the PSF. The staff is headed up by the Executive Administrator, who is chosen by the Commissioner of Education, an appointee of the Governor.

<b>PSF Percentage Contribution to Total Per Capita Public Education Expenditures in Texas</b>	
<b>1994</b>	<b>4.8%</b>
<b>1995</b>	<b>4.5%</b>
<b>1996</b>	<b>4.3%</b>
<b>1997</b>	<b>3.7%</b>
<b>1998</b>	<b>3.6%</b>
<b>1999</b>	<b>3.3%</b>
<b>2000</b>	<b>3.1%</b>
<b>2001</b>	<b>3.3%</b>
<b>2002</b>	<b>3.0%</b>

Source: Texas Education Agency

As of August 31, 2002, the PSF held approximately \$17 billion of stock and bond investments. The Constitution provides that only interest and dividend income earned by the PSF may be spent in any given year. During the fiscal year ended August 31, 2002 PSF contributions, after deducting PSF operating expenses, supported \$736 million of funding for public education.

In addition to managing the PSF, the SBOE oversees the public education system of Texas in accordance with the Texas Education Code.

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## Section 3 — The Interests of the Legislature in the Management of the PSF

**The Legislature, as the sponsor of the PSF and the representative of the State’s citizens and taxpayers, has a legitimate interest in the financial affairs of the PSF and in the manner in which fiduciary decisions involving the PSF are made.**

### **Sponsors and Fiduciaries**

A sponsor is a party that establishes and maintains a public trust fund such as an endowment or pension fund. The sponsor generally establishes the purpose of the fund and designates a party to administer it, who is the fiduciary. The fiduciary is responsible for managing the assets of the fund within parameters set by the sponsor. The fiduciary, unlike the sponsor, must carry out its duties in accordance with strict fiduciary standards established in law, including acting exclusively in the interests of the beneficiaries. In the case of the PSF, the Legislature is the sponsor and the SBOE is the fiduciary.

### **Who Are the Beneficiaries of the PSF?**

Although the stated beneficiaries of the PSF are the present and future schoolchildren of Texas, all taxpayers benefit from having the PSF finance a portion of public education expenditures. Accordingly, the beneficiaries of the PSF include present and future generations of taxpayers as well as schoolchildren.

The pioneers of Texas had hoped that the PSF would be able to provide all of the funding necessary to support public education, thus relieving the State of ever having to provide funding for public education.

Unfortunately, the funding provided by the PSF has always proved insufficient, and the Legislature has always had to play a significant role in financing public education. Analysis of constitutional law supports this finding:

“There was a definite belief long-held in Texas that by reserving the public lands and creating there from a vast trust fund, the income of which could be used to finance public education, the State would be forever relieved from levying any taxes for this purpose. Thus, each constitution made careful stipulations against decimating the principal, and each declared that the income from the perpetual school fund should be earmarked for the available operating fund.”

“Although the pioneers in Texas education visualized a tax free system of schools to be financed by the revenues of the PSF, it was early realized that the revenues from this fund were insufficient for current annual operating expenses; therefore, beginning with the Constitution of 1845 provisions were made for certain state taxes to be levied to augment the income from the PSF.”<sup>3</sup>

The above suggests that the Legislature has always been ultimately responsible for financing public education in Texas, and therefore has a *significant and legitimate interest* in the PSF. In other words, though the management of the PSF, and the related fiduciary risk, rest with the SBOE, the financial risk rests with the Legislature. Furthermore, the above constitutional analysis also suggests that the constitutional provisions protecting the principal of the PSF were intended to protect the interests of the State’s taxpayers, and not only the interests of the schoolchildren, as often appears to be assumed.

The financial risk of the Legislature arises because the Legislature must make up any shortfall between the income earned by the PSF each biennium and the total funds necessary to support public education. The inverse is also true: the State benefits from excess income generated by

<sup>3</sup> *Vernon's Texas Constitution Annotated*, article VIII, §5

the PSF, as less state funding may be required to support public education. This relationship was acknowledged in a recent report by the Texas Comptroller of Public Accounts that noted:

“Earnings from the PSF are distributed to the Available School Fund (ASF) and then to individual school districts. Any increase to the ASF would reduce by almost the same amount the contribution required from the General Revenue Fund for education.”<sup>4</sup>

Because of the size of the PSF, even very small variations in investment earnings can have a significant fiscal impact on the state budget. For example, an increase or decrease in the PSF’s investment earnings of just 0.25% annually affects state finances by \$84,000,000 per biennium.

Because the Legislature bears the financial risk associated with the PSF, it is reasonable for the PSF’s investment policy to reflect the Legislature’s tolerance for risk and return, subject to applicable fiduciary standards of prudence. For example, if state finances can reasonably withstand significant volatility in PSF income levels, then it may be appropriate for the PSF investment policy to reflect relatively higher levels of risk and correspondingly higher expected investment return. Likewise, if state finances cannot tolerate significant volatility in PSF income levels, then a less risky PSF investment policy may be warranted.

The Legislature is also exposed to *accountability risk*. Like the SBOE, the Legislature is an elected body accountable to the citizens of Texas. The Legislature has constitutional authority and responsibility to ensure that an effective board structure is in place to govern the PSF, as indicated by the following provision within the Constitution:

The Legislature shall provide by law for a State Board of Education, whose members shall be appointed or elected in such manner and by such authority and shall serve for such terms as the Legislature shall prescribe not to exceed six years. The said board shall perform such duties as may be prescribed by law.<sup>5</sup>

By virtue of the above authority, performance shortfalls by the PSF are not only a reflection on the SBOE, but also a reflection on the Legislature. The citizens of Texas may hold the Legislature as well as the SBOE accountable for the performance of the PSF.

Given that the Legislature bears financial and accountability risk in connection with the PSF, it stands to reason that the interests of the Legislature should be appropriately reflected in the PSF’s governance structure, guiding parameters, spending policy, and, by extension, asset allocation policy. Our review found that this currently is not the case. Sections 4, 5 and 6 of this report discuss the reasons why.

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<sup>4</sup> “Increase Efficiency of the Permanent School Fund; Increase Distributions from the Available School Fund;” a report by Carole Keeton Strayhorn, Texas Comptroller of Public Accounts, January 2003.

<sup>5</sup> Texas Constitution, Article 7, Section 8.

## **Section 4 —The Inadequacies of the Current Governance Structure**

### **The Governance Structure of the PSF Does Not Adequately Reflect the Legitimate Interests of the Legislature.**

Under the current governance structure of the PSF, the Legislature is in the unusual position of bearing financial and accountability risk in respect of the PSF, but having no role in the governance of the PSF:

- It does not have the authority to appoint members to the PSF’s governing board;
- It does not have ex-officio positions on the governing board; and
- It has no authority to remove any members of the governing board.

Though it is implicitly responsible for making up shortfalls generated by the PSF, the Legislature has no ability to determine who will serve on the PSF’s governing board, the body that makes the decisions that largely determine the performance of the PSF. The Legislature, as the sponsor of the PSF, should clearly have an ability to manage its risk exposure. At a minimum, it should be able to influence the composition of the PSF’s governing board to ensure that it will possess the skills and experience necessary to carry out the purpose of the PSF and protect the Legislature’s legitimate interests.

A recent survey of 50 public investment funds indicates that government entities that sponsor public investment funds invariably have the authority to influence the composition of the funds’ governing boards.<sup>6</sup> All 50 of the funds surveyed indicated that their governing boards contained either individuals appointed by the legislature or by executive branch officials, and/or executive branch officials serving in an ex-officio capacity.

While the Texas Legislature should have a say in the composition of the PSF’s governing board, it should not control the governing board. That is, Legislative appointees should not constitute a majority of the SBOE, as the Legislature would then face an inherent conflict of interest. If it controlled the SBOE, the Legislature could potentially divert the assets of the PSF to uses other than those it was established to serve. Specifically, the Legislature may be tempted to influence distribution levels from the PSF to levels above what would be deemed prudent, in order to meet short-term financial needs. Alternatively, the Legislature may attempt to influence the investment of the PSF’s assets so as to support broader goals or other interests, rather than to support the best interests of the PSF.

Early state leaders recognized the above risk. Accordingly, they provided that the PSF should be managed by the SBOE, a fiduciary body independent of the Legislature and charged with managing the PSF, safeguarding its assets, and ensuring that it achieves its purpose. One of the few authorities that remains with the Legislature is the power to determine whether the SBOE will be comprised of elected or appointed members.

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<sup>6</sup> Survey Results on Structure and Governance, Prepared for the Governor’s Task Force on the Iowa Public Employees Retirement System, Independent Fiduciary Services, Inc., 2001.

Ideally, the composition of the PSF's governing board should balance the need to adequately reflect the interests of the State, with the need to ensure that the governing board will be independent enough to carry out the purpose of the PSF.

A review of the governance structures of large public investment funds in the United States indicates that in fact most of them do reflect an attempt to strike such a balance. The survey referenced above indicates that the composition of most public fund boards reflects some balance between legislative or executive branch appointees, ex-officio members from executive branch levels of government, and individuals appointed or elected by the beneficiaries.<sup>7</sup> It is rare that the board of a public investment fund should have no representation from the sponsor or the executive branch of government. In fact, apart from the PSF, we were unable to find another public fund in which the sponsor was not somehow represented on the governing board.

The compositions of the governing boards of virtually all public retirement systems reflect a mix of individuals representing the interests of the beneficiaries, the Legislature, and other areas of state government.<sup>8</sup> Examples of such public retirement systems include:

- California Public Employees' Retirement System
- California State Teachers' Retirement System
- Maryland State Retirement System
- Missouri State Employees' Retirement System
- New Hampshire Retirement System
- Oklahoma Public Employees' Retirement System
- Public School Employees of Pennsylvania

We were able to identify only two public endowment funds that are comparable in size to the PSF: the Alaska Permanent Fund (APF) and the New Mexico State Investment Council. The composition of their governing boards reflect state interests to an even greater degree than do the governing boards of large public retirement systems:

- The board of the Alaska Permanent Fund is comprised of six members. The Governor appoints four of the members (who are required to have relevant expertise), one is the Commissioner of Revenue, and one is a cabinet member chosen by the Governor.
- The board of the New Mexico State Investment Council is comprised of nine members. Five are ex-officio state officers, and four are public members appointed by the Governor with the advice and consent of the Senate.

The APF is the largest public endowment fund in the United States. As such, its structures and practices may be of interest to anyone involved in public endowment funds. We support some, though not all, of the governance practices and structures in

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<sup>7</sup> Independent Fiduciary Services, Inc., 2001

<sup>8</sup> In conducting our analysis and preparing this report, we have often considered the practices and structures of large public retirement systems, because of the fact that there are relatively few large public endowment funds in existence, and because we believe that the size of a public investment fund is an important criterion when selecting funds for comparative purposes.

place at the APF. For further information and discussion concerning the APF, please refer to Appendix 9.

**The Current Governance Structure Does Not Guarantee that the PSF's Governing Board will be Comprised of Individuals with Relevant Investment and Related Qualifications.**

In the case of many public investment funds, the sponsor has the authority to appoint at least one individual to the governing board. It therefore has the option of appointing an individual with relevant skills and experience. Where governing boards include ex-officio members from the executive branch, the ex-officio officer usually has staff members who can provide expert advice. Because of the fully elected nature of the SBOE, there can be no assurances that the individuals who serve on the SBOE will have relevant qualifications.

In fact, the unique nature of the SBOE makes it less likely that board members will have relevant backgrounds. The SBOE is an elected body with two very different mandates. One is to manage the PSF and the other is to address issues relating to education policy. Of these two mandates, education policy has a far higher profile among the electorate, and is generally what attracts individuals to seek election to the SBOE. Accordingly, the SBOE tends to attract individuals with a strong interest and background in education, rather than investments. The current composition of the SBOE reflects this. Many of the current SBOE members have extensive backgrounds and experience in the field of education. No current member has specific qualifications or background in the management of large public investment funds.

In effect then, the Legislature is unable to ensure that the PSF's governing board will be comprised of individuals who possess relevant investment knowledge and whom it believes can protect the Legislature's legitimate interests. Some large public investment funds (for example, the Teacher Retirement System of Texas, University of Texas Investment Management Company (UTIMCO), and the Alaska Permanent Fund) have statutory provisions requiring at least some of their board members to possess investment or related qualifications.

We must point out that individuals without investment or related qualifications may still make valuable contributions to an investment fund's governing board, including providing valuable perspectives, good judgment, a strong loyalty to the interests of the fund, and plain common sense. Some individuals with backgrounds in education may also become proficient in investments.

The PSF's investment program, however, is enormously complex (and would become even more so should the SBOE eventually invest in non-traditional investments such as private equity and hedge funds). Achieving superior investment performance is a tremendous challenge for even the most skilled investment professionals. In managing the PSF, the SBOE would undoubtedly benefit from having among its members at least some individuals with extensive investment or related qualifications.

Some may argue that the current process for determining the composition of the SBOE is nevertheless effective because, despite being a lay board, the SBOE has access to various sources of expert advice including:

- An Investment Advisory Committee<sup>9</sup>
- Service providers including an investment consultant and a performance measurement consultant
- PSF staff

The above sources of advice are certainly beneficial. We would argue, nevertheless, that the SBOE would be even more effective if at least some of its members also possessed investment or related qualifications. In our experience, most boards have members with investment or related qualifications, as well as access to expert service providers. For such boards, service providers are a complement to the board's qualifications, rather than a substitute for it.

The benefits of having individuals on the PSF's governing board who possess investment or related qualifications include:

- The governing board becomes less reliant on service providers (and informal advisors) and is better positioned to evaluate and challenge the recommendations of service providers.
- The governing board becomes better positioned to invest in more complex asset classes, such as real estate, private equity, and hedge funds, if such asset classes were deemed prudent and supportive of the PSF's purpose.
- The governing board will be better able to identify and manage situations where the interests of the PSF might be at risk by having at least some members who understand how the financial services industry functions. The financial services industry involves countless participants with varying degrees of conflicts of interest. Without a sufficient understanding of the industry, the governing board must rely on its service providers to bring potential conflicts of interest to its attention. However, in some cases, the service providers themselves may have conflicts of interest.
- Appointing the governing board will help ensure greater continuity in board expertise.

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<sup>9</sup> The Investment Advisory Committee is a committee comprised of 15 individuals, each appointed by a member of the SBOE, and required to possess investment knowledge. The Committee's role is to advise individual SBOE members and the SBOE, as a whole, on investment matters.

## Section 5 — Inadequate Parameters Exist to Guide Implementation of the PSF’s Purpose

**The guiding parameters of the PSF have not been clearly defined and, therefore, do not provide sufficient guidance to the SBOE in effectively managing the PSF.**

We were able to find only a few references to the purpose of the PSF in the Texas Constitution and statutes. Article 7, Section 2 of the Constitution, addresses the creation of the PSF:

All funds, lands and other property heretofore set apart and appropriated for the support of public schools; all the alternate sections of land reserved by the State out of grants heretofore made or that may hereafter be made to railroads or other corporations of any nature whatsoever; one half of the public domain of the State; and all sums of money that may come to the State from the sale of any portion of the same, *shall constitute a perpetual public school fund.* [Emphasis added]

And from Article 7, Section 5(a):

“The principal of all bonds and other funds, and the principal arising from the sale of the lands hereinbefore set apart to said school fund, shall be the permanent school fund, and all the interest derivable therefrom and the taxes herein authorized and levied shall be the available school fund. *The available school fund shall be applied annually to the support of the public free schools. Except as provided by this section, no law shall ever be enacted appropriating any part of the permanent or available school fund to any other purpose whatever;* nor shall the same, or any part thereof ever be appropriated to or used for the support of any sectarian school; and the available school fund herein provided shall be distributed to the several counties according to their scholastic population and applied in such manner as may be provided by law.” [Emphasis added]

Chapter 43 of the Texas Education Code, in Section 43.001(a) refers to the PSF as “a perpetual endowment for the public schools of this state.”

Finally, Title 19 of the Texas Administrative Code, in Chapter 33 titled “Statement of Investment Objectives, Policies and Guidelines of the Permanent School Fund” states that:

The purpose of the Texas Permanent School Fund (PSF), as defined by the Texas Constitution, shall be to support and maintain an efficient system of public free schools. The State Board of Education (SBOE) views the PSF as a perpetual institution. Consistent with its perpetual nature, the PSF shall be an endowment fund with a long-term investment horizon. The SBOE shall strive to manage the PSF consistently with respect to the following: generating income for the

benefit of the public free schools of Texas, *the growth of the corpus of the PSF, protecting capital, and balancing the needs of present and future generations of Texas schoolchildren.* [Emphasis added]

The above references taken together indicate the PSF is meant to be an endowment fund that exists in perpetuity and provides support to the public school system of Texas. They do not, however, provide clear parameters to follow in managing the PSF, and do not provide explicit direction on the trade-offs that confront fiduciaries in today's complex capital markets. For example:

- What does it mean to balance “the needs of present and future generations of Texas schoolchildren?” How is this “balance” to be achieved?
- How should the value of the PSF grow? How much growth should the PSF aim for?
- Should the level of distributions from the PSF increase over time? If so, at what rate?
- What is the appropriate measure of inflation?
- Which consideration takes precedence – meeting the current Budget Revenue Estimate (BRE) or maximizing the PSF's long-term investment returns?

### **Intergenerational Equity**

James Tobin of Yale University, winner of the 1981 Nobel Prize in Economics, described the concept of inter-generational equity in the following words:

“The trustees of an endowed institution are the guardians of the future against the claims of the present. Their task is to preserve equity among generations. The trustees of an endowed university like my own assume the institution to be immortal. They want to know, therefore, the rate of consumption from the endowment that can be sustained indefinitely... Consuming endowment income so defined means in principle that the existing endowment can continue to support the same set of activities that it is now supporting.”

-- James Tobin, “What is Permanent Endowment Income?”  
American Economic Review 64, no. 2 (1974): 427-432

A fundamental and well-recognized parameter in endowment fund management is *inter-generational equity*. It states that an endowment fund should provide the same level of support to future generations of beneficiaries as it does to the current generation.

In the case of the PSF, providing “the same level of support” could be interpreted to mean that distributions from the PSF should increase over time to keep pace not only with inflation in the cost of public education in Texas, but also in the growth in the number of students. If distributions fail to do so, the level of distributions per student, adjusted for inflation, will decline (even if total distributions grow in nominal terms). The amount spent will provide less and less support per student, and the role of the PSF and its contribution towards public education in Texas will dwindle over time, requiring taxpayers to fund the shortfall.

At the same time, however, the level of distributions must not be so high as to erode the value of the PSF. In other words, the fiduciaries of the PSF must ensure that the assets also increase at least as fast as inflation and growth in the student population. Otherwise, the PSF will not be able to provide the same level of support to students in the future as it did to students in the past. In other words, maintaining the value of the PSF does not mean simply keeping the nominal value of the assets unchanged. This would only be the case in a world of zero inflation and no growth in the student population. In the real world, in which the Legislature must fund a system of public education that grows continually more expensive and serves an increasing number of students, maintaining the value of the PSF requires that the assets grow over time at least

as fast as inflation *plus* any growth in the student population (and probably a little bit faster to provide a margin of safety).

The laws of the State of Texas should clearly stipulate that the PSF is to achieve fairness among generations of schoolchildren by providing, in the long run, stable distributions per student on an inflation-adjusted basis. To be sustainable, the assets of the PSF must grow over time in line with appropriate measures of inflation and growth in the student population. These parameters should be understood and agreed upon by all parties involved in the management of the PSF.

**The performance of the PSF has not kept pace with inflation and growth in student population.**

Student Population Growth	
Percentage Increase	Average Daily Attendance (Millions)
1990	1990 3.1
1991 0.1%	1991 3.1
1992 3.2%	1992 3.2
1993 2.0%	1993 3.2
1994 2.1%	1994 3.3
1995 1.7%	1995 3.4
1996 2.3%	1996 3.4
1997 2.3%	1997 3.5
1998 1.9%	1998 3.6
1999 1.7%	1999 3.6
2000 1.6%	2000 3.7
2001 2.8%	2001 3.8
2002 1.4%	2002 3.9

Source: PSF staff

The principle of inter-generational equity requires that an endowment fund should provide the same level of support to current and future beneficiaries of the fund. If we apply this principle to the PSF, it suggests that the two fundamental goals of the PSF should be to ensure that:

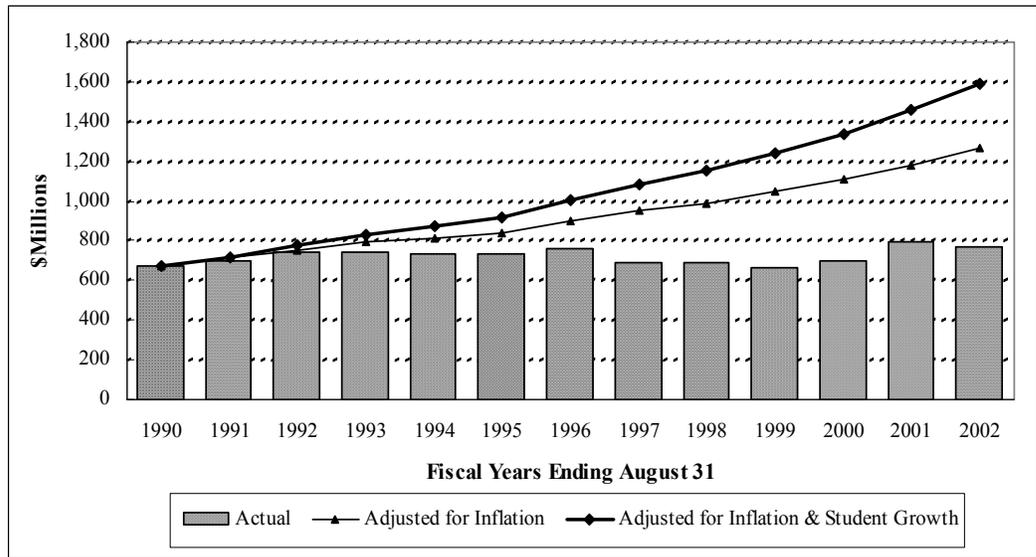
- The distributions from the PSF increase in the long run in keeping with inflation and growth in the student population; and
- The value of the PSF also grows in the long run in accordance with inflation and growth in the student population.

We have examined the performance of the PSF with respect to the growth in the level of distributions and the value of assets over a 13-year period beginning in 1990.<sup>10</sup> Exhibit I, on the next page, compares the total level of distributions in each fiscal year to what it would have been had it kept up with inflation and growth in the student population over the period<sup>11</sup>.

<sup>10</sup> Cortex was asked to review performance of the PSF over a ten-year period. However, because performance reports for the PSF cover a thirteen-year period, we extended our analysis accordingly.

<sup>11</sup> We measured inflation by the Consumer Price Index for Education Books and Supplies (U.S. city average), compiled by the Bureau of Labor Statistics of the U.S. Department of Labor. This was the index that was available for the entire period and was the closest proxy for measuring increases in the cost of public school education in Texas. Student population was measured by the average daily attendance during the year.

**Exhibit I – Total Distributions Have Not Kept Pace with Inflation and Growth in Student Population**

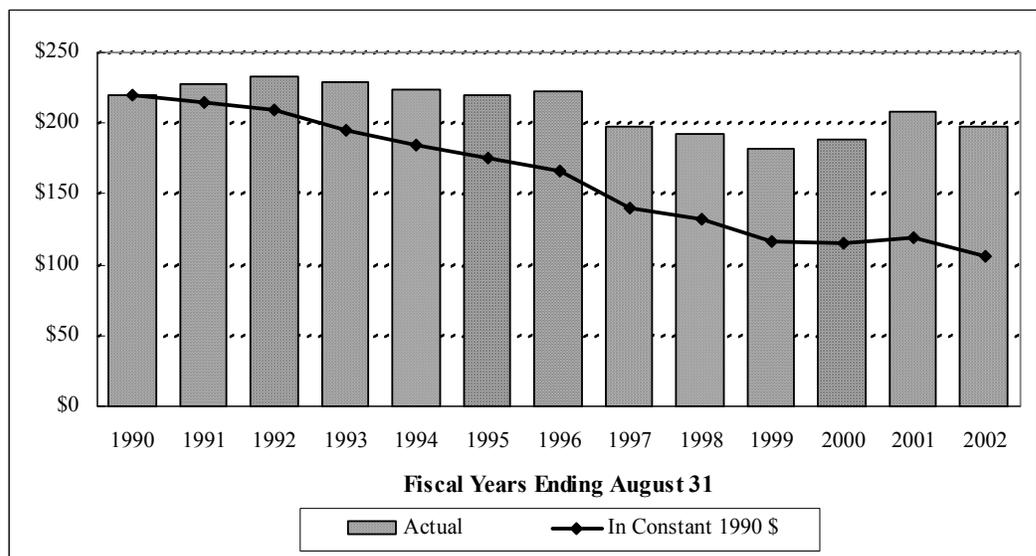


Source: PSF 2001 Annual Report, PSF Staff, and Bureau of Labor Statistics

The chart shows that distributions over the period have failed to keep pace with inflation and growth in the student population. If the level of distributions in fiscal 1990 had increased in line with inflation and student growth, then distributions in 2002 would have been more than double the amount actually distributed in that year.

Exhibit II compares the actual level of distributions per student to distributions per student measured in constant 1990 dollars. It shows that distributions per student have declined over the period in nominal terms and in real terms (that is, adjusted for inflation). In fact, the amount distributed per student in fiscal 2002 was effectively less than half the amount distributed in 1990 after adjusting for inflation.

**Exhibit II – Distributions Per Student Have Fallen**



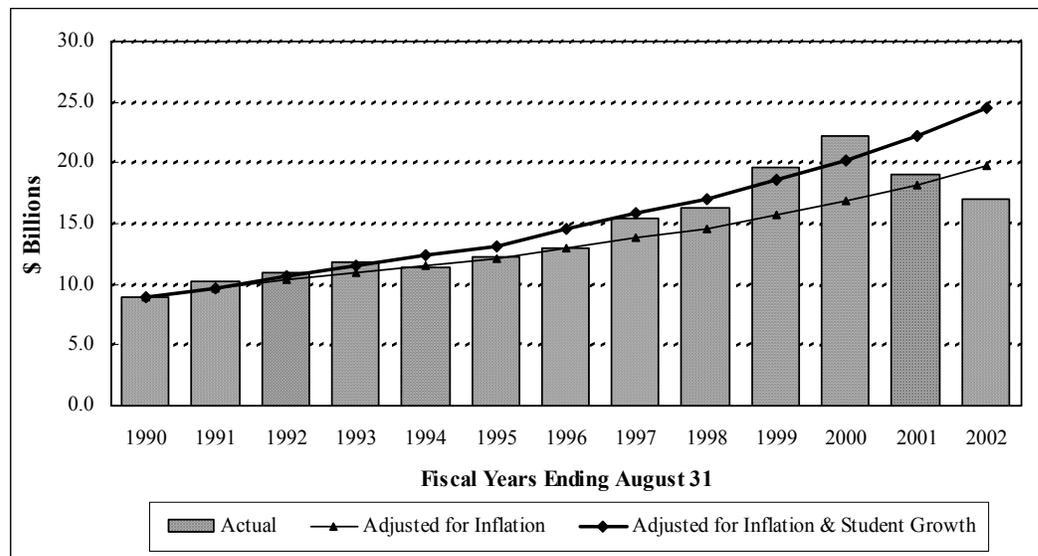
Source: PSF 2001 Annual Report, PSF Staff, and Bureau of Labor Statistics

Exhibit III compares the actual value of the assets in the PSF at the end of each fiscal year with what the value of the PSF would have been if it had kept pace with inflation and student growth. It shows that the value of the PSF’s assets have generally increased in line with inflation and student growth between 1990 and 2002, except for the last two years. In fact, as a result of the strong bull market in stocks during the late 1990s, the value of the PSF at the end of both fiscal 1999 and 2000 was substantially ahead of inflation and student growth. Since then, in part due to the stock market’s decline, the value of the PSF has fallen significantly.

The performance of the PSF during this period, in other words, did not fully meet the generally accepted objectives of an endowment fund. While the value of assets kept pace with inflation and growth in the student population, the level of distributions – which ultimately defines the extent of support provided by the PSF to public education – did not. We attribute this primarily to the PSF’s spending policy – which limits the PSF to distributing only out of interest and dividend income and, furthermore, requires that all of the income earned be distributed. There were, however, other factors that also affected the performance of the PSF.

**The Decline in Interest Rates** – Interest rates have fallen significantly over the past 12 years. The yield on 10-year Treasury bonds, for example, declined from 8.86% in 1990 to 3.78% in 2002. Since interest payments make up a significant part of the PSF’s total investment income, the decline in interest rates was a major factor responsible for the inability of the PSF to increase investment income, and therefore the level of distributions, during the period.

**Exhibit III – The Value of the PSF Has Kept Pace with Inflation and Growth in Student Population Until Recently**



Source: PSF 2001 Annual Report, PSF Staff, and Bureau of Labor Statistics

**The Change in Asset Allocation** – The PSF’s asset allocation policy in 1990 was 65% bonds and 35% stocks; that is, the majority of the assets was invested in higher-income securities, namely bonds, rather than stocks. In October 1994, the SBOE approved a significant change in policy, which increased the allocation to stocks to 63% and reduced the bond allocation to 37%. Although the policy was not fully implemented until 1998 – for example, the PSF was only 50% invested in stocks in 1996, more than

two years after the decision was made to change the asset allocation policy – the gradual change in allocation from bonds to stocks was responsible for further restricting the growth in the investment income of the PSF.

The 1994 decision to change the asset allocation of the PSF to include a higher allocation to stocks (63% of the PSF) did enable the value of the PSF to keep pace with inflation and student growth through the 1990s, although much of that increase has been lost over the last two years ending 2002.

**The Contributions from the General Land Office (GLO)** – Exhibit IV shows that GLO contributions have remained relatively stable in absolute dollars over the last 12 years, but have fallen as a percentage of the assets of the PSF. The Legislature amended the Natural Resources Code effective September 1, 2001 to allow the GLO to deposit some or all of the proceeds of future mineral leases and royalties into a special account to be used by the School Land Board within two years to acquire fee or lessor interests in real property, mineral and royalty interests. The amendment stipulated that any money remaining in the account longer than two years must be transferred to the SBOE for investment in the PSF. Reinvesting funds in real estate or minerals may reduce the GLO’s future contributions to the PSF.

**The Strong Bull Market in Stocks** – The growth in the value of assets was helped considerably by the unprecedented boom in stock markets over the five-year period from 1995 through 1999 during which stock prices more than tripled. Without that very strong bull market, the value of the assets of the PSF would have fallen well behind the amount required to meet inflation in the cost of public education and growth in the student population.

**Exhibit IV – PSF Distributions and GLO Contributions Have Fallen As a Percentage of Assets**

Fiscal Year	Value of Assets (\$ mm)	PSF Distributions		GLO Contributions	
		\$mm	%	\$mm	%
1990	8,931	675	7.6	179	2.0
1991	10,228	700	6.8	176	1.7
1992	10,945	739	6.7	145	1.3
1993	11,822	739	6.3	148	1.3
1994	11,331	738	6.5	151	1.3
1995	12,273	737	6.0	123	1.0
1996	12,996	763	5.9	153	1.2
1997	15,497	693	4.5	199	1.3
1998	16,296	690	4.2	211	1.3
1999	19,616	662	3.4	163	0.8
2000	22,276	698	3.1	178	0.8
2001	19,022	794	4.2	292	1.5
2002	17,047	765	4.5	5	0.0

Source: PSF Annual Reports and PSF staff

**The Spending Policy** – It is the spending policy of the PSF – which requires that all interest and dividend income earned be spent – that is the primary factor ultimately responsible for the fact that the PSF has been unable to grow the level of distributions over the last 13 years in nominal terms (let alone cover inflation and student growth), in spite of the strongest bull market in history. We can speculate as to why the PSF was so

heavily invested in bonds in the early 1990s, whether it reflected a very low tolerance for investment risk on the part of the SBOE at that time, or whether it was due to the need to generate income from the PSF. The fact remains that, given the relatively high interest rates prevailing at that time, the PSF did produce considerable investment income.

It was the spending policy, however, which dictated that the income, all of the income, had to be spent. The PSF was distributing on average about 7% of the value of the PSF; this was probably unsustainable in the face of the relatively high rate of inflation in the cost of public education in those years and growth in the student population, and given realistic expectations of investment income. The bull market in stocks helped the PSF to some extent, but currently the future of the stock market does not look bright.

Today the PSF is distributing 4% to 4.5% of the value of the PSF, which may still be high given uncertain prospects of GLO contributions in the future, and the likelihood of relatively low investment returns – unless the PSF, like other endowment funds, is prepared to invest more aggressively in potentially high-return (and riskier) alternative investments such as private equity and hedge funds. As long as the spending policy forces the PSF to spend all the income that it earns, the SBOE will find it an even greater challenge to fulfill the purpose of the PSF in the years to come. The next section addresses issues relating to the spending policy in greater detail.

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## Section 6 — The PSF Spending Policy

### The Current PSF Spending Policy is Sub-optimal and Does Not Reflect Modern Economic Realities.

The current spending policy is an income-based policy set out in the Constitution. In effect, the policy states that all income earned by the PSF will be spent in support of public education, where income is defined as primarily interest and dividends. Authority to change the spending policy resides with the Legislature and ultimately with the citizens of Texas; that is, only the Legislature, with ratification by the voters, can amend the Constitution and therefore the spending policy.

#### Stocks vs. Bonds

Stocks represent ownership in a corporation and a right to a share of any profits (or losses) the corporation may generate. The return on stocks is highly uncertain from year to year.

Bonds represent a loan to a corporation or government in return for agreed upon interest payments.

Stocks are inherently riskier than bonds and are expected to provide a higher long-term investment return to compensate for the higher risk as demonstrated by historical market returns:

#### Annual Investment Returns over 76 Years ended 12/31/01\*

Small Company Stocks	12.5%
Large Company Stocks	10.7%
Government Bonds	5.3%
Treasury Bills	3.8%
Inflation	3.1%

\*Source: Ibbotson Associates, Inc.

While an income-based spending policy may have been reasonable in pioneer days, such policies do not adequately meet the needs of the State in today's economic world. An income-based spending policy has six significant drawbacks.

#### 1. An Income-Based Spending Policy Limits the Range of Asset Allocation Policies That May Be Implemented

Under the current spending policy, all income from the PSF must be spent. This means that the only sources of growth in the assets available to protect the PSF from the effects of inflation and growth in the student population are contributions from the GLO and capital gains on the investments of the PSF (which are normally only achieved through investment in stocks or similar assets<sup>12</sup>). Given a level of contributions by the GLO, the PSF must be invested in just the right amount of stocks to generate sufficient capital gains to cover both inflation and the rate of student growth — *no more and no less*. (In reality, one might wish to invest a little more in stocks to provide a margin of safety.) More investment in stocks will produce too little income for current generations and potentially too much income for future generations. Less investment in stocks, on the other hand, will produce too much income for the current generation and insufficient income for future generations. (See Appendix 1 for a mathematical perspective on spending policy). In effect, the current spending policy implies that the SBOE has limited control over the asset allocation policy, as there is only one broad mix of stocks and bonds that can reasonably be expected to achieve inter-generational equity.

<sup>12</sup> Examples of asset categories that are considered similar to stocks include real estate, private equity, and hedge funds.

The implications of this are twofold:

1. The SBOE is unable to change the asset allocation to meet the State's income needs, even if these needs are reasonable. If it did so, it would benefit one generation of beneficiaries more than other generations.
2. If the SBOE believes that the asset allocation required by the spending policy is too risky and therefore imprudent, it again cannot change the asset allocation without benefiting one generation of beneficiaries relative to other generations.

The above represents the most significant drawback to an income-based spending policy.

## **2. Under an Income-based Spending Policy, Attempts to Change Spending Levels Will Lead to Unreasonable Outcomes**

Under the current spending policy, the main way to increase the level of distributions from the PSF is to increase the PSF's exposure to bonds, thereby reducing its exposure to stocks. Reducing stock exposure, in turn, lowers the expected future return on the PSF. In effect, to increase distributions, the SBOE must position the PSF to ultimately earn *less return*. This is an unreasonable outcome – if more spending is desired, then the PSF should be positioned to earn more, not less.

Similarly, the main way to decrease the level of distributions from the PSF is to decrease the PSF's exposure to bonds, thereby increasing its exposure to stocks. In effect, to decrease income and distributions, the SBOE must position the PSF to ultimately earn *more* return. Once again, this is an unreasonable outcome. The PSF is exposed to *more risk* because of the higher investments in stocks, but generates *less distributable income*. If one is to accept more risk, one should expect more income, not less.

In other words, under the current spending policy, one can only distribute more if one positions the PSF to earn less in the future. Moreover, if one positions the PSF to earn more, one is forced to distribute less today.

## **3. Under an Income-based Spending Policy, PSF Income is Largely Driven by Factors Outside the Control of the SBOE**

The income generated by the PSF is directly affected by changes in interest rates and dividend yields, both of which are beyond the control of the SBOE. In periods when interest rates are declining, such as over the past decade, the income from the PSF will fall. The only way to potentially maintain income levels in such a situation is to sell stocks and buy more bonds, and/or to invest in higher yielding (thus riskier) bonds. Increasing the PSF's investment in bonds and decreasing its investment in stocks, however, will likely reduce the future growth in the assets of the PSF. Likewise, investing in higher yielding and riskier bonds may not be prudent from a fiduciary perspective.

#### **4. An Income-based Spending Policy, Combined with a Biennial Revenue Estimate (BRE), Interferes with the Prudent Management of the PSF**

Investment funds should monitor the mix of stocks and bonds in their portfolios on a regular basis and follow a policy of systematic rebalancing. Rebalancing a portfolio is necessary because as the stock and bond markets change in value relative to one another, the overall mix of stocks and bonds in the portfolio will also change. If the overall mix is allowed to drift too far from the long-term asset allocation policy, it may significantly change a fund's risk-return profile. Rebalancing the asset allocation from time to time restores the desired risk-return profile and is an important part of prudent risk management. Accordingly, the SBOE has a policy in place that requires rebalancing the portfolio when the allocation of stocks and bonds moves outside specified ranges.

In the case of the PSF, an income-based spending policy, combined with the need to achieve a BRE established by the Comptroller and incorporated into the State's budget, significantly interferes with the rebalancing process:

- If the value of stocks in the PSF were to fall relative to bonds, the rebalancing policy would require the SBOE to rebalance the portfolio by buying stocks and selling bonds. This would decrease the income generated by the PSF and potentially cause it to fail to achieve the BRE. In such case, the SBOE might understandably be reluctant to implement the rebalancing policy, thus exposing the PSF to unnecessary investment risk.
- If, on the other hand, the value of stocks in the PSF were to rise relative to bonds, the rebalancing policy would require the SBOE to rebalance the portfolio by selling stocks and buying bonds. This would increase the income generated by the PSF. The SBOE might then expect that the future BRE established by the Comptroller's Office would rise to reflect this additional investment in bonds. This, in turn, would make it very difficult for the SBOE to rebalance the portfolio in the future, if the value of stocks were to subsequently fall relative to bonds, because this would require the SBOE to sell bonds and buy stock, making it difficult to achieve that future BRE. In this scenario, the SBOE might again be reluctant to implement the rebalancing policy.

Our review of the minutes of SBOE meetings revealed that the SBOE has in fact had to face such situations. For example, in August 1999, after considerable discussion of a staff recommendation to rebalance the portfolio, the PSF Committee voted unanimously to recommend to the SBOE that staff be directed not to rebalance until after the November 1999 SBOE meeting, precisely for the reasons described above. That is, the SBOE was concerned about increasing the level of income and not being able to meet a future BRE. The SBOE did ultimately rebalance the portfolio, but the incident is indicative of the competing (and unnecessary) pressures that arise in the rebalancing process because of the income-based spending policy combined with the BRE target. Future boards, when faced with similar pressures, might just as easily decide to give in to the pressure to meet the BRE and ignore the rebalancing policy, thereby exposing the PSF to unnecessary risk.

## **5. An Income-Based Spending Policy, Combined with the Objective of Achieving a BRE Target, Creates an Incentive to Invest in High Income, Low Growth Investments.**

When faced with situations where the PSF is under pressure to meet a BRE or provide the State with more income, the current spending policy creates an incentive to invest in high income investments such as high-yield bonds (sometimes referred to as junk bonds) or stocks with high dividend yields, but low long-term growth prospects. Alternatively, it creates an incentive to invest a greater proportion of the PSF in bonds rather than stocks. Over-weighting high income, low growth investments may be viewed to be an attractive solution to meeting short-term income needs, regardless of whether such a strategy is prudent or within parameters established for the PSF.

## **6. An Income-Based Spending Policy Will Not Necessarily Protect the Value of the PSF**

There appears to be a belief shared by at least some people familiar with the PSF that an income-based spending policy would necessarily protect the value of the PSF. This is only true if the goal is to protect the PSF's *nominal* value only. It is not true if the goal is to protect the *real* value of the PSF; that is, the value of the PSF after adjusting for inflation and growth in the student population. Industry practice and common sense suggest that the goal of an endowment fund must be to protect the real value of the PSF, for failure to do so will mean that inflation over time will reduce the purchasing power of the PSF until it eventually becomes an insignificant source of funding for public education.

We indicated earlier in the report that, under the current spending policy, in order to protect the PSF from the effects of inflation and growth in the student population, the PSF must have enough stocks to generate sufficient capital gains to cover inflation and growth in the student population (remember that all income must be spent and so cannot be used to protect the PSF). It is quite conceivable that the PSF may be invested in too many bonds and not enough stock, thereby generating too much income for current distribution and not enough capital gains to protect the real value of the PSF. This may have been the case in the early 1990s when distributions from the PSF were more than 7% of the value of the PSF in a number of years. Such high distribution levels were likely detrimental to the PSF, favoring the then current generation of beneficiaries at the expense of future generations. During those years, the PSF's income-based spending policy arguably failed to protect the real value of the PSF; it could easily fail again in the future.

## **Most Endowment Funds Use an Asset-based Spending Policy**

An asset-based spending policy is one that requires that a pre-determined percentage of the total value of an endowment fund be spent each year.<sup>13</sup> Such policies do not have

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<sup>13</sup> To minimize the impact on the sponsor's operating budget, most endowment funds that use an asset-based spending policy try to ensure that the level of spending does not fluctuate too much from year to year due to the volatility of capital markets. This smoothing of spending levels is usually achieved by applying the percentage spending rate to the average value of the assets measured over the preceding three to five years.

any of the drawbacks that we identified above pertaining to income-based spending policies.

In determining the percentage to be spent each year, one conducts an asset allocation study in which one projects the expected growth in the fund over the long run, and subtracts an amount necessary to cover projected rates of inflation and per capita student growth.

For example, let us assume that a hypothetical endowment fund of an educational institution holds the following assumptions:

- Inflation rate of 3.5%<sup>14</sup>;
- Contribution rate of 1%;
- Rate of growth in the student population of 2%;
- Total investment rate of return of 8%;

To ensure intergenerational equity, the following relationship must be maintained (see Appendix 1 for details):

$$\text{Spending} = \text{Investment return} + \text{contributions} - \text{inflation} - \text{population growth}$$

Based on the above relationship, a reasonable spending rate would be 3.5% of the value of the fund – that is, one can spend the projected return on the fund (8%) plus contributions (1%) less inflation (3.5%) and student growth (2%).

A 3.5% spending rate would ensure that both the value of our hypothetical fund and the income paid out from it grow in line with inflation and growth in the student population. That is, the fund would be able to provide the same level of benefits to future generations as it would to the current generation.

Unlike the income-based spending policy, an asset-based spending policy allows one to increase or decrease spending without unreasonable or counterintuitive outcomes, and without favoring one generation of beneficiaries over another.

If our hypothetical fund wishes to increase spending by 0.5%, it simply needs to increase the spending rate from 3.5% to 4%. To support this increased level of spending, it must also increase the expected return of the fund by 0.5% by increasing exposure to higher return (and riskier) investments such as stocks. Assuming it actually earns that higher rate of return, the value of the fund will continue to be protected and both current and future generations will continue to benefit equally from the fund. Remember that under an income-based spending policy, in order to increase distributions, a fund would have to be positioned to earn less rather than more income, thus penalizing future generations of beneficiaries.

Similarly, if our hypothetical fund wishes to reduce the level of distributions, for some reason, say from 3.5% to 3%, it would simply reduce the spending rate. The asset allocation of the fund, however, would also need to be changed in order to lower its expected return so as not to favor future generations of beneficiaries.

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<sup>14</sup> In the case of the PSF, the appropriate measure of inflation should be established as part of the process of clarifying the parameters guiding the management of the PSF.

Of course, like income-based spending policies, asset-based spending policies can result in excessive distributions, which will erode the fund. Specifically, one must be careful not to set the spending rate at too high a level; that is, higher than what the fund can reasonably be expected to earn, after covering inflation and growth in the student population. Ensuring that spending and investment policies are consistent with one another is the essence of endowment fund management and represents the fundamental task of the fiduciaries. As an added safeguard, corridors may be established to ensure that spending rates are set within reasonable bounds. For example, the assumptions listed above for our hypothetical fund are not unrealistic in that they generally reflect recent capital market history and demographic experience. Accordingly, realistic ranges for spending targets might be 3% to 4.5% of asset value, averaged in some manner to smooth the level of volatility in spending.

Over the past 15 years, there has occurred a dramatic shift in the endowment fund industry concerning the types of spending policies in use. Prior to the 1980s, most endowment funds used an income-based spending policy. Since that time, however, the vast majority of endowment funds has switched to some form of asset-based spending policy. We believe that this shift is a reflection of the recognition throughout the industry of the compelling merits of an asset-based spending policy, as we have described in this section of the report.

### **Spending Policy Alone Does Not Determine Distribution Levels and Fund Values**

There appears to be a perception that the choice of spending policy alone determines the level of spending and the value of the PSF. In fact, addressing the spending policy is only a first step towards improving the PSF. The spending policy alone cannot produce higher spending levels or higher fund values. *In the long run, spending levels are ultimately driven by investment return*; that is, one can only spend more if one earns more. The value of the PSF is determined by how much is earned and by how much of that is spent. In effect, income levels and fund values are driven by *both* investment and spending policies.

When debating the relative merits of different types of spending policies, the appropriate question to ask is not which will lead to higher spending levels and fund values, but rather, which type of spending policy allows for more effective management of the PSF and the achievement of intergenerational equity? Our analysis demonstrates that an asset-based spending policy provides far greater control in this regard, and does not give rise to distortions in the decision-making process.

## Section 7 — Organizational Structure

### **In Mitigating its Risk Exposure, the Legislature has Established an Organizational Structure that does not Support Effective Fiduciary Decision-making**

Lacking the ability to directly influence the composition of the SBOE, the Legislature has influenced the PSF's decision-making process indirectly by retaining budget approval authority and reassigning to the Governor the authority to appoint the Commissioner of Education. The Commissioner of Education in turn appoints the Executive Administrator of the PSF.

This has resulted in an organizational structure that differs significantly from the norm. The current organizational structure is inconsistent with those of a significant majority of institutions in the economy, including corporations, not-for-profit organizations, and government agencies. The current structure also differs from those generally found in other large public investment funds. A recent survey of 50 public investment funds indicates that 78% of the governing boards surveyed are responsible for hiring and supervising the Executive Director. *It is important to note, however, that these same boards invariably have sponsor representation, either through sponsor appointees or ex-officio positions.*<sup>15</sup>

More importantly, the PSF's current organizational structure does not support effective fiduciary decision-making. The current organizational structure:

- Places the SBOE in a difficult position in which it bears full fiduciary responsibility for the PSF, but does not have the authority that is generally considered essential to carry out its duties. During interviews, SBOE members were in strong agreement that the SBOE's lack of authority, particularly its inability to appoint the Executive Administrator of the PSF, was the single biggest obstacle to being able to rely on staff in carrying out the SBOE's fiduciary duties.
- Has created a sense of mistrust in staff on the part of SBOE members, as they perceive the PSF staff to be accountable to other areas of state government rather than to the SBOE.
- Has in the past resulted in a perceived need by SBOE members to seek out informal advisors that are perceived to be loyal and responsive to the SBOE. This may have been one of the factors that caused SBOE members to rely on informal advisors, who in fact appeared to have had interests that were contrary to the interests of the PSF.
- May make it extremely difficult to recruit qualified candidates for the position of Executive Administrator, because prospective candidates will likely view the current organizational structure with disfavor. Candidates will recognize the potential for the Executive Administrator to be caught between conflicting expectations of the SBOE and the Commissioner of Education. As a result, we believe that many

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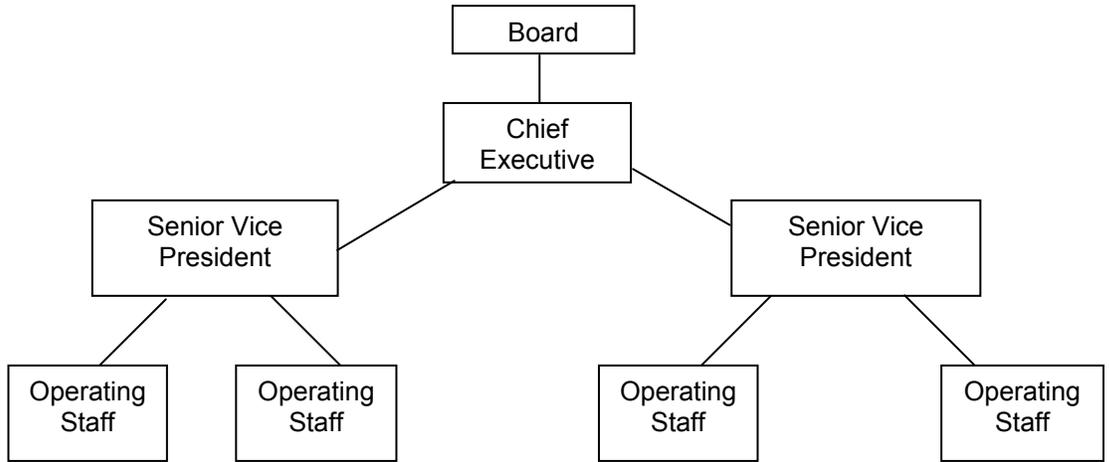
<sup>15</sup> Independent Fiduciary Services Inc., 2001.

qualified candidates will not view the position of Executive Administrator as representing a satisfying, long-term career opportunity.

Despite the difficulties associated with the current organizational structure, it is unreasonable to expect the Legislature to relinquish its authority unless it can be assured, through other means, that the interests it represents will be protected.

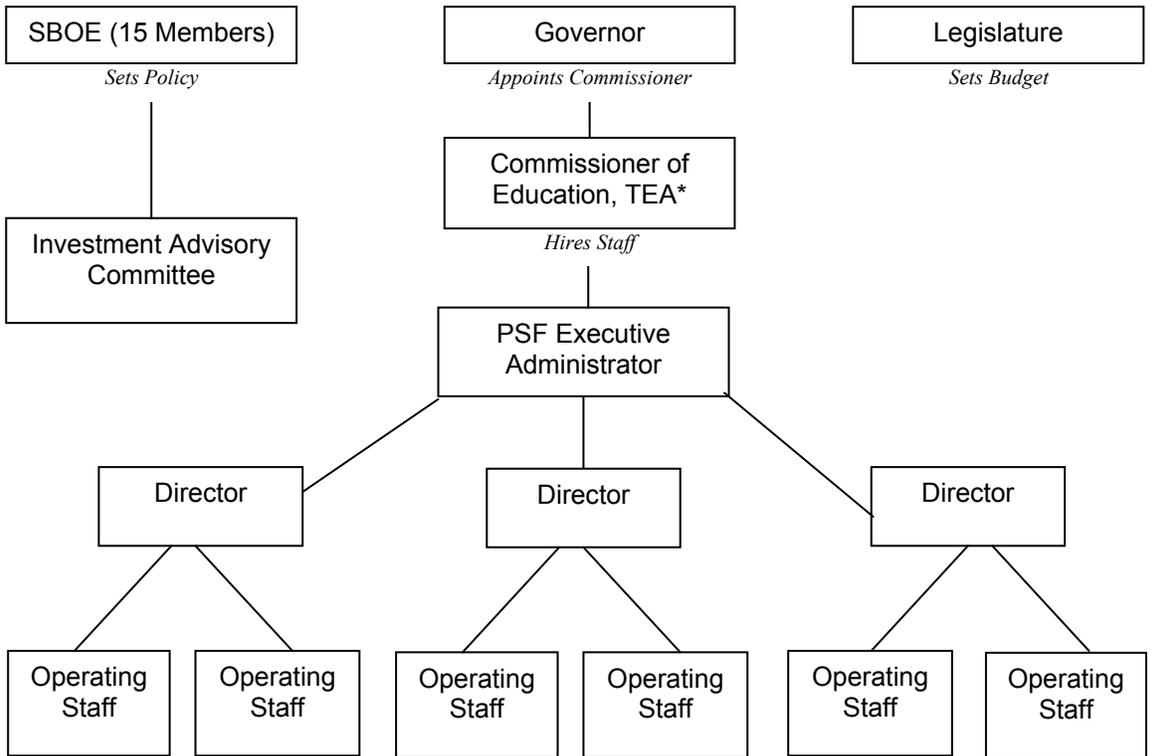
Those who believe the SBOE should be granted full authority to carry out its fiduciary responsibilities might point to the Uniform Management of Public Employee Retirement System Act (UMPERSA) as support for their position. UMPERSA is a model act that was prepared with public retirement systems in mind. Nevertheless, it is widely considered to be instructive for various types of public investment funds. We find, however, that UMPERSA does not address the issue of board composition and the extent to which it should reflect the interests of the sponsor. Accordingly, we would argue that UMPERSA is not applicable to the unique circumstances of the PSF. For further discussion on UMPERSA, see Appendix 2.

## TRADITIONAL ORGANIZATIONAL STRUCTURE



<b>Examples</b>	
Washington State Investment Board	General Electric Company
California State Teachers' Retirement System	Sarah Lee Corporation
Maryland State Retirement & Pension System	International Monetary Fund
Alaska Permanent Fund	

## PSF ORGANIZATION STRUCTURE



\* Texas Education Agency

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## Section 8 - Fiduciary Decision-making Process

**The decision-making process at the PSF has been inconsistent with generally accepted standards of prudence.**

In making decisions, the SBOE in theory uses a process that can be described as follows:

- a) The PSF Committee is charged with making a recommendation to the SBOE on a specific matter.
- b) PSF staff prepares an analysis and often makes a recommendation to the PSF Committee. Various alternatives are considered.
- c) Advice is sought from service providers.
- d) Short lists are developed, when applicable;
- e) Due diligence is performed, when applicable;
- f) The PSF Committee makes a recommendation to the SBOE; and;
- g) The SBOE ultimately decides on the matter.

### The PSF Committee

The PSF Committee refers to the School Finance/Permanent School Fund Committee of the SBOE, which is comprised of five members of the SBOE, appointed by the SBOE Chairperson. The Committee assists the SBOE in overseeing both the finances of the SBOE and the management of the PSF. For purposes of this report, we have focused strictly on the Committee's role as it pertains to the PSF.

For the most part, the above represents, at least on the surface, a reasonable process. We did, however, identify major concerns. We performed our analysis based on generally accepted principles and standards of fiduciary conduct in managing the investments of a public fund (Please see Appendix 3 for details). Below is a summary of our analysis; detailed findings may be found in Appendices 4(a) through 4(i).

### SBOE Decisions Lack Sufficient Analysis and Consideration

On numerous occasions, the SBOE has disagreed with a recommendation of the PSF Committee, despite the fact that the recommendation had been subjected to significant analysis and discussion by the Committee, PSF staff, and service providers. There is nothing inherently wrong in disagreeing with the Committee. The problem arises when the SBOE approves a very different course of action without first subjecting its decision to the same level of analysis and consideration that was brought to bear on the Committee's recommendation. While recommendations to the SBOE are usually the product of a rigorous decision-making process, the ultimate decisions of the SBOE often appear to be made haphazardly.

Below are examples of instances in which the SBOE rejected or ignored recommendations of the PSF Committee. In each instance, the SBOE then proceeded, in the same meeting, to adopt an alternative decision without further analysis, investigation, due diligence or other assessment by staff or service providers. Though the SBOE's process may be consistent with Robert's Rules of Order, we believe it is inappropriate for a public investment board that must make highly technical decisions and that is subject to strict fiduciary standards.

If the SBOE disagrees with a recommendation of the PSF Committee, it would be far more prudent to share its concerns with the Committee and direct it to carefully review its recommendation, perform any additional research and analysis that may be necessary, and return to the SBOE with a second recommendation. This represents a far more

rigorous approach to decision-making and, in our experience, more closely reflects the practices of large public investment funds.

*November 2000 – Allocation of Funds to Managers of International Stocks*

The PSF Committee, after analysis and discussions with its investment consultant, recommended to the SBOE that the allocation to international stocks be divided equally among three managers. The recommendation was based on a unanimous vote of the Committee. At the SBOE meeting the next day, the Committee chairperson made a motion reflecting the Committee's decision of the previous day. The motion was not seconded and died. A second motion was then made to award 50% of the international stock allocation to one manager and 25% to each of the other two managers. This motion was seconded and carried unanimously.

*October 2000- Appointment of Emerging Managers*

The Committee met in October 2000 to review five responses to a Request For Proposal (RFP) for a 'manager of managers' to oversee the emerging manager portfolio. The Committee decided to interview all five respondents and later recommended FIS Funds Management. At the SBOE meeting the next day the Committee Chairman made a motion on the Committee's recommendation. At the same time two other Committee members (who had supported the Committee's recommendation the prior day) made an alternate motion was to appoint FIS as well as Northern Trust as managers of emerging managers, with the allocation split two-thirds to FIS and one-third to Northern Trust. The SBOE unanimously passed the alternate motion.

*March 2000 – Selection of Investment Consultant*

The PSF Committee, after a formal search and due diligence process involving staff, recommended to the SBOE the appointment of Richards and Tierney as the PSF's investment consultant. The SBOE rejected the recommendation and, instead, at the same meeting, appointed Callan Associates.

*September 1999 – Rebalancing*

Based on the recommendations of both staff and the investment consultant, the PSF Committee recommended to the SBOE that the PSF be rebalanced to properly reflect the asset allocation policy of the SBOE. At the SBOE meeting the next day, the SBOE, after some debate, rejected the Committee's recommendation and voted unanimously to direct staff not to rebalance until after the November 1999 meeting.

*September 1999 – Selection of Consultants*

The PSF Committee made a unanimous recommendation to the SBOE to appoint Asset Consulting Group to conduct an asset allocation study. The SBOE rejected the Committee recommendation and, instead, at the same meeting, appointed Richards Tierney to perform the study.

Similarly, the PSF Committee had recommended that both Holbein Associates and Asset Consulting Group be asked to prepare performance measurement reports for the 3<sup>rd</sup> quarter ending September 1999, following which one of the firms would be selected as the performance measurement consultant. The SBOE rejected this recommendation and instead appointed a third firm, Everen Securities, to prepare the 3<sup>rd</sup> quarter report.

*May 1999 – Appointment of Securities Lending Agent*

At its May meeting the PSF Committee made a decision to defer action on the selection of a securities lending agent pending further cost analysis. At the meeting of the SBOE, the next day, however, the SBOE ignored the decision of the Committee and appointed Citibank as its securities lending agent, absent the additional analysis the Committee intended to perform.

**Prudence is Process, Not Outcome**

The prudence of a decision is judged by the process by which it was arrived at, not by the quality of the outcome. Decisions with good outcomes may have been arrived at imprudently, while decisions with bad outcomes may have been arrived at quite prudently. Prudent process does not guarantee success but does increase the odds of success and of withstanding the test of scrutiny.

*July 11, 1997 – Asset Allocation Decision*

Based on the results of a formal asset allocation study and the recommendations of staff and the consultant, the PSF Committee recommended to the SBOE that it adopt an asset allocation that included an allocation to high-yield bonds of 10%. The SBOE disagreed with the Committee’s recommendation and, instead, without further analysis, adopted an asset allocation to high-yield bonds of only 5%, a figure that had not even been considered in the study.<sup>16</sup> The SBOE agreed to revisit the decision at some future date, but never did.

In reporting the above events, we are not suggesting that the SBOE’s decisions were necessarily always wrong. In some

cases, we believe its decisions had good outcomes. Regardless of the outcome, however, we find that the process followed in arriving at the decisions was imprudent.

**There Has Been Inappropriate Use of Service Providers and Advisors in the Decision-making Process**

“For most fiduciaries and trustees, the legal requirements for prudent investment management parallel the course of action that would be followed by an informed professional investor. The courts will judge a fiduciary on the process that was followed in managing investment decisions -- not on the ultimate investment results.”

Donald Trone, et al, *The Management of Investment Decisions*, McGraw-Hill 1996, page 2.

In reviewing the SBOE’s decision-making process we found that the SBOE and the PSF Committee have often used service providers or advisors:

- Whose formal mandates and areas of expertise did not cover the matters they were asked to advise on;
- Who were not sufficiently independent to provide the SBOE objective advice; or
- Who had a personal or informal relationship with individual SBOE members and were not appointed by the SBOE.

<sup>16</sup> A constraint had been imposed on the computer model, which required a minimum allocation to high-yield bonds of 10%.

## **Service Providers Have Been Used in Areas Outside their Mandate**

Between 1999 and 2001, the SBOE employed Everen/First Union Securities, represented by Mr. Russell Stein, to serve strictly as the performance measurement consultant. There are numerous instances in which the SBOE either requested the advice of Mr. Stein, or in which Mr. Stein offered his advice to the SBOE, on matters that were completely outside the scope of his contractual arrangement with the SBOE:

### *Approximately March 2001*

A lobbyist associated with Mr. Stein is reported to have approached members of the Legislature with a proposal to generate approximately \$300 million in additional income over and above the BRE for the biennium.

### *November 2000*

Mr. Stein proposed to the PSF Committee that the portfolio managed by two of the three existing high-yield bond managers be transferred to a third manager, MacKay Shields, and further proposed that MacKay Shields subsequently transition the securities to an investment-grade bond portfolio.

### *September 2000*

At a meeting of the PSF Committee, the Committee directed staff to work with First Union Securities and Callan Associates to develop a transition plan for the domestic stocks of the PSF. Apart from the fact that such activities are outside the scope of services a performance measurement consultant normally provides, the SBOE did not investigate whether either firm was qualified or had experience in performing such work.

### *September 2000*

At the same meeting, PSF staff recommended to the Committee that the PSF should retain its current investment in high-yield bonds rather than shift towards an investment grade bond portfolio because doing so would reduce the income to the ASF. Mr. Stein opposed the recommendation.

### *November - December 2000*

It appears that Mr. Stein informed MacKay Shields directly that the SBOE intended it to begin investing in investment-grade bonds, although a transition plan had not yet been presented by the manager and approved by the SBOE. This was reported to the SBOE by PSF staff. Mr. Stein admitted contacting MacKay Shields but disputed the nature of what was discussed. It has been disclosed that Mr. Stein provides brokerage services for MacKay Shields.

### *May 2000*

Mr. Stein advised the PSF Committee with respect to the development of the PSF's brokerage policy concerning Historically Underutilized Businesses (HUBs). During those deliberations, Mr. Stein advised the Committee that, among other things, it was not unreasonable to over-compensate under-financed start-up firms while putting them on a course to develop research services. Sworn testimony revealed that Mr. Stein lent as much as \$60,000 to one of the HUB brokerage firms vying for business from the PSF.

In each of the above cases, Mr. Stein was either asked to advise or offered unsolicited advice on issues that were outside his mandate, outside the areas of expertise for which

he was retained, or, in the cases of approaching the Legislature or having a financial interest in firms seeking to conduct business with the PSF, were completely inappropriate.

Allowing Mr. Stein to advise on specialized topics outside his formal mandate, without ensuring that he was qualified to address them, demonstrates an imprudent decision-making process. Furthermore, it diminished the integrity and objectivity of the performance measurement function. That is, in order for a performance measurement consultant to be in a position to measure and comment on the performance of the PSF, the consultant must be completely independent and have played no role in the decisions that generated the performance. By advising the SBOE on issues of asset allocation, manager structure, and manager selection, Mr. Stein became subject to a conflict of interest, in that he was expected to measure the effectiveness of decisions in which he was involved in making.

### **Service Providers Were Not Sufficiently Independent**

We briefly addressed the independence of Mr. Stein in the previous section. The issue of independence also arises in the case of the investment consultant. Many investment consultants derive a substantial part of their revenue from affiliations with brokerage firms and business relationships with investment managers. For example, when Callan Associates was hired in March 2000, it had a broker/dealer affiliate that provided performance measurement and marketing advice to investment management firms, and conducted client conferences and seminars which money managers paid to attend and at which they made presentations to plan sponsors and trustees. This could lead to situations in which the advice the investment consultant provides to trustees with respect to the evaluation and selection of money managers may be subject to a conflict of interest because investment consultants can influence the selection of money managers.

The RFP asked respondents to provide the following information concerning potential conflicts of interest:

- Details concerning any financial relationship respondents had with affiliated organizations such as brokerage and money management firms;
- Whether respondents received any fees from money managers (and if so, how much and for what reason?);
- Other potential conflicts of interest; and
- How conflicts would be resolved.

Of the thirteen firms that responded to the RFP, three firms indicated that they did not sell services to third-party vendors, and did not have ties to broker/dealers, or interests in investment management firms. We find it somewhat puzzling that none of the three independent firms was among the six firms invited to make presentations to the Committee. Furthermore, the minutes of a subsequent SBOE meeting in September 2000 indicate that the SBOE had been made aware that Callan Associates had a potential conflict of interest in the selection and evaluation of money managers. We are concerned that the SBOE, in selecting the investment consultant, may not have placed sufficient importance on the need for independence on the part of service providers.

## **Advisors Had a Personal or Informal Relationship with SBOE Members**

The use of so-called “informal” advisors by SBOE members has been extensively documented in previous reports by the State Auditor’s Office as well as by the House Committee on General Investigating. According to these reports, some SBOE members have relied on such informal advisors for analysis and advice on matters concerning the PSF. The informal advisors in some cases were provided with confidential documents pertaining to the PSF. They routinely attended SBOE meeting and often actively contributed to the deliberations. Such use of informal advisors is contrary to proper decision-making. The SBOE should make decisions as a single body, not a collection of individuals. It should rely on the advice and recommendations of service providers operating within their areas of expertise and contracted responsibility who have been formally appointed by the SBOE after appropriate due diligence.

## **The SBOE Has Made a Number of Questionable Decisions**

The previous sections identified flaws in the SBOE decision-making process. A flawed decision-making process necessarily implies a lack of prudence on the part of the SBOE, regardless of whether the resulting decisions turned out to be good or bad. While analysis of the decision-making process is relatively straightforward, it is often difficult to determine the reasonableness of specific decisions. Nevertheless, we did identify several specific decisions that clearly reflected poor judgment or a disregard for the best interests of the PSF.

### **Decision to Appoint Everen Securities (eventually to become First Union) – September 1999**

For a number of reasons, the appointment of Everen Securities as performance measurement consultant for the SBOE was highly questionable in terms of satisfying the standard of prudence:

- Mr. Stein, a principal of Everen Securities, openly flouted the no contact requirement of the SBOE’s RFP;
- Mr. Stein was under investigation by the SEC at the time of his appointment; and
- Everen Securities was a brokerage firm that earned a substantial portion of its revenue from commissions on securities transactions by investment managers. In selecting such a firm to monitor and evaluate the performance of its managers and provide advice and recommendations, the SBOE clearly opened the door to a potential conflict of interest.

Given the above facts, it is difficult to understand how the SBOE, as the fiduciary of a then \$20 billion public fund, could have rationalized the appointment of Everen Securities as an advisor to the SBOE. Furthermore, the SBOE decided not to impose specific conditions on the appointment of Everen Securities, as suggested by a SBOE member, beyond the general requirements of the Code of Ethics, which would have limited the potential for conflicts of interest.

### **Approval of Asset Allocation Policy – January 2002**

In January 2002, the SBOE adopted an asset allocation policy on the basis of a study prepared by its investment consultant. The study, however, had been prepared to assist the SBOE in addressing a somewhat different issue (that is, the specific allocation to high-yield bonds). The report by the investment consultant clearly stated that the alternate asset allocations presented had not been optimized and were therefore not necessarily efficient. That is, the portfolios considered may not have offered the highest levels of return for given levels of risk. Furthermore, the analysis did not take into consideration the impact of inflation and growth in the student population. Accordingly, the alternate asset allocations examined in the report should not have been considered feasible long-term asset allocation policies for the SBOE without further analysis. Nevertheless, the SBOE adopted one of the alternate allocations as its long-term asset allocation policy.

In light of the above, it can be readily argued that the decision to adopt the January 2002 asset allocation policy was imprudent, as it was not based on modern portfolio management theory, which is standard industry practice, and as it did not take into consideration the key parameters of inflation and growth in the student population.

### **Appointment of the Custodian and Securities Lending Agent – 1999**

In January 1999, the SBOE authorized a RFP process to identify a single firm to provide both custody and securities lending services. At the end of the process, the SBOE, against the recommendation of staff, awarded contracts for custody and securities lending services to two firms rather than one. The RFP process had been designed to identify the single most suitable firm to provide both types of services. It had not been designed to identify the single most suitable firm to provide custody services and the single most suitable firm to provide securities lending services. In effect, the SBOE appointed a securities lending agent without the expected analysis to demonstrate that it was the most suitable firm to carry out the contract. Furthermore, the combined fees associated with the two firms selected amount to significantly more than the fees associated with using either of the two firms recommended by staff. Staff calculated that the incremental fees for hiring separate firms were \$1.2 million in the case of its top recommendation, and \$600,000 in the case of its second choice.

Once again, setting aside the process that resulted in the above decision (which is itself highly questionable and is discussed earlier in the report) it is extremely difficult to argue that the SBOE's decision to appoint two different firms, rather than one, reflected good judgment or the best interests of the PSF.

### **Transition of High-Yield Bond Portfolio – February 2001**

In February 2001, MacKay Shields, an investment manager of the PSF, presented a plan to the PSF Committee to transition its high-yield bond portfolio to an investment-grade bond portfolio. Staff advised the Committee that it had not received any information on the performance of the MacKay Shields investment-grade bond product or on the competitiveness of its management fees. Nevertheless, the Committee unanimously recommended to the SBOE that MacKay Shields be directed to transition the high-yield bonds to an investment-grade bond portfolio. The SBOE subsequently voted unanimously to approve the Committee's recommendation. In effect, the PSF

Committee and the SBOE chose to transition the portfolio before receiving additional information on the performance and fees of MacKay Shields' investment-grade bond product.

### **Implementation of Decisions**

Above, we have identified shortcomings in the SBOE's decision-making process, as well as a number of decisions that appear to have been imprudent. Another aspect of the SBOE's decision-making process that warrants comment is the tendency of the SBOE not to fully implement its decisions in a timely manner. There are numerous examples that illustrate this tendency:

#### *July 1997 – Asset Allocation Decision*

An asset allocation policy adopted by the SBOE in July 1997 was only partially implemented, and that did not occur until January 1998. In fact, as late as June 2000, after the appointment of a new investment consultant, the 1997 investment policy had still not been fully implemented. Specifically, the allocation to small and mid-cap stocks was only 4% whereas the policy required a 20% allocation, and the allocation to large cap domestic stocks was approximately 56.1% whereas the policy stipulated an allocation of only 37.1%

#### *July 1997 – Internal vs. External Management*

In July 1997, the SBOE also approved a significant change in the allocation to internally and externally managed assets. The decision stated that internal staff would manage all large cap core domestic stocks and investment-grade bonds, amounting to 45% of total assets, and external investment managers would invest the remaining 55% in large cap non-core stocks, small and mid-cap stocks, international stocks and high-yield bonds. This decision was never fully or properly implemented. For example, as of the end of fiscal 1999, 65% of the assets of the PSF were still internally managed. Furthermore, when the domestic equity structure of the PSF was reviewed by the new investment consultant, Callan Associates, as of December 31, 1999, four of the ten externally managed portfolios were determined to be following a large cap core investment style, as opposed to non-core, contrary to the structure approved by the SBOE more than two years earlier.

#### *May 2001 – Asset Allocation*

The SBOE adopted another asset allocation policy in May 2001. The policy reinstated a 10% allocation to high-yield bonds and, therefore, required the selection of external high-yield bond management services. In September of that year, the SBOE became concerned with its earlier decision to allocate funds to high-yield bonds, which SBOE members began to refer to as "junk bonds." In November 2001, the SBOE decided to reduce its commitment to high-yield bonds to 5% despite the fact that its policy required an allocation of 10%. The SBOE eventually adopted a new and different asset allocation policy in January 2002, which provided for a 5% allocation to high-yield bonds. In effect, the asset allocation decision made by the SBOE in May 2001 was never implemented.

#### *November 1999 – Rebalancing*

In November 1999, despite a recommendation by the PSF Committee that was supported by the advice of staff and the investment consultant, the SBOE decided not to rebalance the portfolio as was required under the existing rebalancing policy of the SBOE.

### 2002 – Rebalancing

A situation similar to the above also arose in 2002 when the SBOE again decided not to comply with the requirements of its rebalancing policy, despite recommendations from PSF staff and Callan Associates to do so.

### Insufficient Attention to Investment Costs

We have found several examples of instances in which the SBOE had not demonstrated sufficient appreciation of the importance of minimizing investment costs. Minimizing costs is key to a successful investment program and is an important requirement of fulfilling one's fiduciary responsibilities.

1. The SBOE has been aware for some time that its external domestic equity managers have not added value. The large cap equity managers, as a group, have underperformed their benchmark since their inception seven years ago in 1995 by nearly 0.5% or about \$ 9 million a year based on the value of assets today, not counting another \$6 million a year in fees. The small/mid cap equity managers have underperformed since their inception in 1998 by 1.4% or \$16 million a year, plus another \$4 million in fees annually. A passively managed portfolio that would match the performance of an index would cost less than one-tenth of the fees associated with an external, actively managed portfolio, and yet the SBOE did not establish an indexed portfolio for externally managed domestic stocks until fairly recently (that is, early 2001). Today less than 17% of the PSF's assets are passively managed.
2. There were repeated attempts by some members of the SBOE from May 2001 to January 2002 to have the SBOE issue a RFP for external management of investment-grade bonds. Staff informed the PSF Committee that internal management of these bonds had generally added value and had cost only half a basis point (0.005%). Callan Associates advised the Committee on more than one occasion that it would be difficult to find an external manager who would manage bonds to an income as opposed to a total return target. An external manager would charge 10 to 20 basis points to manage a bond portfolio (\$8 million - \$16 million in fees a year versus \$400,000 in fees a year for internal management of an \$8 billion bond portfolio), and Callan Associates had very little confidence that the Committee could find a manager who would do better than internal staff or add value net of fees. (See Appendix 4(D) for details.)
3. The SBOE decided in March 1999 to separate custody from securities lending and appoint different service providers for the two functions. This was against the recommendation of staff to have one provider for both services. Staff had estimated at the time that separation of the two functions would result in additional costs of \$600,000 to \$1,200,000 per year. In fact, an analysis by PSF staff since that time indicates that additional costs have amounted to \$1.4 million to \$2 million per year.
4. In order to meet social objectives, some members of the SBOE have encouraged and even insisted that HUB brokers – most of which only provide trade execution but no research and have limited capital and trading capability – be paid the same commission as “full service” brokers who, in addition to trade execution, provide investment research, first call on new information, access to industry analysts and company executives, commitment of capital, ability to handle complex trades; etc. We find that almost all investment managers, including internal staff, are paying

HUB brokers an average commission rate equal to and often more than what they are paying to non-HUB brokers. The SBOE has established a target of 20% of commissions to be directed to HUB brokers. The difference in commission rates on full service and “execution only” trades is at least 2 cents a share. The average trading volume for domestic equity transactions (both purchases and sales) during June and July of 2002 was about 25 million shares a month. Based on these numbers we estimate that excess payments to HUB brokers could amount to \$1.2 million annually.

5. One specific instance in which the SBOE’s HUB brokerage policy resulted in an increase in the expenses of the PSF occurred in May 2000. The SBOE terminated a small cap manager, Loomis & Sayles, and transferred the assets to another small cap manager, Harbor Capital, which was then allowed to transition the assets. Harbor

Capital undertook a number of transactions over the following months for which they paid a non-HUB broker 4 cents per share instead of 2 cents per share that they would have normally paid to that broker on such trades. PSF staff estimated that the difference in total commissions on these trades was about \$216,000. Harbor Capital explained that at that time there were no HUB brokers that could undertake such large program trades. In order to comply with the SBOE’s “mandate” to direct “at least” 20% of commissions to minority firms, they asked the non-HUB broker to “step-out” some of the trades to HUB brokers. In other words, the HUB brokers were paid part of the commissions but did not, in fact, execute any trades. Harbor Capital indicated that it was fully aware of the requirement for best execution at lowest cost under the SBOE’s brokerage policy. A representative of the firm stated, “It is possible that Harbor Capital could have obtained a lower execution on these trades if it had requested execution only services on these trades. It did not do so because it was attempting to balance conflicting SBOE mandates”.

**Are Social Considerations by Fiduciaries Prudent?**

Fiduciaries may consider social issues when making investment decisions so long as they do so as a secondary consideration to the fiduciary’s primary concern with risk and return. Fiduciaries are required to act solely in the interest of the beneficiaries and for the exclusive purpose of providing benefits to the beneficiaries. An investment, or an investment course of action, will not be prudent if it is expected to provide a lower rate of return, or higher costs, than available from alternate investments, or providers, given equal levels or risk.

The bottom line is that socially motivated selections of money management or brokerage services must be consistent with the objective of **lowest cost, best execution.**

6. Finally, aspects of the emerging manager program appear to be inconsistent with the fiduciary requirement to obtain appropriate value for all fees paid. The PSF employs FIS Funds Management, Inc. (FIS) as a “manager of emerging money managers” at a cost of 50 basis points per year (0.5%). One of the firms chosen by FIS to manage a \$60 million portfolio is San Antonio based Presidio Asset Management (Presidio). Presidio, however, does not actually manage this money itself. Rather, Presidio subcontracts the actual management of this portfolio to Avatar Associates, a large New York City based money management firm. In effect, contrary to

the purpose of the emerging manager program, the PSF is not receiving the services of an emerging manager, but rather the services of a well-established investment manager. Had the objective been to use the services of a well-established investment manager, such services could have been obtained, and normally are obtained, for substantially less than the 50 basis points charged by FIS. Hiring a well-established manager and paying that manager a typical market fee would have generated savings for the PSF of more than \$100,000 per year. Securities and Exchange Commission filings also indicate that Presidio is jointly owned by Avatar Associates and a former Executive Administrator of the PSF.

## Section 9 — Ethics and Conflicts of Interest

**The SBOE has experienced difficulty in establishing, implementing, and enforcing a comprehensive code of ethics that effectively addresses matters of ethics and conflicts of interest.**

Attempts were made in 2001 and 2002 to strengthen the SBOE’s *Code of Ethics, Texas Administrative Code, Title 19, §33.5* (the “Code of Ethics”), and to broaden its scope. A revised version of the policy was most recently approved by the SBOE on November 15, 2002. Notwithstanding these revisions, there are still some major topic areas not covered by the SBOE policy, including:

1. Blanket prohibitions against disclosing confidential information to unauthorized parties.
2. Trading rules for SBOE members.

We also found numerous gaps and weaknesses in the provisions of the policy, which, in some instances, appear to make the respective provisions ineffective. Of greatest concern is a gap in the policy that has the effect of allowing service providers to indefinitely postpone any disclosure of a conflict of interest.

### Enforcement Provisions

We found that the mechanisms established to enforce compliance with the Code of Ethics are severely lacking. Penalties for violation of the Code of Ethics, as set out in subsection (o)(2) are not well defined, are not necessarily applicable to all potential classes of violators, and are relatively weak compared to many provisions in the ethics policies of other jurisdictions (including the Teacher Retirement System of Texas, UTIMCO, and the California Model Conflict of Interest Code, adopted by many California public retirement systems).

We also found inconsistencies in filing and disclosure requirements required under the Code of Ethics. We found that in certain cases, filing dates or time limits are missing, or the identities of the intended recipients of the reports are missing.<sup>17</sup>

### Implementation of the Code of Ethics

We uncovered several weaknesses in the procedures and processes employed to monitor compliance with the Code of Ethics. Specific details are provided in Appendix 5 to this Report; the areas of main concern, however, are as follows:

1. In the recent past there have been insufficient resources directed towards monitoring and analyzing the periodic filings required under the Code of Ethics.<sup>18</sup>

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<sup>17</sup> A detailed analysis of the existing filing requirements for SBOE members, PSF staff and service providers, as well as the missing details, is contained in Schedule 1 to Appendix 5.

<sup>18</sup> To address this problem, the TEA has recently hired a Compliance Officer to specifically deal with the compliance of PSF policies, including the Code of Ethics. Nevertheless, PSF staff still has communicated concerns over their ability to process all the information currently received, even with the new dedicated staff person.

2. There has been a lack of formalized systems in place to analyze all the information obtained through the annual filings, and there has not been a specified or consistent format for reporting this information to the SBOE. However, we understand that the TEA is currently in the process of putting many of the necessary systems in place.
3. PSF staff has raised concerns over the usefulness of some of the information collected, and whether or not there is value in using that information to attempt to uncover undisclosed conflicts of interest.
4. The SBOE has failed to enforce section (n)(2) of its Code of Ethics by not requiring all its service providers to disclose the amount of fees received from other service providers of the PSF. The SBOE has allowed service providers to disclose only the existence of fees and commissions, but not the amount, contrary to its Code of Ethics. Knowing the amount is critical to evaluating the degree of potential influence to which a service provider may be subject.

### **Responsiveness to Prior Recommendations Concerning the Code of Ethics**

We found that the SBOE has not adopted recommendations from previous investigations by both the House Committee on General Investigating and the State Auditor's Office.

Ten of the recommendations made in the House report dealt with conflicts of interest and ethics.<sup>19</sup> Only two of the recommendations were implemented, one of them only partially.

In a 2001 State Auditor's report, six specific recommendations were made to strengthen the provisions of the existing Code of Ethics.<sup>20</sup> Only the first of the six recommendations (disclosure of informal advisors) was adopted by the SBOE.

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<sup>19</sup> *A Report to the House of Representatives, 77<sup>th</sup> Texas Legislature, Interim Report 2000*, pages 2.15 to 2.17. These recommendations are also included in Appendix 5, Schedule 2.

<sup>20</sup> *A Follow-up Report on Two Reviews of Controls Over Investment Practices at State Investing Entities, January 2001*. State Auditor's 2001 Report, page 47 ff. These recommendations are also included in Appendix 5, Schedule 2.

## Section 10 — Recommendations

We believe that the inadequacies of the PSF’s governance structure, guiding parameters, spending policy, and organizational structure (described in sections 4, 5, 6 and 7 of this Report respectively) have to some extent contributed to the shortcomings identified in the PSF’s fiduciary decision-making process (described in sections 8 and 9 respectively). More appropriate structures and policies would likely have resulted in a more effective fiduciary decision-making process and may have facilitated the development of a more effective code of ethics.

### Recommendations to the Legislature

Accordingly, for the Legislature’s consideration we have developed the following recommendations that focus on improving the governance structure, guiding parameters, spending policy, and organizational structure of the PSF.

- 1.1 As sponsor of the PSF, the Legislature should clarify the parameters within which the PSF is to achieve its Constitutional purpose. The parameters should incorporate the principle of intergenerational equity, which can be satisfied by growing the PSF and its distributions at a rate that keeps pace with the student population and appropriate measures of inflation. In addition, the Legislature should communicate the parameters to all interested parties including the PSF’s governing board. We believe that by clarifying and communicating the guiding parameters, the Legislature will greatly enhance the potential for effective, long-term management of the PSF.
- 1.2 By constitutional amendment, a new state-sponsored, quasi-independent investment management organization should be created to administer the PSF. The composition of the governing board of the new organization should appropriately balance the Legislature’s legitimate interests with the PSF’s need for protection from non-fiduciary considerations.

The composition of the new governing board should accomplish the following:

- a) Be sufficiently independent to ensure that fiduciary decisions affecting the PSF are not unduly influenced by non-fiduciary considerations that may be detrimental to the long-term financial integrity of the PSF.
- b) Reflect the fact that the Legislature has important and legitimate interests in the performance and activities of the PSF.
- c) Include a sufficient number of individuals with relevant investment or related qualifications to help ensure that adequate technical knowledge is brought to bear on all fiduciary decisions involving the PSF.
- d) Be the right size to balance the need for efficient and effective decision-making with the need to sufficiently represent all interested parties.

Consistent with the above principles, we offer the following recommendations concerning the composition of the new governing board:

- i) The size of the new governing board should be limited to 9 members, the majority of whom should be independent of state government and school districts. Such a size would be large enough to allow sufficient perspectives and expertise to be brought to bear on all decisions, would facilitate the meeting of quorum requirements, and would support the use of committees. At the same time, such a board would be small enough to ensure effective and efficient deliberations.
- ii) The board should contain five qualified individuals appointed by the Governor, with the advice and consent of the Senate, from a list of candidates submitted by the SBOE, but not to include SBOE members. No fewer than two candidates should be submitted by the SBOE to the Governor for each open board position. This recommendation reflects the need for independent board members possessing investment or related qualifications.
- iii) The board should contain one qualified individual appointed by the Lieutenant Governor, reflecting the fact that the State Senate has a legitimate interest in the activities of the PSF.
- iv) The board should contain one qualified individual appointed by the Lieutenant Governor from a list of candidates submitted by the Speaker of the House of Representatives, reflecting the fact that the House of Representatives has a legitimate interest in the activities of the PSF.
- v) The board should contain one qualified individual appointed by the Governor to reflect checks and balances that are customary in government.
- vi) The board should contain one qualified individual appointed by the Commissioner of Education from a list of candidates submitted by a representative number of school districts, to reflect the fact that the school districts are the direct recipients of funding from the ASF, which is partially funded by the PSF.
- vii) All individuals appointed to the new board should be required to possess investment or related qualifications, or experience in government and be free of inherent conflicts of interest. Ruling out individuals who face inherent conflicts of interest will admittedly reduce the pool of potential candidates significantly. Nevertheless, we believe that independent and qualified candidates could be drawn, for example, from the ranks of academics, independent investment consultants, former chief executives of public or private investment funds, former senior executives of insurance companies, former government officials, and professionals in the fields of law, accounting, or auditing. To ensure a diversity of informed views and perspectives, there should not be a concentration of individuals on the board from any one field or discipline.
- viii) Consideration should be given to establishing a process whereby any member of the new governing board could be removed for cause relating to the improper discharge of a fiduciary duty.
- ix) The PSF's governing board should have the authority to select its own chair from among its members.

- 1.3 If, and only if, the composition of the PSF's governing board is modified as recommended above, we would recommend that the PSF's governing board be granted greater authority to administer the PSF. At a minimum, such expanded authority should include the ability to appoint the Executive Administrator of the PSF. This would result in a more traditional organizational structure in which management and operating staff are directly accountable to the governing board. This in turn would ensure an alignment between the governing board's fiduciary duties and its authority to carry out its duties. This would also reduce any perceived need by members of the governing board to seek advice from informal advisors. We also believe this recommendation would facilitate recruitment of future Executive Administrators, because the current organizational structure is a likely deterrent to qualified candidates.
  
- 1.4 We recommend that the Constitution be amended to provide for an asset-based spending policy that sets distributions from the PSF by applying a percentage rate to the market value of the PSF. The percentage rate should be determined from time to time by the PSF's governing board, and appropriate smoothing mechanisms should be established as part of the spending policy to minimize fluctuations in annual distributions from the PSF. Other suggested spending policy provisions include the following:
  - a) The percentage rate established by the PSF's governing board should ensure that, given reasonable capital market assumptions, the assets of the PSF and the distributions from the PSF will, in the long run, grow in line with growth in student population and appropriate measures of inflation.
  - b) The PSF's governing board should review the percentage rate at least every three years, using the services of an experienced investment advisor. The review should be based on generally accepted principles of endowment fund management and reasonable and appropriate capital market assumptions.
  - c) If the Legislature is reluctant to allow the PSF's governing board full discretion in setting the above distribution percentage rate, the Legislature may wish to consider establishing in statute a corridor of acceptable rates, based upon the recommendations of an independent, experienced investment advisor. As the outlook for investment returns changes, so too should the corridor. Accordingly, if the Legislature establishes a corridor, we would suggest that the Legislature review the corridor once every 10 years. While a corridor may put interested parties at ease, it is not without risk. A corridor is likely to have an upward bias. That is, during periods of high investment returns the Legislature will have ample incentive to shift the corridor upwards because this may lead to higher distributions. However, during periods of low investment returns the Legislature will have little incentive to shift the corridor downward because this may lead to lower distributions.
  
- 1.5 The Legislature by statute should require that the Legislative Audit Committee periodically commission a review to evaluate the PSF's investment practices and performance. This review should be performed by an independent firm with substantial experience in conducting such reviews. The costs of the review should be payable out of the PSF's administrative budget. This requirement has already been established for the Teacher Retirement System of Texas. The findings of the

reviews should be submitted to both the Legislative Audit Committee and the governing board of the PSF.

- 1.6 The PSF's governing board should be required to report annually to the Legislature on its investment performance and fiduciary practices. Investment reporting and benchmarks should be consistent with generally accepted standards of performance measurement. At a minimum, reporting on fiduciary practices should include confirmation of compliance with appropriately stringent codes of ethics and/or conflict of interest policies. The report should include a plain-language summary.

### **Recommendations to the State Board of Education**

The following recommendations can be implemented by the SBOE or by a new governing board, without amendments to the Constitution or to legislation. These additional recommendations are intended to enhance the governance and management of the PSF, regardless of whether a new investment management organization is established to administer the PSF.

- 2.1 The SBOE rules of order should be modified to ensure that no significant decision of the SBOE can be made without a full and detailed analysis involving PSF staff and, where applicable, service providers. More specifically:
  - a) The SBOE should not maintain a standing agenda item that allows any member of the SBOE to make a motion, for immediate consideration and adoption, to change the investment manager structure of the PSF.
  - b) The SBOE should prohibit itself from adopting a course of action contrary to a recommendation of the PSF Committee without further analysis. Prior to any such action, the SBOE should communicate any concerns it may have about a recommendation to the PSF Committee, and should direct the PSF Committee to review its original recommendation and submit a second recommendation at a future date.

We recognize that the above recommendations may lengthen the time it takes for the SBOE to make decisions. We believe, however, that provided the SBOE is focused on making long-term policy decisions, as it should be, a speedy policy-making process is less important than ensuring that prudent, well supported decisions are made.

We further recognize that the above recommendations may not be consistent with Robert's Rules of Order. However, while Robert's Rules of Order may be appropriate in a parliamentary or legislative setting, they are less appropriate in the case of an investment decision-making process of a fiduciary nature. The SBOE therefore may follow Robert's Rules of Order with certain exceptions as recommended above.

- 2.2 The SBOE should modify its decision-making structure (that is, the job descriptions and mandates of key fiduciaries of the PSF) to ensure that the SBOE is focused almost exclusively on matters of policy and oversight, while PSF staff are allowed to focus on the day-to-day management of the PSF. Specific tasks that should be delegated to PSF staff include:

- a) Investment due diligence;
  - b) Manager selection; and
  - c) Execution of the rebalancing policy.
- 2.3 Under the current decision-making structure, the Investment Advisory Committee (IAC) can serve as a valuable expert resource to the SBOE. If, however, a new governing board for the PSF is established in accordance with our primary recommendations and, as a result, the PSF's governing board contains individuals with relevant qualifications, then the need for an IAC should be revisited, as it would make the decision-making structure unnecessarily complicated and unwieldy.
- 2.4 In the event the current governance structure of the PSF remains in place, we would recommend that the SBOE take steps to position the Investment Advisory Committee (IAC) to be more effective. Specifically,
- a) The IAC should be positioned to be a *true* committee serving the SBOE as a whole. The members of the IAC should be appointed by the SBOE, rather than by individual members of the SBOE. This will help to ensure that the IAC is accountable to the SBOE, and advises the SBOE with a single voice rather than 15 independent voices, as appears to be the case at the present time.
  - b) Assuming that recommendation a) above is implemented, we recommend that the size of the IAC be reduced to three to five members. This will serve to make the IAC more efficient and effective and will reduce the funds necessary to support the IAC's travel and related expenditures.
  - c) Since its reestablishment the IAC has been authorized to meet in person only twice annually. As a result, the IAC has resorted to holding additional meetings by telephone. We recommend that sufficient resources be made available to allow the IAC to meet in person, a minimum of four times annually, or more often if deemed necessary by the IAC.
- 2.5 We recommend that the SBOE establish an SBOE Communications Policy to provide clear guidance to SBOE members, PSF staff, and service providers on matters of communications. At a minimum, such a policy should clarify who is authorized to communicate with the Legislature, PSF staff, and service providers on behalf of the SBOE, and any subsequent reporting requirements to be satisfied.
- 2.6 We recommend that the SBOE should establish a documented investment philosophy that sets out the SBOE's fundamental beliefs about endowment fund management, investments, and capital markets. The philosophy should set forth the principles and assumptions upon which the PSF's investment program and policies are based, and should address, at a minimum, the issues of intergenerational equity, investment risk, capital market efficiency, performance measurement, and diversification. The development of a philosophy would help to create a stronger consensus among board members as to how the PSF is to be managed, facilitate policy making and board deliberations, and aid new board members in better understanding the rationale behind the PSF's investment program.
- 2.7 The SBOE should establish a formal, comprehensive fiduciary education program with the following features:

- a) It should be guided by a formal education policy approved by the SBOE.
- b) The content of the program should reflect a balance between theoretical concepts and practical industry-related information to ensure that the SBOE will gain an understanding of investment theory and the practical workings of the financial services sector, including potential sources of conflicts of interest.
- c) The program should include an extensive orientation component for all new members of the SBOE.
- d) The program should provide for ongoing education of all members of the SBOE and should prescribe minimum expectations concerning participation.
- e) The program should require SBOE members to attend conferences as well as in-house seminars. Priority, however, should be placed on in-house seminars to ensure that the educational content will be relevant to the SBOE. Many conference agendas are designed by the service provider community and may not effectively meet the needs of the SBOE.
- f) Independent parties able to provide an objective perspective on investment and fiduciary concepts should deliver a significant portion of all in-house education content. This will avoid situations where, for example, an external, active investment manager is asked to provide the SBOE with objective information on the merits of active investment management.

2.8 We recommend that the SBOE develop a means of communicating with all candidates running for election to the SBOE to make them clearly aware of the fiduciary responsibilities associated with the position by virtue of the SBOE's duty to manage the PSF. Candidates should also be informed of the provisions of the SBOE Code of Ethics. This recommendation is intended to ensure that all individuals contemplating election to the SBOE are fully aware of the fiduciary responsibilities associated with the position. It should be noted that if a new investment management organization is established to administer the PSF, the SBOE would likely no longer be a fiduciary with respect to the PSF.

2.9 We recommend that the SBOE Code of Ethics be modified to address numerous gaps and weaknesses we identified in our review. These include, among other things, adopting stricter rules regarding confidentiality of information, use of informal advisors, and disclosure of conflicts of interest; devising stronger deterrents to and sanctions for breaching the Code of Ethics; and establishing more effective monitoring and reporting mechanisms. Our detailed recommendations concerning the Code of Ethics are found in Appendix 5.

**Minimum Recommendations** (for consideration in the event that Recommendations 1.1 and 1.2 to the Legislature are not implemented)

3.1 We recommend that the Legislature, by statute and/or rider require that:

- a) The PSF governing board establish a policy requiring that all fees paid by the PSF to HUB brokers be not more than the fees paid to non-HUB brokers for equivalent services, consistent with the principle of "lowest cost, best execution".

- b) That investment management fees paid to emerging managers (including managers of emerging managers) be not more than the fees paid to non-emerging managers for equivalent services.

3.2 In the course of our review, we identified concerns on the part of the Legislature and individual SBOE members concerning alleged conflict of interest situations that have arisen from time-to-time since the SBOE began hiring external investment managers. Should our primary recommendations not be implemented, and, in keeping with the above concerns, we recommend that serious consideration be given to simplifying the PSF's investment program by substantially increasing the levels of internal and passive investment management. This will provide significant benefits.

**Passive vs. Active Investment Management**

A passive strategy seeks to match, rather than outperform, a market index (benchmark) by fully or substantially mirroring the index's composition. Funds using this strategy are often called index funds.

An active strategy seeks to beat a market index's return by investing in different stocks or bonds that, based on research, are expected to outperform the stocks or bonds in the index.

The management, brokerage, and other transactions costs of active strategies are typically much greater than the costs of passive management.

First, simplification of the investment program would greatly reduce the potential for conflicts of interest involving external third parties, because there would be significantly fewer opportunities for external third parties, such as money managers and brokers, to be awarded business. As a result, there would be far less incentive for external third parties to attempt to influence members of the SBOE or PSF staff.

Second, it would significantly reduce the overall costs of the PSF's investment program. External, active investment management generally costs the PSF about 0.30% to 0.35% of the assets in question, or more than \$45 million per biennium. Internal

passive management, on the other hand, would cost the PSF no more than 0.01% - 0.02% annually. This would likely amount to less than \$2 million per biennium. That is, the costs of external active management are 15 to 35 times greater than the costs of internal passive management. The savings associated with internal passive management represent a guaranteed, risk-free addition to the PSF's investment returns that accrue year after year.

The savings associated with internal passive investment management must be weighed against the potential added value that external active investment managers may achieve. Proponents of active management may claim that skilled active managers can add value of 0.5% to 1.0% or more. A large body of academic research, however, does not support such claims:

- Academic analysis has shown that before costs, the return on the average actively managed dollar is, by definition, the return on the average passively managed dollar; and after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar because active management costs more than passive management.<sup>21</sup>
- Research shows that active management in certain asset classes has failed to add value over and above a passive benchmark. One study by a well-known

<sup>21</sup> Sharpe, William. "The Arithmetic of Active Management," *Financial Analysts Journal*, January-February, 1991, pp. 7-8.

academic found that the average active investment manager under-performs the Standard and Poor's 500 stock index by 1.83% annually.<sup>22</sup>

- Research also shows that even if investors are able to identify an active investment manager that has succeeded in adding value in the past, there is no guarantee that the manager will succeed in the future. That is, there is no persistence in investment performance.<sup>23</sup>

The experience of the PSF with external investment management is consistent with the above research. The external large cap equity managers, as a group, have under-performed equivalent passive strategies since their inception in 1995 by nearly 0.5% or about \$9 million a year based on the value of assets today, not counting another \$6 million a year in fees. The small/mid cap equity managers have under-performed since their inception in 1998 by 1.4% or \$16 million a year, plus another \$4 million in fees annually.

All interested parties need to recognize that even with optimal governance and organizational structures in place, successful external, active management is far from guaranteed. Without such structures, successful active management would be extremely difficult indeed. As discussed earlier, however, the incremental costs associated with external active management *are significant and guaranteed*.

We recognize that some asset classes (for example, high-yield bonds) are less efficient than others (such as U.S. stocks) or simply cannot be managed internally by most large public investment funds (for example, private equity). Such asset classes lend themselves to either active management or external management, or both. We do not, therefore, recommend that the PSF's investment program should necessarily be managed completely passively and internally. Among the asset classes in which the PSF is presently invested, high-yield bonds are likely candidates for continued external management. Consequently, more than 80% - 90% of the PSF's assets lend themselves to internal, passive management.

Instituting internal, passive investment management will limit the PSF's exposure to conflicts of interest, which is an important consideration for a public trust fund. Academic research indicates that, at least for relatively efficient asset classes, passive management is a more prudent investment strategy. Finally, we conclude that internal management offers significant cost savings that in effect represent risk-free incremental returns.

In light of all of the above considerations, we recommend that, if the governance and organizational structures of the PSF are not changed in accordance with our primary recommendations, one should carefully examine those components of the PSF's investment program that are currently managed actively and externally to determine if any of them can be converted to an internal, passive investment strategy. This would provide the important benefits described above.

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<sup>22</sup> Malkiel, B., *A Random Walk Down Wall Street*, W.W. Norton & Company, Inc., 1999, pp. 261

<sup>23</sup> Dunn P. and Thiesen, "How Consistently Do Active Managers Win?", *Journal of Portfolio Management*, Summer 1983, p. 47-51

Should the SBOE decide in the future to invest in non-traditional asset categories, such as private equity and hedge funds, the importance of employing a passive and internal investment strategy wherever possible would be magnified, because the SBOE would need to focus its attention and oversight on the non-traditional asset classes, which are more complex and will demand more of the SBOE's time and attention.

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## **Section 11 — Responses Submitted by State Board of Education Members**

Responses to the draft report were received from four State Board of Education members. The responses are reproduced on the following pages exactly as received. Cortex’s follow-up comments to the responses begin on page vi of this report.

Mr. Dan Montgomery, State Board of Education Member .....	53
Ms. Gail Lowe, State Board of Education Member .....	55
Mr. Joe J. Bernal, Ph.D., State Board of Education Member .....	59
Dr. Don McLeroy, State Board of Education Member .....	69

In addition, technical comments, including a detailed analysis of Cortex’s recommendations regarding ethics and conflicts of interest, were received from the Commissioner of Education and from Permanent School Fund staff. In response to these comments, Cortex has made several corrections or clarifications to the report. The Commissioner of Education stated that a copy of the technical comments will be provided to the members of the State Board of Education.

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## Response from Mr. Dan Montgomery

I will reply only to Section 10 - Recommendations

- 1) Concur
- 2) Disagree for the following reasons:
  - a) If the audit's recommendation to internally index equities is adopted, there would be no need to have another group of appointed individuals to manage the fund. This would be just another layer of bureaucracy spending taxpayer money with very little to do.
  - b) There is no evidence that appointed boards are less likely to have conflicts of interest than elected ones. In fact, evidence suggests that just the opposite is likely to occur because appointees are usually campaign donors to those that appoint them. Also, individuals who possess "investment expertise" are very likely to be from the money manager and brokerage communities, and would probably favor outside money management, an idea that the auditors seem to oppose. In fact, those individuals mentioned in the audit report as having conflicts of interest would be qualified to serve on this new board because they all have "investment expertise".
  - c) Most of the problems mentioned in the report that supports this recommendation occurred prior to 2001. These problems, for the most part, have since been corrected with new board and PSF committee majorities. In addition, six new board members have come aboard this year. I see no need to try to correct problems that have already been corrected.
- 3) N/A since I disagree with 2.
- 4) Concur (only if the proposed amendment limits the annual withdrawal rate to 4.5% and "allows" but does not "require" the SBOE to use total return.
- 5) Concur
- 6) Concur (only if the SBOE remains the governing board)

### RECOMMENDATIONS TO THE STATE BOARD OF EDUCATION:

I fully concur with all of these recommendations.

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## **Response from Ms. Gail Lowe**

The Cortex Applied Research Inc. draft of the State Board of Education and its fiduciary responsibilities for investment of the Permanent School Fund appears to have skimmed over several pertinent issues in its recommendations.

One key area in the governance review is the relationship between sponsor (the Texas Legislature), fiduciary (the SBOE) and beneficiary (present and future generations of public schoolchildren and, indirectly, state taxpayers). Cortex dwells on its belief that the governance structure, spending policy and asset allocation of the PSF do not adequately reflect the interests of the Legislature. Yet what is paramount is that the fiduciary must act **exclusively in the interests of the beneficiaries, not the sponsor.**

The fiduciary responsibilities for the PSF wisely reflect the Texas Constitution's separation of powers that pioneering Texans believed and generations of citizens since that time also believe to be valuable. Management of the fund is given to the SBOE, while the Legislature controls the spending of the PSF income. Conflicts of interest would arise were the same party to control both spending and investment decisions.

To grant investment oversight of the PSF to a board appointed by members of the Legislature and the Governor of Texas would erase this system of checks and balances, as those who have an interest in spending the funds would also control its management. Appointed members would be accountable only to those who hold power over their appointment, which would inhibit their ability to focus exclusively on the interests of the beneficiaries, as a fiduciary correctly must do.

Cortex also makes the assumption that because SBOE members are elected, they may not have the investment expertise necessary to oversee management of the PSF. By the same logic, since members of the Texas Legislature and the executive branch are elected officials and reflect a diverse body of individuals with various "mandates" for service, there is no guarantee they are any more versed in investment procedures than SBOE members. Indeed, because the responsibilities of these other elected officials divide their time and interests much more so than with SBOE members whose duties and constituent groups are more narrowly defined, SBOE members have the opportunity to devote more time and concentrated focus on their only priority -- public education in Texas and providing adequately for generations of Texas schoolchildren.

The audit report correctly identifies one of the big inhibitors to the SBOE in performance of its fiduciary responsibilities over the PSF: inability to hire the executive administrator of the fund. A PSF chief executive, appointed by a commissioner of education, who in turn is appointed by the governor, clearly creates conflicting expectations for the administrator, whose loyalties should be to the SBOE and beneficiaries of the fund. It is imperative the SBOE be allowed full authority to name the PSF executive administrator, who would report directly to the board rather than to intermediaries or others who control his appointment.

The Legislature can remedy this organizational imposition easily by granting the SBOE authority over the executive administrator and the ability to hold PSF staff accountable. No constitutional amendment is required, and no new level of bureaucracy need be created that would insulate its members from public scrutiny and accountability.

Removal of PSF matters from SBOE committee status to a Committee of the Whole for all investment procedures would help ensure that a few members do not control or distort the process. Informal advisors would have less sway over the board, and the entire 15-member body would more properly exercise its fiduciary responsibilities as a unit. This is a step that could take place immediately and would reduce possible unethical influence exerted by a few individuals who might target a portion of the group.

The Cortex report mentions only in passing another vital point: Research consistently has shown that active managers fail over time to outperform industry benchmarks. They do not add the value their higher fees would warrant. Were the SBOE to move the majority of its PSF investments to passive instruments, managed internally by the Texas Education Agency's PSF staff, not only would it save money on larger external management fees, but it also would lessen the need to solicit outside advice and help avoid potential conflicts of interest.

As asset allocation is the single-most important factor in the performance of an investment portfolio, consultants should be used to provide analysis of the composition of the PSF portfolio. Funds then would be indexed, and rebalancing, based on the asset allocation parameters established by the SBOE, would be performed periodically to ensure the appropriate mix is adhered to, which would generate income to meet the SBOE's biennial revenue estimate as well as ensure intergenerational equity of the fund.

A final issue is the recommendation by Cortex that PSF investments be restructured to reflect a total return policy. In its analysis, Cortex provides no weaknesses to the proposed spending policy. It ignores the fact that total return has become popular with large public trust funds only in recent years. There is no historical track record to show total return is appropriate for PSF spending. As recently as 1985, more than 80 percent of all similar funds utilized income-based spending, as is true of the PSF. Total return has been used largely in the appreciating markets of the last two decades, with nothing to show how such a spending policy would hold up during long periods of declining markets.

Cortex also ignores the Texas Constitution's careful stipulations against decimating the principal of the PSF and its mandate that the income from the perpetual school fund be earmarked for the available operating fund. Title 19 of the Texas Administrative Code, Chapter 33 titled "Statement of Investment Objectives, Policies and Guidelines of the Permanent School Fund" explicitly states "the PSF shall be an endowment fund with a long-term investment horizon. The SBOE shall strive to manage the PSF consistently with respect to the following: generating income for the benefit of the public free schools of Texas, **the growth of the corpus of the PSF, protecting capital**, and balancing the needs of present and future generations of Texas schoolchildren."

Cortex cites the state comptroller's report, "Increase Efficiency of the Permanent School Fund; Increase Distributions from the Available School Fund," issued in January 2003, yet it ignores the comptroller's projections that total-return spending for PSF would lead to a loss of corpus of more than \$3 million in 2005, a loss of almost \$25 million in 2006, a loss of corpus above \$31 million by 2007, and a loss of corpus greater than \$43 million in 2008. Retention of the income-spending policy puts none of the corpus at risk.

Also overlooked is the Bond Guarantee Program, which benefits all the public school districts of the state. The Bond Guarantee Program depends on a stable PSF corpus, which is never touched under the constitutional income-spending structure established

and utilized for more than 125 years. Were the spending structure to change instead to total return, the Bond Guarantee Program would be jeopardized, as the corpus would be affected by both market value and spending.

A Cambridge Associates Study, cited in a previous report by the state auditor's office, verified that "payout rates in excess of 5 percent almost guarantees the depletion of the real value of a foundation." As reported in April 2002 in the New York Times, Deutsche Bank contends that with merely a 4 percent payout, the probability of a fund maintaining its purchase power is only 40 percent. By retaining the income-spending policy that has proven successful for generations of Texas schoolchildren and taxpayers, 100 percent of the principal is protected, and the corpus can be grown to assist in meeting the future needs of education.

\* \* \*

As a side note, the report issued by Cortex mentions prominently the need for a more sufficient code of ethics to govern the SBOE members and others who would deal with PSF matters. While this may certainly be true, it should be noted that details of the confidential Cortex audit were provided to an area newspaper before its public release was allowed, despite a prominent disclaimer atop each page of the report stating there is a penalty for public release. A code of ethics is only as good as those who subscribe to ethical behavior. Having a stringent code in place, with penalties for non-compliance, did nothing to restrict the unauthorized release of this report. To paraphrase President John Adams, our Constitution (and any proposed code of ethics) was made only for a moral people. It is wholly inadequate to govern any other.

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## Response from Mr. Joe J. Bernal, Ph. D.

FROM : HOE, J, BERNAL

FAX NO. : 1

Mar. 14 2003 06:35PM P2

This letter will attempt to deal with some of the issues raised in the report entitled *A Fiduciary Review of Key Governance & Investment Functions of the Texas Permanent School Fund* issued by Cortex Applied Research, Inc., and dated February 2003. The report makes a series of recommendations for the possible future direction of the Permanent School Fund. I regard a number of these recommendations as positive and will help implement them in future State Board of Education meetings. However, some of the recommendations should be rejected. I will attempt to outline my views on the report below.

### *Intergenerational Equity: A Prime SBOE Concern*

As an initial matter the Cortex Report cites the maintenance of "intergenerational equity" as a predominant objective in the management of the Permanent School Fund. State Board of Education members agree and with that proposition. To that very end I seconded the motion made by Mr. Will Davis on March 3, 2000 to hire the firm of Callan & Associates to assist the State Board of Education in creating an asset allocation policy, within the constraints of Article VII of the Texas Constitution, which ensured intergenerational equity. The State Board of Education unanimously approved the selection of Callan at that meeting. You have described the meeting in part in Part B, Appendix 4(C), Page 41-42 of your report, but you miss the point of the Board's discussion by focusing exclusively upon the issue of who was ultimately selected.

On May 12, 2000 the State Board of Education, after considerable discussion and in consultation with its expert advisers, adopted an asset allocation plan that balanced the Fund at 65% equities and 35% fixed income securities. In furtherance of this asset allocation, managers were hired and the Permanent School Fund embarked upon a course of action designed to guarantee the value of the Permanent School Fund to future generations of Texas school children.

### *SBOE's asset allocation plan was radically altered*

In May 2001 the SBOE's asset allocation plan was radically altered at the behest of the 77<sup>th</sup> Legislature. Your report misses the significance of these external pressures. In its 2001 Appropriations Act, the Texas Legislature adopted, as a part of its 2002-03 appropriation to the Texas Education Agency two riders. One of the Riders, Rider 38 merely provided a method of financing for the Board's external asset managers. It had no significant negative impact upon the Fund's performance. It was the second Rider, Rider 90 which negatively altered the State Board of Education's asset allocation plan. Both of these Riders will be discussed below.

#### *A. Rider 38*

The first such Rider, Rider 38 contained a specific authorization for the State Board of Education to expend available school funds in excess of the Comptroller's Biennial Revenue Estimate ("BRE") for the payment of internal costs and external money managers employed by the State Board of Education. Rider 38 provides:

|

**Permanent School Fund: External Management Fees.** Contingent on the State Board of Education adopting asset allocation and investment policies for the Permanent School Fund that produce income to the Available School Fund for support of appropriations above for Strategies A.2.1, FSP - Equalized Operations and C.1.2, School Finance System Operations, in excess of the amounts estimated in the Biennial Revenue Estimate prepared by the Comptroller of Public Accounts for the 2002-03 biennium, additional income projected by the Board for the Available School Fund from Permanent School Fund investments is appropriated to Strategy C.1.2, School Finance System Operations, for expenditure for internal costs and fees for external management of Permanent School Fund assets.

The additional amounts appropriated for external management costs may not exceed .5 percent of market value of funds placed with external managers and may not be transferred to any other strategy within Goal C, Texas Education Agency Operations, or to Goal D, Indirect Administration. The amounts appropriated shall be made available for expenditure on a quarterly basis. Appropriations for external management costs may only be expended if the Board awards contracts for external management services on an open, formal request for proposal process, which gives consideration to both performance and price.

Rider 38 is, of course, necessarily limited by the Board's authority and responsibility under Article VII § 5(d) of the Texas Constitution to manage the assets of the Permanent School Fund as follows:

(d) Notwithstanding any other provision of this constitution, in managing the assets of the permanent school fund, the State Board of Education may acquire, exchange, sell, supervise, manage, or retain, through procedures and subject to restrictions it establishes and in amounts it considers appropriate, any kind of investment, including investments in the Texas growth fund created by Article XVI, Section 70, of this constitution, that persons of ordinary prudence, discretion, and intelligence, exercising the judgment and care under the circumstances then prevailing, acquire or retain for their own account in the management of their affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital. [Emphasis added.]

The provisions of the Texas Constitution are further delineated under the Chapter 43 of the Texas Education Code. This Chapter provides the specific in its delineation of the Board's authority to retain assistance in its management of the Fund. Tex. Educ. Code Section 43.0006(a) provides:

(a) The State Board of Education may delegate investment authority and contract for the investment of the permanent school fund to the same extent as the governing board of an institution of higher education with respect to an institutional fund under Chapter 163, Property Code.

Chapter 163.006(2) and (3) of the Property Code provides that the State Board of Education may:

- (2) contract with independent investment advisors, investment counsel, investment managers, banks, or trust companies to act for the board in investment of institutional funds; and
- (3) authorize payment of compensation for investment advisory or management services.

FROM : HOE. J, BERNAL

FAX NO. : 1

Mar. 14 2003 06:36PM P4

*B. Rider 90 -The Legislative Mandate*

The second and more onerous Rider adopted in 2001 is Rider 90. As opposed to Rider 38 which simply provides a method of financing for PSF operations, Rider 90 is a specific directive that the State Board of Education deliver an increased revenue stream of \$150 Million of income to the Available School Fund during the biennium. Rider 90 provides:

**Available School Fund.** The State Board of Education shall provide to the Comptroller of Public Accounts a memorandum of commitment indicating that changes in the Permanent School Fund investment strategy will result in an additional \$150,000,000 in the 2002-03 biennium over the Comptroller's official estimate of Permanent School Fund interest, dividend, and other revenue earnings as reported in the 2002-03 Biennial Revenue Estimate or, if applicable, in the latest succeeding official revenue estimate issued by the Comptroller prior to the date of the agreement.

Owing to its willingness to cooperate with the Legislature, the SBOE delivered the required memorandum of Commitment to the Comptroller in Fall 2001. No one would dispute the Legislature's desire to secure the additional funding was for the legitimate and beneficial purpose of funding a health insurance program for all public school employees in the State. However, it should be equally clear that the call for additional funds caused the SBOE to distort its previously adopted asset allocation policy. In order to attempt to raise additional \$150 Million in Available School Fund revenues the SBOE was required to move away from its previously adopted asset allocation strategy of 65% equity securities. The change in asset mix moved the SBOE away from its policy goal of intergenerational equity.

Were the events which occurred in the 77<sup>th</sup> Legislature in 2001 an isolated occurrence it could be ignored as an aberration. Unfortunately, this is not the case. The Texas Legislature has had a substantial involvement in setting very precise income standards for the State Board of Education throughout the decade of the nineties. This involvement has manifested itself in form of highly specific Appropriations Act Rider language, which has been incorporated into every General Appropriations Act, which was passed during the Decade of the Nineties.

*1991 - The 72<sup>nd</sup> Legislature, Demand Is Made For An Additional \$50 Million*

In 1991, as a part of House Bill 1, 72<sup>nd</sup> Legislature, First Called Session, the Legislature adopted Rider 22 as a part of the Texas Education Agency Budget in Article III of the Act. This rider was deemed necessary because two serious financial problems created legislative priorities. First, the State was in the midst of the *Edgewood v. Kirby* school finance suit and new funds were desperately needed for equalization. Second, the State was in the midst of a serious decline in property tax values that arose in significant part from the savings and loan crisis. Both of these phenomena increased the demand for increased State funding under the formula funding system. As a result of these influences Rider 22 was placed in the Appropriations Bill. It provided:

**Available School Fund.** It is the intent of the legislature that the State Board of Education provide to the Comptroller of Public Accounts a memorandum of commitment indicating that changes in the Permanent School Fund strategy will result in an additional \$ 50 million in Available School Fund income for the 1992-1993 biennium.

This income contemplated by this rider was in addition to the revenues estimated by the Comptroller and specifically set forth in the Method of Finance portion of the Bill. Dr. Carolyn Crawford, Chair of the State Board of Education on behalf of the entire Board, executed the memorandum of commitment. As a result of this commitment and because of the income driven spending rule in the Texas Constitution, the State Board of Education raised revenues by shifting its asset allocation towards fixed income securities and away from equities. By shifting assets the State Board of Education met its enhanced income targets for both years of the biennium.

*1993 - 73<sup>rd</sup> Legislature, Additional \$50 Million Is Demanded*

In 1993 the Legislature was still faced with the twin problems of *Edgewood v. Kirby* and continuing declines in statewide property values. Again the State Board of Education was called upon for additional support. The provisions of Texas Education Agency Rider 58 in Article III of Senate Bill 5, 73rd Legislature, Regular Session imposed this legislative mandate. Rider 58 provided:

**Available School Fund.** The State Board of Education provide to the Comptroller of Public Accounts a memorandum of commitment indicating that changes in the Permanent School Fund strategy will result in an additional \$ 50 million in Available School Fund income for the 1994-1995 biennium over the Comptroller's official estimate of Permanent School Fund interest, dividend and other revenue earnings as reported in the Biennium Revenue Estimate for 1994-95 or, if applicable, in the latest succeeding official revenue estimate issued by the Comptroller prior to the date of the agreement.

Because the structural changes that the State Board of Education had enacted to meet the 1992-1993 revenue targets had been factored into the Comptroller's revenue estimates, the State Board was forced to shift additional assets out of equities and into higher income producing fixed income securities in order to meet this enhanced revenue requirements. Again, the State Board executed the memorandum of commitment. Again it shifted assets and met the income target for 1994.

*1995 - 74<sup>th</sup> Legislature, The State Board Gets Billed for a Revenue Shortfall*

In FY 1995 owing primarily to an enormous disruption in the bond markets during the last quarter of 1994, the Board failed to meet its enhanced income target for 1995. The Board was able to exceed the revenues set forth in the Comptroller's revenue estimate, but it fell short of meeting the enhanced revenue requirement imposed by Rider 58. This is the only year during the decade in which the State Board of Education could arguably have failed to meet the income target set by the Texas Legislature through its various appropriations riders.

The Legislature was informed of the revenue shortfall when the 74<sup>th</sup> Legislature convened in January 1995. As was stated above most of the damage to the markets had been done by December 1994. The Legislature did not however, ignore the shortfall. The State Board of Education was presented with a bill for the shortage in the form of Texas Education Agency Rider 48 in Article III, House Bill 1, 74<sup>th</sup> Legislature, Regular Session. Rider 48 provided:

**Permanent School Fund: External Management Fees.** Provided the State Board of Education adopts asset allocation and investment policies for the Permanent School Fund that will produce a minimum of \$673,762,000 in income in fiscal year 1996, in addition to any one-time recognition of income pursuant to S.B. 409, Seventy-fourth Legislature, Regular Session, plus any shortfall in income below the \$733,020,000 estimated for fiscal 1995 in the Biennial Revenue Estimate, and a minimum of \$625,367,000 in income in fiscal year 1997 for the Available School Fund for support of appropriations above for Strategies A.1.1., School Finance System and B.1.1., School Finance – Operations, additional income projected by the Board for the Available School Fund from Permanent School Fund investments is appropriated to Strategy B.1.1., School Finance-Operations, for expenditure for fees for external management of Permanent School Fund assets.

The additional amounts appropriated for external management costs may not exceed .5 percent of market value of funds placed with external managers and may not be transferred to any other strategy within Goal B., Equity and Achievement-Operations, or to Goal C., Indirect Administration. The amounts appropriated shall be made available for expenditure on a quarterly basis. Appropriations for external management costs may only be expended if the Board awards contracts for external management services on an open, formal request for proposal process which gives consideration to both performance and price.

Rider 48 was significant in several respects. The 1994-1995 biennium presented a far better economic picture than the prior two. Property wealth had begun to rise on a statewide basis. Other tax revenues were increasing as a result of general economic improvement. Finally, the recapture provisions that had been built into the school finance system by Senate Bill 4 from the previous session were proving to be a significant source of revenue for school finance. After a lengthy asset allocation study conducted by a national asset allocation consultant (Mercer), Texas Education Agency staff conducted lengthy discussions with the LBB staff and the Comptroller's office about restructuring the Permanent School Fund along the lines of Modern Portfolio Theory. This meant that the PSF would increase its equity exposure and reduce its exposure to fixed income securities. This shift would naturally result in a reduction of income under the Constitutional definition, but it would increase the total return of the PSF. The income reduction is reflected on the face of the rider itself. The income expectation for FY 1995 was set at \$ 733,020,000. For FY 1996 the income target was set at \$ 673,762,000. For FY 1997 the income target was set at \$ 625,367,000.

After the legislative session started discussions were held with legislative leadership. These discussions culminated in the language of Rider 48 being placed into the Appropriations Act. The Legislature was aware of the specific income target demanded of the State Board of Education by these negotiations. For the first time, the rider set revenue targets directly in law instead of by reference to the

Comptroller's revenue estimate.

The State Board of Education met the income targets of Rider 48, including the make up provision. The rider also authorized the Board to employ and pay outside money managers to assist in managing the PSF. Rider 48 required that the PSF earn sufficient revenues to pay these outside managers in addition to the Fund's obligation to deliver the specified amount of revenue to the Available School Fund. Again, the State Board was able to meet all income targets in the Rider.

*1997 – 75<sup>th</sup> Legislature, The State Board Is Left To Manage The Fund*

In the 1997-1998 the pattern established in the previous biennium was continued. Economic conditions continued to be positive and property values continued to grow. The 75<sup>th</sup> Legislature passed House Bill 1 which contained as a part of the Article III Texas Education Agency Appropriation, Rider 44, which provided:

**Permanent School Fund: External Management Fees.** Contingent on the State Board of Education adopting asset allocation and investment policies for the Permanent School Fund that produce income to the Available School Fund for support of appropriations above for Strategies A.2.1., Foundation School Program and C.1.2. School Finance System- Operations, in excess of the amounts estimated in the Biennial Revenue Estimate prepared by the comptroller of Public Accounts for the 1998-99 biennium, additional income projected by the Board for the Available School Fund from Permanent School Fund investments is appropriated to Strategy C.1.2., School Finance System-Operations, for expenditure for internal costs and fees for external management of Permanent School Fund assets.

The additional amounts appropriated for external management costs may not exceed .5 percent of market value of funds placed with external managers and may not be transferred to any other strategy within Goal C., Texas Education Agency Operations, or to Goal D., Indirect Administration. The amounts appropriated shall be made available for expenditure on a quarterly basis. Appropriations for external management costs may only be expended if the Board awards contracts for external management services on an open, formal request for proposal process which gives consideration to both performance and price.

*1999 – 76<sup>th</sup> Legislature, The State Board Is Again Left To manage The Fund*

The 76<sup>th</sup> Legislature continued the pattern established in the prior biennium by adopting House Bill 1, which contained as a part of the Article III Texas Education Agency Appropriation, Rider 40, which provided:

**Permanent School Fund: External Management Fees.** Contingent on the State Board of Education adopting asset allocation and investment policies for the Permanent School Fund that produce income to the Available School Fund for support of appropriations above for Strategies A.2.1., Foundation School Program and C.1.2., School Finance System-Operations, in excess of the amounts estimated in the Biennial Revenue Estimate prepared by the Comptroller of Public Accounts for the 2000-01 biennium, additional income projected by the Board for the Available School Fund from Permanent School Fund investments is appropriated to Strategy C.1.2., School Finance System-Operations, for expenditure for internal costs and fees for external management of Permanent School Fund assets.

The additional amounts appropriated for external management costs may not exceed .5 percent of market value of funds placed with external managers and may not be transferred to any other strategy within Goal C., Texas Education Agency Operations, or to Goal D., Indirect Administration. The amounts appropriated shall be made available for expenditure on a quarterly basis. Appropriations for external management services on an open, formal request for proposal process which gives consideration to both performance and price.

During the period of reduced income expectations, from FY 1996 through 2000, the PSF corpus increased significantly. As a result of both Legislative foresight, and the prudent management of the State Board of Education, the Permanent School Fund significantly enhanced its capacity to assist in the financing of public education in this State. Additionally during the six year period during which Legislative interference was minimized, the PSF's performance was outstanding. The performance decline in the 2001 Fiscal year was as a direct result of the SBOE's response to Legislative demands for additional revenue in excess of the Comptroller's Biennial Revenue Estimate.

*Increasing Legislative Access to PSF Will Not Improve Intergenerational Equity*

The SBOE has frequently discussed, debated, and decided that maintaining its current asset allocation policy, including its current external investment managers and accompanying schedule of fees, best fulfills the SBOE's constitutional mandate to manage prudently the assets of the Permanent School Fund. The record is clear. If the policy goal is to encourage intergenerational equity, it is best to isolate the PSF from the biennial cash demands that are the inevitable Legislative response to the appropriations process. As can be readily seen from the funding crisis being experienced by the 78<sup>th</sup> Legislature, if an option to extract additional revenue from the Permanent School Fund is offered to an appropriations process which is in need of cash, the temptation extract additional funds at the expense of future growth becomes irresistible to the Legislature. Appropriations bills, which by their very nature have only a two year lifespan, do not take the long view.

Because of the foregoing history, I must reject Recommendations I. Your proposition that increasing Legislative control will promote intergenerational equity is simply not supported by the evidence. The historical record clearly demonstrates that the opposite is true. Therefore, I, and I am sure that my colleagues will support me in this, strongly disagree with your proposition that the State Board of Education should be replaced as the fiduciaries of the Fund. History shows that the independence of the State Board of Education is the only viable bulwark of intergenerational equity. This relationship must be preserved. Since 1995 and the adoption of the first PSF asset allocation strategy, the State Board of Education's stewardship of the fund has been directed toward the management of the corpus in a manner sufficient to grow sufficiently to keep up with inflation plus growth in student population growth. That was a key reason for outsourcing since 1995. As can be seen in the performance of the PSF in comparison to other State funds, the policy has been successful.

*Other Issues*

I agree with your Recommendation 3, that the Executive Director should be appointed by the Board. As I and numerous other Board Members related to you in your interview, the situation in which the Fund's Executive Director does not work for the Fund's trustees has caused much unnecessary turmoil. I am gratified we agree.

Your recommendation that the Executive reporting relationship should be changed only if the State Board of Education is replaced is illogical. Your appendices carefully chronicle circumstances in which the State Board of Education differed with the PSF Executive Administrator. What you fail to note is that the Board seldom disagreed with or failed to follow the advice of its primary outside consultant, Callan & Associates. The lack of disagreement with Callan is due to the simple fact that the State Board of Education shared the same investment philosophies as Callan. That is as it should be. The Board selected Callan. The most recent PSF Executive Administrator, Paul Ballard, was not selected by the State Board of Education. He was named by Commissioner Nelson without the consent of the Board. Mr. Ballard did not share the same investment philosophy as a majority of the members of the State Board of Education. Consequently there were disagreements. The necessary alignment between the SBOE and its staff did not exist. At page 27 of Part A of your report, you delineate the traditional organizational structure for a fund such as the PSF. This model could be easily remedied within the current fiscal structure by having Commissioner Alanis delegate the responsibility of selecting the Fund's Executive Administrator to the State Board of Education. This is hardly a radical notion. Prior to the unilateral selection of Mr. Ballard, every prior Executive Administrator of the Permanent School Fund had been approved by the SBOE. The system has served the State well in the past. It was not the State Board of Education which departed from it. We should return to it.

In recommendation 4 you repeat a recommendation that has been presented to the Legislature on numerous previous occasions. While I am aware that the State Auditor's Office has persistently attempted to induce Legislative action in favor of the total return concept, these attempts have been rejected. Your argument that the fund's performance would be enhanced by adopting this concept is not supported by the facts. The Texas Permanent School Fund, when it has been unburdened by Legislative Riders, has consistently exceeded the performance of its policy benchmarks. This fact has been recently documented by the State Auditor's Office. This record of consistent performance should not be disturbed. As to the recommendation the Board should be given enhanced "discretion" in adopting a spending policy, I refer you to the opening section of my remarks. We can rest assured that any discretion in spending policy will be used by a cash starved Legislature as a means of extracting ever increasing current revenues from the fund at the direct expense of intergenerational equity.

As to your recommendations 5 and 6 regarding periodic reporting and review by the Legislative Audit Committee, I agree that the Texas Permanent School Fund, as all other State funds should be subject to periodic review. We would welcome the opportunity to demonstrate our history of performance alongside of our sister funds. We know that we will compare favorably.

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*Response to Recommendations Beginning On Page 46*

Both my colleagues and I have noted the recent history of disagreement between the full State Board of Education and the PSF Committee. Your recommendation 1 attempts to deal with this situation by essentially disenfranchising the ten SBOE Members who do not sit on the PSF Committee. There is a better way. In order to rectify that situation and to ensure that each State Board of Education member has a full set of information upon which to make decisions, we will be discussing the realignment of State Board of Education Committees to conduct Permanent School Fund business before the Committee of the Whole. In that manner, all members will be able to fully participate in the deliberative process.

In recommendation 2 you recommend that the fund abdicate its responsibilities for the Fund to its staff. We reject this notion. As fiduciaries of the Fund we must retain the ultimate responsibility for decisions that impact the Fund. The State Board of Education meets in open session in order to conduct its business. This adds accountability to the process. SBOE decisions regarding PSF operations are openly debated with opportunity for public input into the process. Delegation to staff would remove the existing transparency in the process.

In recommendations 3 and 4 you advocate increased utilization of the Investment Advisory Committee. I agree. This Committee was recently re-established after having been functionally disbanded by Commissioner Moses. The Board and the IAC are currently working smoothly together. The process should be given time to work. Artificial constraints, such as the Commissioner's limitation of two meetings per year, should be removed in order to ensure success. In the upcoming months the Board will be revising its charge to the IAC to build upon its growing relationship.

I agree with recommendations 5 and 6, although as I have discussed above, I believe our asset allocation embodies our investment philosophy.

I agree with your Recommendations 7 and 8 and hope that the State Board of Education will lead the way in providing fiduciary education not only for its own members, but for all trustees of public funds in Texas as well as for candidates.

I am proud that the State Board of Education currently has the most rigorous ethics policy in the State of Texas. We will continue to monitor compliance and to make modifications where they are necessary. We will review the recommendations contained in your Appendix 5 in the near future. You may rest assured that we will make our ethics policy work for all of us.

*Indexing*

Finally, I cannot agree with your premise on indexing. Indexing does not eliminate conflicts or enhance performance. The State Auditor's Office recently looked at performance in its *Report Comparing Texas's Five Largest Long Term Investment Funds*,

February 2003. In Chapter 2-A the Auditor's Office found that:

PSF's total fund underperformed its policy index in the one-year period ending June 30, 2002, but outperformed its policy index in the three- and five-year periods.

As discussed above the Funds one-year underperformance is explainable by the distortions caused by the SBOE's attempts to raise the additional funds demanded by Rider 90. The five-year number is reflective of the Board's long term performance which compares favorably with all State funds. Over ten years the PSF's total annualized return of 11.75% per year exceeded the performance of the ERS, the PUF, and equaled the return of TRS. Active management both by internal and external managers has long been a part of the mix. The 2000 State Board of Education asset allocation developed in conjunction with Callan & Associates carefully considered the proper mix of active and passive management styles. Currently one-half of the PSF's Domestic equity portfolio is managed actively and one-half is indexed. This mix was carefully determined to optimize performance should remain undisturbed until the Board reconsiders its asset allocation. We believe that an appropriate asset allocation plan which is strictly followed can ensure superior investment performance. The Board, in conjunction with its consultant, Callan & Associates has carefully weighed the relative merits of active and passive management styles. The current asset allocation strikes what the Board believed to be an appropriate mix. There is no data or information presented in the Cortex report which would lead us to alter our previous decision. Our current asset allocation should be given the opportunity to work over the long term, as it was intended to do.

## **Response from Dr. Don McLeroy**

### **Part I**

#### **I. Introduction**

I warmly and enthusiastically welcomed the prospect of a fiduciary governance audit for the Permanent School Fund (PSF). As a former local school Board member, it had been drilled into us that the key to successful governance is in the Board's responsibility to hire and fire the superintendent. The wisdom of that governance structure impressed me.

The importance of this governance structure was also impressed upon me by a presentation given by Keith Ambachtsheer to the State Board of Education (SBOE) at a PSF Board training session in May 1999. He clearly identified that the key issue in the performance of any fund is the proper relationship between the Board and its chief executive officer (CEO). At the PSF, we do not have it.

Therefore, I saw the opportunity of a fiduciary governance audit as the key in winning legislative support to help us correct this flaw in the governance of the PSF. I expected the audit to give an unqualified strong recommendation to restore SBOE authority to hire and fire our CEO—the Executive Director; I expected an accurate, professional, unbiased analysis of our spending policy. I also expected that a thorough fiduciary review would identify other governance issues, conflicts of interest issues, and ethical issues that would make the effort worth the estimated \$250,000 cost.

After Cortex was hired, I prepared a 500 page notebook of relevant documents, transcripts and analyses so that they would know the “story” that had been ignored in earlier reviews and reports. This notebook was organized around the charge given in the Consultant Proposal Request issued by the State Auditor's Office (SAO). Cortex even commented that no fiduciary had ever gone so much trouble for any of their other audits. I told them that no fund had ever needed a Board member to do so.

#### **General Response to the Draft Release**

I was greatly disappointed by this review. While it is highly readable (in contrast to the previous *State Auditor's Office 2001 Report* and *November 2000 House Committee on General Investigating Report*), it presents recommendations that, if adopted, will harm the fund. Most importantly, implementation of their recommendations will remove from the fund its key distinctive protective separation of powers between fiduciaries and sponsors; second, it will leave untouched the key structural governance flaw of the PSF—the Board's lack of authority over its CEO.

In my view, this review, instead of being an impartial analysis, perfectly reflects the view of people that hired them—the SAO. Cortex's recommendations are a rewrite of *State Auditor's Office 2001 Report*. By selective recognition of certain facts and omission of others both reports justify removing the PSF from the State Board of Education and setting up a special appointed Board to govern it. They both require that the appointed Board members have financial expertise. They both recommend giving this new Board the authority to hire and fire its CEO and they both fail to recommend

restoring to the present SBOE the power to hire and fire its CEO. (i.e., If their recommendations #1 and #2 are not adopted.)

Not only does this review offer flawed recommendations that would harm the fund, it also does not follow the Consultant Proposal Request's mandated guidelines as issued by the SAO last June. In the key paragraph about the purpose of the audit, the Consultant Proposal Request states:

*"In assessing the PSF, the consultant should consider the actions taken or decisions made by any party associated with the PSF. However, this review is **not** intended to be a conclusive investigation of any individual allegations or occurrences." (Emphasis added)*

I specifically met with Carol Smith, Roger Farris and Joe White of the SAO and I was assured this fiduciary audit was not to be a rehash of previous reports.

If it was, I wanted included the scope of the audit, an evaluation of all the previous actions and reports of all parties, including for example, the accuracy and completeness of reports issued to the legislature by the SAO, the Comptroller, and the PSF staff and legislative committees. Cortex's review does not evaluate these earlier reports; they accept them as authoritative and objective. No mention is given to the extended Board responses that refute the claims made in these reports.

This review does contain some excellent information and some useful recommendations. However, these are all overshadowed by its failure to fully correct the PSF's most fundamental governance flaw and by its failure to follow the guidelines set forth in the Consultant Proposal Request.

### **The Scope of My Response**

This response will consist of six main sections. The first section will deal Cortex's analysis and protection of the PSF's constitutional separation of powers established by the Constitution of Texas of 1876. The early history of the fund clearly showed the need for the creation of a State Board of Education to oversee the fund; recent history confirms it. Cortex's review never fully grasps the SBOE's special significance. Thus, Cortex begins its review by recommending Texas should abolish its pioneers' safeguard separation of powers.

The second section will establish the unequivocal need for the SBOE to have its authority over its CEO restored. It will show that much of the criticism of the Board included in this review and used as evidence to replace it with a new Board, is a direct result of the removal of this authority from the Board in legislation passed in 1995.

The third section will deal Cortex's violation of the scope of the audit given in the purpose of the Consultant Proposal Request. By overstating facts, by understating facts, and by simply ignoring and disregarding relevant facts Cortex presents a story that is a distortion of what really happened at the PSF. It is in this telling of their story that Cortex goes beyond the scope of the audit and violates the mandate given them in the Consultant Proposal Request.

The fourth section will highlight the areas of agreement and areas where their report is helpful.

The fifth section will deal with Cortex's recommendations in the areas of spending policy, and intergenerational equity. Cortex, like the SAO that hired them, miss the real reason the PSF's per capita student spending has decreased and blames it on the spending policy. In my response I will include the real reason for the drop in spending levels. I will also challenge the reasoning of their analysis.

The concluding section will provide an alternate set of recommendations. They will be in alignment with the ageless principles of the Texas historical pioneers who set up this fund to be permanent.

## **II Section One—Separation of Powers and the SBOE's Independence**

### **The Constitution of 1876 Establishes the Separation**

The PSF has just faced and survived the second greatest crisis in its history during the last legislative session. Cortex's review will be used to re-ignite this crisis. I was hoping it would be the salve that would heal the PSF's governance flaws.

In 1854 we had the birth of the PSF which was then named the Special School Fund. It began with an endowment of \$2 million in leftover bonds that Texas had received as payment for disputed territory. It immediately faced its first crisis as the fund barely survived its infancy and teen years. It was during this period that early state legislatures appropriated money from the fund for non-school uses. Fortunately, at the age of 22 it was given constitutional protection, and very importantly, it was given a new name—the Permanent School Fund—to signify the purpose and vision of the fund.

The newly adopted State Constitution of 1876 set it apart and protected it from the difficult and demanding biennial appropriations process. In the beginning, it was this entanglement with the budget process that almost doomed the fund and it was to protect the fund from this entanglement that our state forefathers made the changes, gave it its new name, and gave it a special governance Board with special investing guidelines. The goal was to benefit all the future school children of Texas. Strict restrictions were established for preservation of capital and protection of the corpus. This constitutional arrangement has served our great-great-grandparents, and is poised to provide for our great-great-grandchildren.

In the 127 years since 1876, this vision of the fund was never been seriously threatened; the commitment of all Texans has been to maintain the fund as established in The Constitution of Texas 1876. Last session, however, a lot of the state government's attention was focused on the PSF and its then \$22 billion. At the beginning of the 77th Legislature session there was a *State Auditor's Office 2001 Report* and *November 2000 House Committee on General Investigating Report* recommending changes; there was a Senate Subcommittee Report recommending changes; the Lieutenant Governor, the Comptroller, the Land Commissioner, the Speaker of the House, the Senate Finance Committee Chairman, the House Appropriations Committee Chairman, all supported constitutional changes for the PSF.

Today, in the middle of the 78<sup>th</sup> legislature, it is this Cortex review that is recommending changes.

The PSF’s second major crisis is essentially the same as the crisis of its infancy—a crisis of entanglement with the budget process. It would be wise to position the Fund once again on a solid base that can carry it independent of the appropriations process for another 127 years.

Cortex understands the importance of this separation of powers. In their Consultant Proposal Request response that earned them this contract, they state in Appendix G:

*(The following are exact quotes except for the added emphasis and the words “state leadership” is substituted for “sponsor”, “Texas school children” for “beneficiaries” and “Board” for “trustee”.)*

*Criterion ONE: The functions of the State Leadership and Board must remain separate.*

*In developing a governance framework, it is critical that all parties recognize the distinctions between State Leadership and Board roles. Each plays a fundamental role in the development and operation of a plan, but each must function separately to avoid conflicts and complications that can impede the plan’s effectiveness. ....*

*Even though the State Leadership creates the Board, the same party cannot effectively execute the two roles. In a multi-employer plan, the party that acts as State Leadership should not also act as Board; nor should the Board act as the plan’s State Leadership.*

*Among other things, this separation of roles provides an additional check on the State Leadership. In assuming their role, the Board also assume a fiduciary obligation to protect the interests of the Texas school children, even from the State Leadership. ....*

*Likewise, the separation of roles also facilitates decision-making by State Leadership. State Leaders are not fiduciaries. They are free to make decisions in pursuit of other interests. Relieved of Board obligations to the plan’s Texas school children, State Leaders can better focus on State Leadership-related decisions. (Emphasis added)*

In spite of what they believe, when Cortex wrote their review, they forgot their own advice and put forth recommendations that would weaken this 127 year separation of powers. However, even as they recommend a new Board, they insist that the first requirement for that Board is to:

*“be sufficiently independent to ensure that fiduciary decisions affecting the PSF are not unduly influenced by non-fiduciary considerations that may be detrimental to the long-term financial integrity of the PSF.” ( p. iii) (Emphasis added)*

Why not just maintain the present Board? The present Board ensures this independence as much as is possible.

The Cortex review also mischaracterize the relationship of the PSF to the state budget as a potential “shortfall”. The money generated by the PSF should always be looked at as a “windfall”—a gift from our Texas forefathers. It should never be looked at as a “shortfall”. Ideally, the SBOE should manage the fund without any consideration of

current budget conditions of the state; the SBOE focuses on only one goal—intergenerational equity. Then, in order that the legislature can effectively plan its budget, the Comptroller includes an estimated projection of income in its Biennial Revenue Estimate (BRE).

The fund will either exceed or fall short of this estimate depending on the accuracy of the estimate and/or what the prudent management of the fund toward intergenerational equity will generate. In either case, the money generated is a “windfall” for the legislators.

As already mentioned, there was a strong coordinated effort to increase income from the PSF during the 77<sup>th</sup> legislature without considering intergenerational equity. Today, under much greater budget pressures, the effort continues to extract extra income from the fund. Clearly, with the current separation of powers and the independence of the SBOE, the fund has a much better chance of being protected from overspending.

### **Recent Legislation Threatens the Pioneer’s Separation**

The minutes of a Board PSF training session on March 3, 1999 reflect Mr. Jim Hooks, former executive director of the PSF, as telling Board members: “The biggest threat to the PSF was attempts by the Legislature to extract greater income from the fund.” I agree.

As an example, Senator Bill Ratliff, as reported in the *Longview News Gazette* on July, 31 2000, suggested “And I think the public would vote for a constitutional amendment that would allow us to invade the Permanent School Fund one time so that we could completely shift all of our schools in Texas.” (to laptop computers for textbooks )

The following is a list of recent legislative actions that have established beyond doubt that legislative oversight exists in abundance. Unfortunately, all these actions have weakened the funds ability to meet its intergenerational goal and thus have harmed the PSF.

### HB 3558

Cortex mentions HB 3558 but offers no opinion on the appropriateness of the legislation:

*The Contributions from the General Land Office (GLO) – Exhibit IV shows that GLO contributions have remained relatively stable in absolute dollars over the last 12 years, but have fallen as a percentage of the assets of the PSF. The Legislature amended the Natural Resources Code effective September 1, 2001 to allow the GLO to deposit some or all of the proceeds of future mineral leases and royalties into a special account to be used by the School Land Board within two years to acquire fee or lessor interests in real property, mineral and royalty interests. The amendment stipulated that any money remaining in the account longer than two years must be transferred to the SBOE for investment in the PSF. Reinvesting funds in real estate or minerals may reduce the GLO’s future contributions to the PSF. (p. 16) (Emphasis added)*

This bill virtually eliminated all new GLO cash flow contributions into the corpus of the Fund.

- In FY 2000, before HB 3558, the GLO contributions were \$291,880,880;
- In FY 2001, after HB 3558, the GLO contributions were \$5,207,665.

This new money is the most important money in the PSF as it gives the PSF flexibility to help maintain its long-term adopted asset allocation.

When you analyze Cortex's total return percentages on page 23, you will see that the loss of the one percent GLO contributions would mean the payout of the fund would be only 2.5%. A \$17 billion fund would then pay out only \$425 million a year.

This legislation clearly shows that the legislature is still strongly represented on PSF matters. Thus Cortex's main contention that the legislature is not represented on PSF issues is contrary to the facts. This legislation clearly hurt the PSF.

### Rider 38

The last several appropriation bills have included a Rider that require a major portion of the funding that pays the fund's administrative expenses to be contingent on the fund exceeding the Comptroller's BRE. Cortex mentions this Rider but offers little opinion on the appropriateness of the legislation. Cortex limits its comments to: "This is a significant constraint and a very real problem." (Appendix p. 33) They, however do not find it significant enough to rate a recommendation.

Since the BRE is currently estimated by assuming the average historical stock market return, this means that 50 percent of the time, when the markets are below average, we will not be able to pay our bills. This totally unnecessary constraint has severely crippled the fund's asset allocation this biennium.

This legislation also clearly shows the legislature is still strongly represented on PSF matters. Thus Cortex's main contention that the legislature is not represented on PSF issues is contrary to the facts. This legislation clearly hurt the PSF.

### Other Riders

In 1991, the 72<sup>nd</sup> Legislature in HB 1, Rider 22 requested an additional \$50 million over the Comptroller's Revenue Estimate for the 1992-1993 biennium.

In 1993, the 73<sup>rd</sup> Legislature in SB5, Rider 58 requested an additional \$50 million over the Comptroller's Revenue Estimate for the 1994-1995 biennium.

In 1995, the 74<sup>th</sup> Legislature in HB1, Rider 48 actually specified income in the law. The Legislature in SB 409 required an additional \$42.1 million in 1996, and SB 1 removed the appropriations budget of the SBOE and gave it to the Commissioner of Education.

While Cortex was presented with this information, they fail to find it significant enough to comment on. All of these riders demonstrate the legislature's historic record of dealing with the PSF; it demonstrates that the legislature wants to spend the money. Do these riders show a commitment to intergenerational equity? To the future schoolchildren of Texas?

Again, this legislation clearly shows the legislature is still strongly represented on PSF matters. Thus, Cortex's main contention that the legislature is not represented on PSF issues is contrary to the facts. All this legislation clearly hurt the PSF.

### Summary

In summary, the present 127 year old separation of fiduciaries and sponsors promotes and protects Texas' pioneer's vision. By the examples given above, the proposed changes by Cortex to increase the legislative role would weaken this vision. What we need is to reestablish and strengthen this separation of powers that protect this fund.

### III. Section Two—Authority over the Executive Director

#### The Cortex Philosophy on the Authority to Appoint the CEO

Cortex, in applying for this job in their Consultant Proposal Request response, unequivocally established their belief in a Board having the proper authority over the CEO. In Appendix C "Cortex's Governance Experience" they state:

*A properly constituted Board with requisite authority that understands its role and, and as a fiduciary body, possesses the necessary skills, experience, integrity, time and equally important, the will and authority to act, is the cornerstone of good governance... Boards, in order to be held accountable and to hold staff accountable, should: a) set out the policy framework within which staff can operate; b) insure that the policy framework is complied with; and c) Select senior staff to carry out the functions that require specific professional expertise. (Emphasis added)*

In Appendix D "Sample Decision Matrix" they list governance priorities. For the Board:

- The first priority in "policy" is to approve its own chairperson and the CEO.
- The first priority in "operations" is to appoint a CEO and provide advice and counsel as appropriate.
- The first priority in "monitoring" is to evaluate the performance of the CEO.

For the CEO:

- The first priority for the CEO in "policy" is to provide support for its Board.
- The first priority of a CEO in "monitoring" is to ensure the Board receives necessary reports and information to enable it carry out its oversight role.

In Appendix H entitled "Good Pension Governance: An Advocates Guide for Improvement" they note that lack of clear roles has resulted in numerous problems such as strained working relationships between Board and staff. They state:

*The devil is in the details and in the case of a public pension fund there are an awful lot of details. For example: Who hires service providers (e.g. investment managers, investment consultants...)? Who hires staff (the Chief Investment Officer, the portfolio managers etc.)?" (Emphasis added)*

In all of these statements they are echoing what a fellow Canadian told the Board in 1999. At that meeting and in his book Pension Fund Excellence, Creating Value for Stockholders, John Wiley & Sons Inc., 1998, Keith P. Ambachtsheer declares:

- The number one blockage to achieving excellence in pension fund management is organizational dysfunction.
- Only Boards and chief executives who respect each other, and can work well together, have any chance of removing such barriers to excellence.
- *What is the difference between competent and incompetent Boards? ....They know what they don't know. They are prepared to hire a competent CEO and delegate management and operational authority, and are prepared to support a compensation philosophy that ties reward to results.(Emphasis added)*

### **Cortex's Puzzling Recommendations**

With all this in mind, how can Cortex recommend only giving a new Board the authority over its CEO? They back away from their own statements and declare "If an only if" a new Board is created will the PSF be good enough for this undeniably beneficial governance structure. This recommendation is not an affront to the SBOE, it is an affront to the PSF. What's good for an appointed Board is not enough for an elected Board—so the PSF suffers. No justification for this discrimination is given.

Up until 1995 the SBOE had this authority. Before this authority was taken away there were no governance problems. Since 1995 the governance has deteriorated.

It should be noted that in making this recommendation they follow the same view of the people that hired them. The *State Auditor's Office 2001 Report* made the exact parallel recommendation: "The Legislature could give the investment Board its own budget, possibly funded from investment returns, and permit it to appoint and replace the fund's chief investment officer."(p. 20)

One of the consequences of the lack of authority of the SBOE has been the rise of the "informal adviser". In fact, the Cortex report openly parallels the *State Auditor's Office 2001 Report* in the use of the term "informal advisor." Cortex uses the exact same term that permeates the *State Auditor's Office 2001 Report* and the *November 2000 House Committee on General Investigating Report*. At least, Cortex correctly observes the correlation of the governance structure—the lack of authority over the CEO—with the presence of the informal adviser. The question is: If they believe the informal adviser is such a major problem, why do they not recommend that authority over the CEO be restored so that the need of an informal adviser will be eliminated?

### **Cortex's Omissions of TEA Lack of Fiduciary Loyalty**

One of the major flaws of this review, like the *State Auditor's Office 2001 Report*, is the selective recognition of certain facts and omission of others. Would the following have occurred had the SBOE had the proper authority?

#### Commissioner Nelson Appoints Paul Ballard

The Cortex Review is silent about a real disruption that occurred between the Board and its CEO. Commissioner of Education, Jim Nelson abruptly broke off a cooperative effort with the PSF Committee to select a new Executive Director. He appointed Paul Ballard to the job, when it was well known that Mr. Ballard did not have the support of a major

portion of the Board. If the Board can not do its on selection, at least the appointment must be with their support. Evidently to Cortex, this antagonistic action by the Commissioner did not deserve mention in their report.

### HB 3558

Staff knew about this bill in early April of 2001, during the legislative session. The SBOE was not notified about this bill throughout the 77th legislature by our TEA for five months. Without notification, the SBOE had no opportunity to present its case to the legislature when the bill came up for public debate. This withholding of information of H. B. 3558 from the SBOE is a serious matter. It has led to a lack of trust and confidence in the TEA staff by many on the Board. Also, that the legislature would pass this bill without notifying the Chairman of the SBOE deserves mention, as Cortex's review would give the legislature more control over the PSF. The passage of this effectively eliminated new money into the PSF.

### Paul Ballard Meets with Legislative Leaders

Texas Education Code Chapter 33 specifically gives the SBOE the exclusive duty of "representing the PSF to the State." It states PSF staff shall only "advise any officials."

Board member Will Davis was the unofficial Board designee to perform this duty. Since he lived in Austin and knew many members of the legislature, he would informally negotiate with the legislature about prospective income. In 2001, during the last legislature, two Board members were likewise informally negotiating with legislators with the knowledge of many other Board members. These meetings, while not commissioned by the Board, are the only effective way the Board has to represent the school fund to the state, since the Board only meets every two months, these members took the initiative to takeover the now departed Will Davis' unofficial designation to talk to the legislature. They knew that they would have to convince the rest of the Board to formalize any of their negotiations.

At that point we had, according to the tape of the PSF Committee meeting on May 10, 2001, "an unprecedented visit from Rob Junell and Rodney Ellis to Paul Ballard's office." This was confirmed, according to the tape of the SBOE meeting on July 13, 2001, by Commissioner Nelson who stated "We were very involved with Senator Ellis and Representative Junell. Paul, in particular, had a number of meetings with them to kind of iron-out some of these things." The problem is these meetings were contrary to the education code.

Cortex was aware of the law; and Cortex was aware of these meetings. Yet, Cortex chooses to chastise the Board members very strongly (Appendix pp. 25-26) for what was legitimate action, but are silent about TEA's meeting with the legislators which was illegal.

### The Day the PSF Lost its Focus—May 10, 2001

TEA staff failed to properly advise and inform the SBOE on May 10, 2001 which led to two years of chaos at the PSF. TEA staff led the Board into adopting a new inappropriate asset allocation designed to hit an unrealistically high income target. Instead of sending the proposal to the Board members before the meeting, the plan was given the committee at the meeting; there was no time for thoughtful reflection. Cortex

covers this day and most of its ramifications extensively in their review. (Appendix pp. 23-27) They correctly point out the many deficiencies of this day but fail to address the staff's major role in this debacle.

Aside from the fact that this was a staff led initiative, here are some other facts that Cortex omits.

During this period of time, the TEA staff repeatedly and falsely described the PSF's goal as "to manage to an income target" instead of intergenerational equity.

After the May meeting, the TEA staff, without consultation with the Board, began selling high grade bonds and converting them to cash in anticipation of funding a \$2 billion high-yield bond allocation. It turns out that this cash was never used to buy high-yield bonds but was eventually used to repurchase high grade bonds—all during a decreasing interest rate market. To buy and sell bonds in active management is fine; to buy and sell as was done in this case was risky and unwise as it extended the maturity of the bond portfolio. Also, TEA staff violated prudent management practices by holding an excessive amount of cash—a practice not allowed our outside money managers.

To fund the high yield bonds, the now dominant improper goal of managing to an "income target" forced the fund to sell our recently funded international equities at a \$140 million corpus lost. This \$140 million capital loss to the fund can never be recovered and jeopardized the Bond Guarantee Program.

#### Rider 38—Rider 90

In January 2002, Paul Ballard informs the PSF committee that it is projected that the PSF will not be able to pay its money managers for the biennium; he states that before we can access extra appropriations to pay our managers, we must exceed the BRE by Rider 90's \$150 million.

Rider 38 requires that the Board meet the BRE before it can tap into extra appropriations money to cover its expenses. Regular appropriations are not sufficient to manage the fund. Rider 90 was passed after the Board adopted the new asset allocation in May 2001 and requires that the SBOE sign a Memorandum of Commitment to provide and extra \$150 million over the BRE.

This January 2002 meeting is the first time I can find any mention of the idea that the Rider 90 is linked to Rider 38.

#### *Where did this idea come from?*

Where ever it came from, the TEA should have done the homework represented in the next section and refuted it. It appears the two Riders were linked as an afterthought. The SBOE eventually appealed to the Attorney General for an opinion and on January 29, 2003 he ruled in the Board's favor.

Because of the lack of initiative and leadership of the PSF staff, the PSF was forced to take unnecessary and drastic action that was in direct conflict with the PSF's overall investment goal of attaining intergenerational equity.

TEA Attorney Misrepresents the Law to the Board about Rider 38 and 90

On May 28, 2002 the SBOE was in session to deal with the issue of paying money managers. At this meeting, TEA attorney Joan Allen identified and then misquoted Section 6.05 of the appropriations bill. To misquote from a section that is one sentence long in a 973 page document is peculiar. She stated:

*Well, the opinions definitely and especially from the legislators do demonstrate legislative intent. And, furthermore, in the appropriations act we have a section 6.05 which indicates to agencies that if you cannot figure out what the legislative intent was, you need to go to the chairs of the legislative committees who were in charge of that particular provision and ask them for their legislative intent. That is what happened here, and they indicated, as did Ms. Rylander that the monies, that Rider 38 cannot be accessed prior to meeting the Rider 90 income requirements.*

In May, the Board had just received letters from all the legislative leaders stating their intent for the two Riders in question to be read together. Her comments quickly removed the argument that the two Riders should not be considered together. Upon returning home from the meeting that day, I looked up the wording of legislative intent in the Appropriations Bill and found the following:

Section 6.05 states:

*Senate Bill 1, General Appropriations Bill, 2002-2003, Article IX, Sec. 6.05. **Interpretation of Legislative Intent.** Funds appropriated by this Act shall be expended as nearly as practicable, for the purposes for which appropriated. In the event an agency cannot determine legislative purpose from the patterns of appropriations, the agency shall seek to determine that purpose from the proceedings of the legislative committees responsible for proposing appropriations for this state.*

The Board had been seriously misled. Later, I searched out the proceedings of the committee on the audio archives of the legislature and transcribed it. The transcript of the entire proceedings of the legislative committee—The Conference Committee on SB 1—on Rider 90, May 14, 2001, is as follows:

*Representative ?????:*

*Then on page 7c, we would move to increase the fund 2, that is the Available School Fund, to the Foundation School Program by \$75 million each year for the 02-03 biennium and reduce fund 193 Foundation School Program by the same amount. This is a result of action taken by the State Board of Education this past Thursday, by which they increased, by a vote unanimously of the Board, the amount of money over the Biennial Revenue Estimate for the Available School Fund.*

*So I would move that we would take those actions by \$75 million each year of the biennium and then add the new rider to the TEA Available School Fund. The action that shown there, this is consistent and correct with the action they took Thursday which their Board took.*

*Senator Ellis:*

*You have heard the motion, is there an objection, the motion is adopted.*

There was not even a hint of reference to Rider 38 and the accessing of appropriations money to pay our managers. Clearly the SBOE was ill served by Ms. Allen.

This is yet another example of lack of TEA support for a Board who has lost its authority. Cortex knew of this most serious conduct by the TEA but fails to mention it. Ms. Allen's comments stopped the Board discussion at the time that could have led to a quick decision on the Rider 38—Rider 90 issue; this would have saved the TEA and Board a lot of wasted time and effort.

#### TEA Staff Did Not Keep the SBOE Informed

I learned some things in this report. I learned that FIS Funds Management, an emerging manager, has hired a Presidio Asset Management, who then passes the job on to Avatar a large New York Investing Firm. (p. 38-39 Appendix p. 65)

I remember Paul Ballard questioning FIS at a committee meeting on January 10, 2002. He mentioned Presidio and Avatar and that Presidio was “downstreaming”. Board member Rene Nunez defended Presidio and said that Carlos Resendez of Presidio, a former Executive Director of the PSF, was making the decisions. The matter was then dropped.

Cortex's review is either faulty or the SBOE was never fully informed about the situation.

#### Other TEA Staff Failures

Cortex states:

*More importantly, the PSF's current organizational structure does not support effective fiduciary decision-making. The current organizational structure:*

- *Places the SBOE in a difficult position in which it bears full fiduciary responsibility for the PSF, but does not have the authority that is generally considered essential to carry out its duties. During interviews, SBOE members were in strong agreement that the SBOE's lack of authority, particularly its inability to appoint the Executive Administrator of the PSF, was the single biggest obstacle to being able to rely on staff in carrying out the SBOE's fiduciary duties.*
- *Has created a sense of mistrust in staff on the part of SBOE members, as they perceive the PSF staff to be accountable to other areas of state government rather than to the SBOE.*
- *Has in the past resulted in a perceived need by SBOE members to seek out informal advisors that are perceived to be loyal and responsive to the SBOE. (p. 25)*

I concur that the Board's mistrust of staff is directly attributable to staff's actions that would not be recurring if we had “*the authority that is generally considered essential to carry out its duties* “. The frustration and void created by the deprivation of timely and accurate information due to the actions or inactions of an unaccountable TEA staff

would naturally be filled by other parties of trust and competence. Cortex has conspicuously refrained from criticizing the Texas Education Agency staff and/ or Commissioner.

Other failures not already noted are:

- TEA's redacting of 1997 RFP documents provided at the request of a Board member;
- Failure of advisory consultants to provide any documentation, notes, or work product related to the 1997 manager selection, even after being directly requested to do so by a Board member;
- Board minutes reflect Commissioner's statements affirming his purposeful instructions to an advisory consultant to withhold pertinent information from Board members until the day of a meeting, denying Board members sufficient time to digest and contemplate significant information.
- Commissioner's refusal to comply with PSF Committee chairman's request for financial data. Subsequent demand for \$14,400 to Board member under Open Records Request was unwarranted. Information requested was "push-button" data available from custodian bank.
- Commissioner's refusal to appoint investment advisory committee members;
- The executive director of the PSF substituted a page of his own creation within a document provided by a consultant without disclosure to the Board.
- Our executive director failed to disclose his working relationship with a newly hired investment manager, both having arrived at the PSF at approximately the same time.
- More grievous was that while questions were being asked in 1998 about that newly hired manager's qualifications and performance and resume', the incoming executive director failed to inform this Board that the firm had been terminated by the Kansas City Retirement Fund for poor investment performance just six months prior, while he was executive director of that fund.
- A critical report generated by TEA staff regarding the cost of splitting the custodial banking and securities lending services was proved to be fraught with mathematical errors and flawed assumptions. Again, the report was published numerous times in the papers, casting the SBOE in an unfavorable light, even though the SBOE's correct decision proved to have added over \$4 million in additional income to the fund.
- The Attorney General report issued at the request of Chairman Untermeyer regarding the 1997 investment manager selection process identified that TEA personnel and investment consultants failed to provide and withheld from members of the SBOE information developed in the RFP/ selection processes which would have significantly impacted Board decisions.

## Summary

My simple conclusion is that no matter who comprises the Board, the Board must be able to hire and fire its CEO. This is the primary key governance structure that if not in place will cause the greatest disruption in the performance of fund. It is the primary flaw that must be remedied. With the appointment of Holland Timmons as the acting director of Permanent School Fund, Commissioner of Education Felipe Alanis, has for the first time since I have been on this Board, put in place a technically qualified Chartered Financial Analyst as director. I have already found his unquestioned superior expertise to be extremely helpful.

## IV. Section Three—Cortex’s Violation of the Scope of the Audit

### The Charge Given Cortex

Cortex was specifically charged in the Consultant Proposal Request to:  
*consider actions taken or decisions made by any party associated with the PSF. However, the review is not intended to be a conclusive investigation of any individual allegations or occurrences.*

Cortex acknowledges this important point in a September 3, 2002 memorandum to all individuals that would be interviewed for this review. They state:

*It is important to point out that Cortex’s review is intended to address specific topic areas relating to the governance and management practices and structures of the PSF, to compare these practices to best practices and standards throughout the public funds industry, and to offer recommendations for enhancing the quality and efficiency of the PSF decision-making process. The review is not, in any way, intended to be an investigation of the PSF, the SBOE, or any individuals connected with the PSF.(Emphasis added)*

Cortex failed to follow this charge. In the main body of their report, this mandate is handled appropriately, however, in Appendix 4 they go into a detailed investigation of the PSF, the SBOE, or any individuals connected with the PSF. They retell the investigation and allegations told in the *State Auditor’s Office 2001 Report*.

If the SBOE, who commissioned this audit, had wanted this story of allegations retold we could have reprinted the *State Auditor’s Office 2001 Report*, stood pat on our responses and saved the Texas Education Agency \$250,000. A revisit of these allegations was not the purpose of this report. These issues have already been dealt with.

Since these issues have surfaced again, I urge all concerned readers to get a copy of the *State Auditor’s Office 2001 Report*; study it and the responses of the Board members. Obtain a transcript, available at the TEA, of the presentation of this report by Carol Smith and Roger Farris to the SBOE on March 29, 2001. Then, come to your own conclusions on these matters. The point here is that these exact issues have been dealt with in great detail. They deserve only minor mention in this report.

### **And Now You Will Hear “The Rest of the Story”**

Since this story has resurfaced again, I will briefly tell the “rest of the story”. This is the story that is not in any of the reports about the PSF, but it is the actual story of what happened.

It is the story of a Board member who near the end of the 1997 process to select external money managers accidentally discovered “sweetheart” deals being given certain firms. When he and a fellow Board member asked some minor questions they generated a major response. The then Commissioner of Education, Mike Moses, made a late-night phone call to a Board member asking why they were asking questions about the Permanent School Fund. This strange response raised these members suspicions and motivated them to begin diligently searching for answers. With the help of an extremely knowledgeable, former UTIMCO whistle-blower, these Board members became empowered; their questions became very specific and uncomfortable for many surrounding the PSF. (It should be noted that Time magazine honored whistle-blowers as their Time 2002 Persons of the Year.)

This led to a contentious process resulting in the Board reorganizing their consultant structure, their asset allocation, and putting out to bid all of their external manager slots. This 2000 process was executed in a clearly superior manner. At the end of this process the final result was praised by Will Davis, a longtime Board member and PSF committee man who had been involved in both manager selections. His farewell statement to the Board is the best brief rebuttal to the State Auditor’s Office 2001 Report and the story Cortex reprints in this report. His closing comment was: “This Fund is in the best shape it has ever been in—don’t mess it up “

It should be noted that the thoroughness of the 2000 process was the direct result of the involvement of the expert whistle-blower and the extra advice given by our performance measurement consultant.

### **Which Story is Right? Check Out the 1997 Process**

The real key to unlocking the veracity of the two stories is to trace back and see where they first begin to diverge and see which one is based on the facts. The point of divergence is this 1997 manager selection process and how they both assess it. Cortex finds the hiring of the money managers as

*“in accordance with standards of prudence in delegation and decision-making by fiduciaries.” P. 34 [Page 33]*

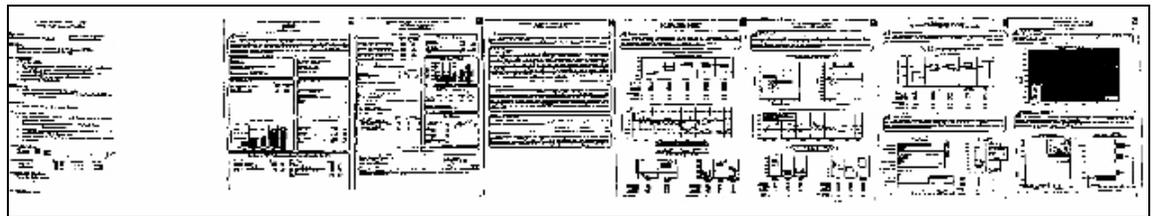
*They state: “Staff and the investment consultant provided a great deal of information to the SBOE and the committee during this process. If some members felt that not enough information had been provided to them, it was their fiduciary duty to ask for more information. The State Auditor’s Office reviewed the selection process and found it to have been ‘well-designed and effective’. We concur. “ p.35 [Page 34]*

(As an aside, I find it surprising that Cortex chides the Board member who accidentally, at the last minute, discovered problems and then had the strength of conviction to check them out and if necessary to expose them. In my opinion, this Board member acted in the highest sense of fiduciary responsibility.)

Cortex/SAO says that the 1997 process was well-designed and effective, while a large portion of the SBOE says that the process was tainted and needed cleaning up. Both can not be true. Unfortunately for the SAO and Cortex, the Attorney General does not agree with their analysis and the indisputable facts contradict their story.

The Attorney General, in a November 4, 1999 letter to SBOE Chairman Chase Untermeyer, states about the 1997 process: “Our review did discover inaccuracies in responses and considerable confusion in the RFP process.” (Emphasis added)

Now let us look at the facts. Was a lot of information provided the Board in 1997 as is stated in the Cortex review? Let us look at the amount of information provided to the Board for a single manager in the two searches. The graphic shows in thumbnail form the difference in the two. The thumbnail on the far left shows all the information that was provided to the Board in 1997, while the seven thumbnails on the right show what was provided the Board in 2000 for the same manager. The documents provided to the Board and displayed in this graphic conclusively demonstrate that a great deal of information was not provided to the Board in 1997 as Cortex claims.



Thumbnails comparing the 1997 and 1999 Manager Selection Processes

Thus, one story claims that the 1997 selection process was well established. It then goes on cite allegation after allegation against the Board, a performance measurement consultant, and an “informal advisor” for conflicts of interests as they succeed in undoing the 1997 process.

The other story claims that the 1997 selection process was “considerably confused”, tainted and improper. It then goes on with the Board cleaning up the confused 1997 process—utilizing the help of a former public fund expert whistle-blower and a performance consultant earning his “other services” pay.

### **Summary**

To conclude this section, the Cortex review fails to follow the directions given in the CPR; they revisit the same allegations that were exhaustively made and responded to in the *State Auditor's Office 2001 Report*. In the unnecessary detailed accounting of these allegations, they selectively recognize certain facts while omitting others and thereby attempt to reach a particular preconceived conclusion. Their analysis and conclusions about the manager selection process of 1997, the point at which their story diverges, are not based on fact. Therefore, the story they tell loses credibility.

## Some Potpourri

This subsection will list one thing Cortex included and emphasized in their review and list two things that I think should have been covered but were left out.

### Included

This response has noted many items of interest Cortex choose to leave out of its review, therefore it is also interesting to see how much space it gives a relatively minor proposal to issue an RFP for external high grade fixed income managers. Before 1997 the PSF had external bond managers. (Appendix p. 15)

In their section about inattention to costs, they note the attempt to issue an RFP against Staff's recommendations. This was beginning in May, 2001, when the staff had lost much of its credibility with some members of the Board. We did not trust them. This issue was continually brought up because it was never finalized but only tabled. This is what happens when something is tabled, it is always brought up. When it was finally discussed thoroughly the matter was dropped and no RFP was issued.

It is amazing how much space Cortex gives this discussion. This subject is mentioned on page 37 of the main body of the report, and on pages 50-51 and page 54 of the Appendices. This account is even more amazing as Cortex presents itself to be mind-readers and not analysts. They state:

*It appears that some members of the SBOE clearly wanted to outsource the management of at least part if not all of the assets of the internally managed bond portfolio. (Appendix p. 51) (Emphasis added) [Page 50]*

It never appeared to me that members of the Board wanted to outsource all of the bond portfolio. All we were interested in was good bond portfolio management.

### Excluded

#### High-Yield Bonds

Cortex ignores discussing the appropriateness of high-yield bonds for the PSF. This has been a major point of contention for years at the PSF. Is it wise for an income-based fund to invest in high-yield? Is trading "principal for income" the right choice.

Cortex was given a lot of information about this important subject but choose to offer no expert opinion. I find this absence of analysis disappointing. Why devote three pages to a proposed RFP for high grade bonds that was a minor blip on the screen of the PSF and ignore this still debated high-yield issue?

## Harvesting Growth Stocks but not Value Stocks

In the discussion of the \$ 1.3 billion rebalancing in 1999 and 2000, nothing is noted about the selection of the stocks being from the growth style. This was perfect timing to get out of the growth style but Cortex fails to note it. Why?

## V. Section Four—Cortex Gives Good Advice

I have been highly critical of Cortex’s Review. However, I do concur with some of their report. Given the brief time we have to respond to their report I have concentrated my narrative to what I consider the flaws of their report. For this section, I will list in bullet form and in report order the areas of agreement that I believe need a big “second”.

- *p. v [Page iv] A corridor is likely to have an upward bias. That is, during periods of high investment returns the Legislature will have ample incentive to shift the corridor upwards because this may lead to higher distributions. However, during periods of low investment returns the Legislature will have little incentive to shift the corridor downward because this may lead to lower distributions.*

I concur. This would be a danger to the fund’s goal of intergenerational equity that can still best be protected by an independent elected SBOE.

- *p. 9 We must point out that individuals without investment or related qualifications may still make valuable contributions to an investment fund’s governing Board, including providing valuable perspectives, good judgment, a strong loyalty to the interests of the fund, and plain common sense.*

I concur. This is the special gift of the SBOE.

- *p. 13 To be sustainable, the assets of the PSF must grow over time in line with appropriate measures of inflation and growth in the student population. These parameters should be understood and agreed upon by all parties involved in the management of the PSF.*

This is an excellent description of intergenerational equity.

- *p. 22 This may have been the case in the early 1990s when distributions from the PSF were more than 7% of the value of the PSF in a number of years. Such high distribution levels were likely detrimental to the PSF, favoring the then current generation of beneficiaries at the expense of future generations. During those years, the PSF’s income-based spending policy arguably failed to protect the real value of the PSF; it could easily fail again in the future.*

This observation makes my case about overspending as the chief problem of the PSF.

- *p.24 The spending policy alone cannot produce higher spending levels or higher fund values.*

This refutes all the talk about “total return” can generate more income for the next biennium.

- *p. 25 This has resulted in an organizational structure that differs significantly from the norm....More importantly, the PSF’s current*

*organizational structure does not support effective fiduciary decision-making....Places the SBOE in a difficult position in which it bears full fiduciary responsibility for the PSF, but does not have the authority that is generally considered essential to carry out its duties.... Has created a sense of mistrust in staff on the part of SBOE members, as they perceive the PSF staff to be accountable to other areas of state government rather than to the SBOE.*

With this admission on their part, I do not understand their recommendations to not give the SBOE this authority, if their other recommendations fail to be accepted.

- *p.46 [Page 44] b) The SBOE should prohibit itself from adopting a course of action contrary to a recommendation of the PSF Committee without further analysis. Prior to any such action, the SBOE should communicate any concerns it may have about a recommendation to the PSF Committee, and should direct the PSF Committee to review its original recommendation and submit a second recommendation at a future date.*

If the SBOE met more frequently, as they did in the 1980's, I think this would be a good recommendation. As it today with only six meetings a year. I would recommend PSF items to be included in the Committee of the Whole.

- *p.48 [Page 46] The SBOE should establish a formal, comprehensive fiduciary education program ...*

I totally agree. The last training was in March and May 1999.

- *p.49 [Page 47] we recommend that serious consideration be given to simplifying the PSF's investment program by substantially increasing the levels of internal and passive investment management.*

I agree. This is in keeping with the history of the fund.

- *Appendix pp. 32-33 **Rebalancing March 2002***

*We have not found in any of the laws and statutes governing the PSF that the SBOE is required to change the asset allocation of the PSF or its rebalancing policy to meet a specific income target.*

I concur.

- *(Appendix pp. 46-47) [Appendix pages 45-46] **March 2002 - Selection of Performance Measurement Consultant***

*The SBOE acted appropriately in rejecting the Committee's recommendation not to issue an RFP. While we have argued in similar situations that the SBOE should have sent the matter back to the Committee, in this case the SBOE's decision to issue an RFP – the only other course of action – against the recommendation of the Committee, after seeking advice from the investment consultant (which the Committee should have done in the first place), and based on an unanimous vote was probably the appropriate thing to do.*

I concur.

## **VI. Section Five—Spending Policy Recommendations and Intergenerational Equity**

### **Cortex’s Two Great Omissions**

There has probably been more “picking and choosing” of certain facts and omission of others in an attempt to reach a particular, preconceived result in the area of spending policy than in any other. Cortex’s recommendations follow this same selective pattern to justify a “total return” spending policy.

#### Callan’s March 2001 Spending Policy Study

The first and most glaring omission of the Cortex review is the lack of recognition and mention of a March 2001 Callan Associates study on this very issue. This study is still the only “total return” study produced by our chief consultant; it is still the only study that does not use “historical” data; it is still the only study that is based on expectations of future returns. Cortex is well aware of the importance of this distinction as they comment on it in their analysis of the 1997 and 2000 asset allocation studies. They note the superior methodology of the 2000 study which is based on expectation of future returns. Cortex was also well aware of this Callan study on spending policy. The omission by Cortex of the only study the SBOE’s chief investment counsel produced, the omission of the only study that is accurately based on future expectations is puzzling.

This Callan study is one that any prudent fiduciary would have to follow or at least explain why they won’t. How could a Board member make a decision in this area of spending policy without giving this study their utmost attention? Any Board member that would do so would leave themselves open to valid criticism.

The accuracy of this Callan study has not been disputed. It must be either refuted or included in any analysis of PSF spending policy. Its omission in this audit is very revealing and also very convenient.

Is this because this Callan study disproves their case? I suggest it does. Callan’s analysis unequivocally demonstrates that there is no difference in future (20 year) ending market values and per capita spending. No wonder it is not dealt with.

#### Historic PSF Overspending

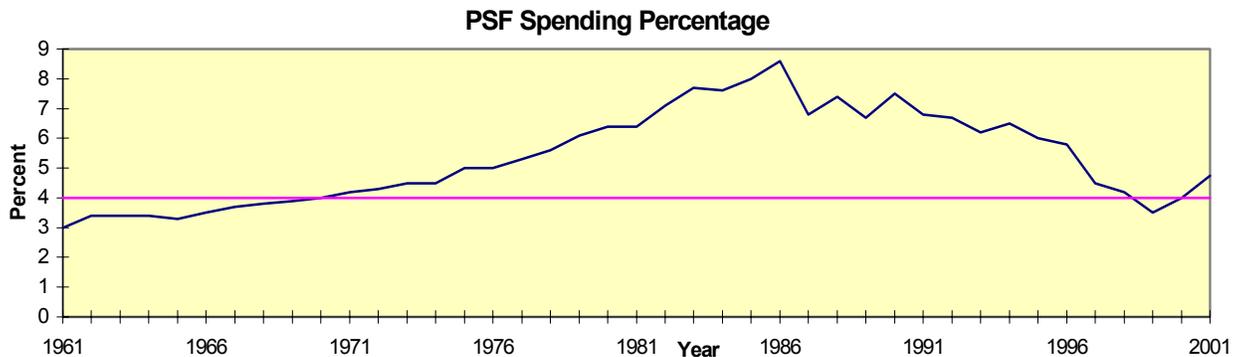
Once you have chosen to ignore the only legitimate study on “total return”, you are left to rely only on inferior analyses of past historical data as a guide. Thus, their second great omission is their failure to include the most relevant historical data. This makes Cortex’s selection of 1990 as the historical baseline for measuring intergenerational equity the next most glaring example of “picking and choosing” certain scenarios to reach a particular, preconceived result. In the case of the PSF, choosing 1990 as a baseline of per capita spending is like choosing 2000 as a baseline for measuring the performance of stocks. (p. 13-18)

What is accomplished for the total return proponents by choosing 1990 as the baseline? The answer is simple; it shows the PSF’s failure to keep its intergenerational equity mandate. Then, by jumping to a conclusion, they claim it is the PSF’s income-based spending policy that is responsible for this failure.

*It is the spending policy of the PSF – which requires that all interest and dividend income earned be spent – that is the primary factor ultimately responsible for the fact that the PSF has been unable to grow the level of distributions over the last 13 years in nominal terms (let alone cover inflation and student growth), in spite of the strongest bull market in history. (p. 17) (Emphasis added)*

But is it? What conclusions would you come to if you consider an earlier baseline?

If you trace the percent payout of the fund, you will find that until 1960 the PSF averaged a 3.5 percent payout. In 1967 the PSF began a gradual, steady, incremental increase in spending. Then, in the early 1980's, a once in a lifetime opportunity occurred. Huge amounts of new money came into the fund from high oil prices and high double-digit interest paying bonds became available for purchase. All of this new money and some existing equities were used to purchase these high paying bonds; this led to spending levels well outside prudent limits.



This more complete historical data picture demonstrates that the PSF beginning in 1967 and for the following thirty years dramatically produced excessive income. It is my opinion that this “overspending” is the one and only reason responsible for the fact that the PSF was unable to grow the level of distributions over the last 13 years.

It is fascinating to “what if” the past.

“What if” the PSF had a disciplined total return spending policy during this time? This would have allowed the PSF to have maximized the opportunity of high interests and new GLO contributions. Yet, “what if” the PSF had a disciplined income-based spending policy? This would have utilized 50 percent of the new money to purchase stocks would have also been very beneficial. Hindsight shows that this would have been even more advantageous as it would have positioned the fund to take maximum advantage of the longest bull market in history—again another once in a lifetime opportunity. The key to success in either spending scenario is a disciplined asset allocation and spending policy.

In conclusion, it is a lack of commitment by the Board, by the PSF staff, by the SAO, by the legislature, to the PSF’s primary goal of intergenerational equity that led to a lack of intergenerational equity.

Cortex emphasizes the importance of intergenerational equity throughout its report. However, they conclude an income-based spending policy is the reason for a lack of intergenerational equity when it was overspending and a lack of commitment to intergenerational equity that actually caused it. It is puzzling that they emphasize intergenerational equity so much but when that primary goal is abandoned they fail to recognize it.

### **Is An Appointed Board the Answer to Overspending?**

Would following Cortex's # 1 recommendation of having an appointed Board have prevented this overspending?

Before 1876 the school fund was heavily overspent. Thus, the pioneers of Texas created the SBOE as a separate independent entity to prevent overspending. What would happen to the independence needed if we followed Cortex's lead and had an appointed Board? Would this new Board represent the leaders that appointed them and who have to deal with the incredible pressures of balancing a state budget or would they be independent enough to protect the PSF?

Our present Board even has trouble maintaining its independence. How independent is the present Board? Is it free from pressures of the legislature?

In all pension funds, fiduciaries have to be careful to separate their role of fiduciary from their role as a representative. For example, at the Teachers Retirement System, some fiduciaries may be the "retired teachers" person on Board, other fiduciaries may be the "active teachers" person on the Board. This conflict of interest also impacts the PSF. An SBOE member that wants to please current legislators becomes the "current legislators" person on the Board. In fact, several present Board members received significant financial support from an influential State Senator.

This tendency would be greatly magnified should the fiduciary's appointment be dependent on pleasing state leadership. Thus, it is not likely that an appointed Board could have prevented this.

To change spending policy to total return is not the answer, to change the fiduciaries to a special appointed Board of financial experts is not the answer.

The only solution to prevent the PSF from being overspent is to constantly keep before the Board its primary goal is that future children benefit from the fund to the same degree as the present children.

### **Cortex's Incredible Total Return Claim**

The heart of Cortex's section on total return is a critique of the PSF's current income-based spending policy. They state:

*An income-based spending policy has six significant drawbacks. p. 21  
[Page 19] Such policies (total return) do not have any of the drawbacks  
that we identified above pertaining to income-based spending policies.  
p. 22-23 (Emphasis added)*

Cortex identifies six drawbacks to an income-based spending policy; they then claim that total return policies do not have any of these drawbacks. Let's look at each of the drawbacks one by one:

1. An Income-Based Spending Policy Limits the Range of Asset Allocation Policies That May Be Implemented.

According to the math in Appendix 1, Cortex demonstrates that in an income-based spending policy, capital gains are the only source to protect against inflation and student growth. They give us this formula:

$$(8) \quad \% \text{ Capital Gains} = \% \text{ Inflation} + \% \text{ Student Growth} - \% \text{ Contributions}$$

But since HB 3558, % Contributions = 0%, thus we have the real equation I will label "(8a)".

$$(8a) \quad \% \text{ Capital Gains} = \% \text{ Inflation} + \% \text{ Student Growth} \text{ (for income-based)}$$

To find %Capital Gains for total return we must add back what was canceled out in their equation "(7)". You will then get a new equation for total return that is equivalent to "(8a)" for income-based.

$$(8b) \quad \% \text{ Capital Gains} = \% \text{ Inflation} + \% \text{ Student Growth} + \% \text{ Distributions} - \% \text{ Investment Income} \text{ (for total return)}$$

As you can see, with total return, the capital gains must likewise cover inflation and student growth; in addition they must also cover the distributions, less what the investment income produces. If investment income is greater than the distributions you will need less capital gains; if investment income is less than the distributions then you will need more capital gains. If you try to keep investment income equal to the distributions you circle back to an income-based policy.

Both income-based and total return spending policies require capital gains growth to meet the PSF's intergenerational goals.

*Drawback No. 1 is a draw, it favors neither.*

2. Under an Income-based Spending Policy, Attempts to Change Spending Levels Will Lead to Unreasonable Outcomes

There is nothing about an income-based policy that leads to unreasonable outcomes as long as the fund is always managed to the goal of intergenerational equity. All it takes is

- getting the right asset allocation, and
- sticking with it; rebalancing both ways.

First, Cortex's statement "*to increase distributions, the SBOE must position the PSF to ultimately earn less return.*" (p. 20) is simply not accurate. The PSF increases distributions by increasing return. We did it by harvesting \$1.3 billion of growth stocks in 1999-2000. With income-based spending policy, it just takes two steps instead of one. Stocks are the growth engine; when stocks grow to a higher percentage of the fund,

the fund re-balances and income goes up. The second step, when the bonds are purchased, does lower return. This is elementary; even a dentist can understand it. To make their claim is really presenting a half truth as they misrepresent our current policy by only mentioning the second step. I am surprised professionals could make this mistake.

Actually this two step process is beneficial. It works like a protective governor on a lawn mower engine. Income can be adjusted, but more slowly. It protects the fund from too quick and drastic changes.

Second, Cortex's statement "*If one is to accept more risk, one should expect more income, not less.*" (p. 20) is actually not reasonable. To make it reasonable it should read "If one is to accept more risk, one should expect more return, not less."

*Drawback No. 2 is not even a draw, it is non-reason.*

3. Under an Income-based Spending Policy, PSF Income is Largely Driven by Factors Outside the Control of the SBOE

The income generated by the PSF is directly affected by changes in interest rates and dividend yields, both of which are beyond the control of the SBOE. Since when are interest rates and dividend yields under the control of total return investors? Maybe capital gains are under their control also?

*Drawback No. 3 is not even a draw, it is also non-reason.*

4. An Income-based Spending Policy, Combined with a Biennial Revenue Estimate (BRE), Interferes with the Prudent Management of the PSF

The BRE can only interfere with the PSF if the PSF abandons its goal of intergenerational equity. Whatever spending policy is in place makes no difference.

*Drawback No. 4 is a draw, it favors neither.*

5. An Income-Based Spending Policy, Combined with the Objective of Achieving a BRE Target, Creates an Incentive to Invest in High Income, Low Growth Investments.

A total return spending policy, combined with the objective of achieving a BRE target, creates an incentive to invest in riskier investments. Check out the Permanent University Fund (PUF).

*Drawback No. 5 is a draw, it favors neither.*

6. An Income-Based Spending Policy Will Not Necessarily Protect the Value of the PSF

Total return will not necessarily protect the value of the PSF either. Check out the PUF again.

Drawback No. 6 is a draw, it favors neither.

This is an amazing section of their review; in contrast to their claim not one of the listed drawbacks is peculiar to income-based policy.

### **Cortex's Spending Payout Percentage**

Here Cortex does good work. They clearly present a realistic payout for the PSF. The only problem with their reasoning is there is no longer a contribution rate of 1 percent. Thanks to the legislature, when HB 3558 went into effect the contribution rate dropped to 0 percent.

This means that the reasonable spending rate for the PSF is 2.5 percent. With a \$17 billion fund, that is only \$425 million/year. For a point of reference, the BRE for 2004-2005 calls for approximately \$733 million/year income. Thus, after studying this section, the SBOE should question whether the PSF is still unfairly treating the future schoolchildren of Texas. According to Cortex, we should consider re-structuring the PSF to lower present distributions so that we would be in line with our intergenerational equity goal.

### **Spending Policies Results and Risk**

The Permanent School Fund's (PSF) current spending policy allows the PSF to grow at the same rate and pay out the same distributions as a total return spending policy, and with less risk.

#### Same Results

Back tests analysis are interesting, but the only meaningful analysis our consultants would provide is a long term predictive analysis. Our chief consultant, Callan Associates, determined in 2001 that in 20 years there would be no significant difference in corpus growth and generated income between our current spending model and total return.<sup>24</sup>

#### Less Risk

Total Return is Untested in Down Markets. In 1985, 19 percent of similar funds were total return; in 2001 it was 97.5 percent. This gigantic shift occurred during the longest bull market in history. How are these funds performing in the present bear market? The PUF, having failed to meet its present BRE income, is considering moving more of the fund into risky hedge fund and derivative investments.<sup>25</sup> The Tobacco Settlement Fund, managed by the Comptroller, had to dip into its constitutionally untouchable initial corpus to make its first payments. In contrast, the PSF met its BRE. Total return results in down markets are unknown at best; this means more risk.

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<sup>24</sup> "Texas Permanent School Fund Spending Comparison", Callan Associates, March 2001 (*See Attachment*)

<sup>25</sup> "UT May Shift Endowment Investments", Ralph K. M. Haurwitz, Austin American-Statesman, 8 January 2003

Too High Total Return Payout Could Ruin the Fund. As reported in the New York Times last April, Deutsche Bank contends that if total return “payout is pushed up to 4 percent, the bank says, the probability of the fund maintaining its purchasing power falls to 40 percent. A payout of 5 percent lowers the probability to a mere 5 percent.”<sup>26</sup> This is real risk.

### **Summary**

The current spending policy of an untouchable corpus has served our great-grandparents, grandparents, parents, us, and our children well. Cortex does not make the case for total return but in fact, weakens it. Are we confident that we an untested (in down markets), higher risk, total return policy can continue to do the same thing?

## **VII Section 6—Recommendations**

1. Keep the elected SBOE as the fiduciaries of the PSF.
2. Restore unto the SBOE the authority to hire and fire its CEO.
3. Keep the “income-based” spending policy.
4. Conduct a thorough spending policy study that does not selectively “pick and choose” and omit crucial facts to reach a predetermined opinion.
5. Conduct all PSF business in the Committee of the Whole.
6. Reproduce on a wall chart the essence of Cortex’s description of intergenerational equity (p. 12-13) and place it in a prominent position in the Board meeting room. A recommendation to get the wording started:

**As State Board of Education Members and as Fiduciaries for the Children of Texas,  
Both Present and Future,  
We Vow to Manage the Permanent School Fund Not to Any Budget Need but  
According to the Goal of Intergenerational Equity  
by Maintaining a Prudent and Disciplined Asset Allocation.**

<sup>26</sup> “States Ease Rules on Tapping Into Trust Funds” , John Kimelman, New York Times, April 7, 2002

## Part II

### Section One—*State Auditor’s Office 2001 Report Repeat Responses*

These are some of the Board responses from the *State Auditor’s Office 2001 Report* to the of the individual allegations that are repeated in this review.

(Page 9)

#### ***The Current Governance Structure Does Not Guarantee that the PSF’s Governing Board will be Comprised of Individuals with Relevant Investment and Related Qualifications***

Response follows:

- (1) SBOE bylaws and structures are already sufficient to achieve the desired level of expertise. The Texas Legislature made funding appropriations to ensure and effect the availability of multiple investment advisory firms, including:
  - (a) services of professional money management firms, whose other clients are similar to the Permanent School Fund;
  - (b) the services of investment consulting firms, such as Callan & Associates, one of the largest investment consulting firms in the nation;
  - (c) performance measurement services to closely track fund performance and trends; and
  - (d) trade and brokerage cost analysis to inform the Board of inefficiencies and excess expenses. This hiring was implemented only this past year at the insistence of Board members.
- (2)
  - (a) Large funds, such as the Permanent School Fund, should and have easily attracted the best available advisors and the largest firms in the investment industry. We now enjoy the benefits of such professional relationships.
  - (b) The consultants employed by the Board at this date are nationally recognized firms which represent clients with over \$1 trillion under management collectively. Historically, other state offices and agencies have employed smaller firms.
- (3)
  - (a) The Auditor’s opinion that Board members relied on advice from outside parties, giving those parties a greater impact than necessary on the oversight and management of the PSF is erroneous and inflammatory.
  - (b) At no time did Board members give their authority to oversee and manage the PSF to any outside party. At no time did Board members allow any outside party to impact their oversight and management of the PSF.
- (4)
  - (a) As for requiring any other financial/ investment expertise over and above that held by the elected members of the Board, the Constitution makes no such requirement, nor does the Constitution require such financial expertise of any

other state elected officials and legislators who deal with many billions of dollars of expenditures. Our government is a representative government.

(b) Would the Auditor suggest that all elected officials carry minimum requirements of expertise in any field?

(c) Surely the Auditor would not recommend an appointed Legislature to ensure expertise on all committees.

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***There Has Been Inappropriate Use of Service Providers and Advisors in the Decision-making Process***

*In reviewing the SBOE's decision-making process we found that the SBOE and the PSF Committee have often used service providers or advisors:*

- *Whose formal mandates and areas of expertise did not cover the matters they were asked to advise on;*

Response follows:

The Auditor is erroneous in implying that the SBOE acted improperly in permitting “the Performance Consultant to provide services outside the scope of his firm’s contract.” Board members can allow comment from any investment professional as part of a deliberative process, hired or not, formal or informal.

- (1) Precedence has allowed advisors to provide input to Board members on topics outside of their primary contracted role.
- (2) Our ten-year-plus internal “stock picker” consultant has provided input to Board members on topics ranging from the safety of securities lending and applying firms’ abilities to the appropriateness of owning and adding high-yield bonds to our asset allocation. Both of those roles are covered by another advisory contract, but his input was welcomed.
- (3) The current Performance Measurement Consultant’s contract (a TEA standard contract) includes a clause in Section C, permitting the Board or the TEA to contract for other services up to and including a fee of up to \$25,000 per year.
- (4) To selectively draw from a lengthy discussion a conclusion that the Performance Measurement Consultant would know that a specific HUB broker-dealer firm would benefit from a discussion in which the Performance Measurement consultant participated is offered without evidence.
- (5) The fact that (a) all PSF trades must be executed at “best price/ best execution” and (b) there being no barrier to entry for Texas-based HUBs doing business with the PSF, it would be impossible for any one party to know what firm or firms would benefit from the above referenced discussion.

(6) The role of the Performance Consultant is to analyze and report fund investment performance to the SBOE. The Performance Measurement Consultant has no role and no impact on contracts executed between external money managers or TEA staff's trading with brokerage firms, HUB or otherwise.

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***Advisors Had a Personal or Informal Relationship with SBOE Members***

Response follows:

(1) Board members possess the right, as do all elected officials, to seek and receive informal input when comfortable with the expertise of an individual.

(2) It is neither unprecedented nor inappropriate for constituents to offer informal input to Board members, even if they are “uncredentialed” in the eyes of the Auditor.

(3) The Auditor is singling out SBOE members with the spurious notion that they should be required to research, identify and evaluate every individual with whom they come into contact in the course of their duties or social lives. To suggest that any elected official investigate every financial dealing and/or relationship of every constituent, citizen or social contact who offers an observation or opinion is ridiculous.

(4) The Auditor is attempting to hold the SBOE and its advisors to a higher standard than any other elected state officials or other public fund Board members. This demonstrates an attempt to reach a particular, preconceived result.

(5) The State Board of Education has enacted the most stringent ethics policy of any state fund. The State Board of Education actively supports studying the creation and adoption of uniform standards by all State funds.

**Section Two—Other Responses**

**Main Body**

(Page 3)

***PSF Percentage Contribution to Total Per Capita Public Education Expenditures in Texas***

Response:

Why does this table begin in 1994? Why not go back and find if and when the contributions were stable year after year? Then, see what the percentages were.

(Page 26)

*Despite the difficulties associated with the current organizational structure, it is unreasonable to expect the Legislature to relinquish its authority unless it can be assured, through other means, that the interests it represents will be protected.*

Response:

This is the constant main thread throughout this review that the legislatures interest must be protected. I will repeat in Cortex's own words from their application to do this review

*Among other things, this separation of roles provides an additional check on the State Leadership. In assuming their role, the Board also*

*assume a fiduciary obligation to protect the interests of the Texas school children, even from the State Leadership.*

It is not the legislature's interest that need protecting, it is the future school children. Cortex ignores this except for their insistence on intergenerational equity. Their insistence on protecting the interests of the legislature has undermined their advocacy of intergenerational equity.

(Page 34)

*The informal advisors in some cases were provided with confidential documents pertaining to the PSF.*

Response:

I asked if what confidential documents had ever been given me as a PSF committee person. No one has yet to give me an example of any. Only the SAO reports have been marked confidential, but these are from confidential from public release only.

(Page 42) [Pages 78-79 Part B, Appendix 5]

***Responsiveness to Prior Recommendations Concerning the Code of Ethics***

*We found that the SBOE has not adopted recommendations from previous investigations by both the House Committee on General Investigating and the State Auditor's Office.*

*Ten of the recommendations made in the House report dealt with conflicts of interest and ethics.17 Only one of the recommendations was implemented through an amendment to the Code of Ethics.*

*In a 2001 State Auditor's report, six specific recommendations were made to strengthen the provisions of the existing Code of Ethics.18 Only the first of the six recommendations (disclosure of informal advisors) was adopted by the SBOE.*

Response:

This is unfair. In the November 2000 House Committee on General Investigating Report, the recommendations were not given to the SBOE but to the legislature. The vast majority of the recommendations can only be accomplished by them. For Cortex to hold us accountable for what it is impossible for us to do is puzzling. I do agree with establishing a web page for the PSF.

As to the SAO's recommendations, two of them deal with confidential information, of which there is none.

Cortex is unreasonable and unfair in this criticism of the SBOE.

### **Appendices**

(Appendix Page 17)

*The total implementation cost was estimated at \$118 million. Staff recommended that the services of the Plexus Group be used to assist in the transition process.*

Response:

This was not recommended by staff; this was a Board initiated action working on advice of the performance measurement consultant and former whistle-blower. In fact it was a disastrous transition by staff the year before that initiated this suggestion.