

The Permanent School Fund of Texas

Progress Report: Legislative Proposals, Fund Management & Investments

I. Introduction

The Texas Permanent School Fund (Fund) and its managers, the State Board of Education (Board), have become the focus of much critical attention over the past decade. Forever seeking greater sources of funding, the Texas Legislature has attempted to exercise greater control over the Fund to meet the State's short-term needs for revenue. On the other hand, the Board has sought to accommodate the legislature while fulfilling its duty of protecting and growing a permanent, perpetual endowment fund.

This report examines the aftermath of the 77th legislative session, and analyzes the issues surrounding a commitment by the Board to provide the Texas Legislature with \$150 million in additional monies from the Fund over the current biennium (2002-2003). It also examines the Board's past and current investment strategies, and addresses compliance of current allocation proposals with the "prudent person standard."

This report is the conclusion of a two-part study of the Permanent School Fund of Texas; the initial report was published as a *Perspectives on Texas Public Policy* in April 2001 (available at www.tppf.org).

II. Background

The Fund is a \$20.1 billion perpetual endowment¹ managed by the state Board.² The funding source for the Fund is not tax revenue, but proceeds from the sale and lease of public lands, including mineral rights, and net realized gains from the sale of Fund assets. Over the past decade, the traditional public-land revenue has diminished considerably; net realized gains on Fund investments are the primary source of revenue, amounting to 93 percent of Fund revenue in 2000.

When the Fund was established in 1854 with an initial legislative appropriation of \$2 million, the only revenue sources were the public lands. Those revenues were used to invest in bonds and other funds.³ Interest earned from the bonds provided income to help finance public education,

¹ A perpetual endowment is an endowment Fund with a long-term investment horizon (Tex. Adm. Code, sec. 33 (1)(a)).

² The 15-member Board is a part of the Texas Education Agency (Agency). Its members are elected for four-year terms from single-member districts. The Governor, with the advice and consent of the Senate, appoints the chair from among the membership of the Board for a two-year term.

³ Original language of the Texas Constitution, Article VII, sec. 5 (a).

which is the sole purpose of the Fund.⁴ Gradually, however, public-land revenues were also invested in equities (corporate stocks). Equities provide income in two ways: they pay dividends, a direct source of Fund income, and when equities appreciate, they may be sold and the net realized gains reallocated to fixed-income securities (corporate bonds, government securities, mortgages), which then provide interest income. Equities, as they appreciate in market value, are the “growth engine” of the Fund, and the fixed-income securities are the “income engine.”⁵ Both “engines” must grow in order to keep up with inflation and a growing student population.

Maintaining a proper balance between the two “engines” is a primary function of the Board. They maintain that delicate balance through an asset allocation plan: a strategic plan that defines how much of Fund assets should be invested in equities and how much in fixed-income securities (asset mix), and within the two asset categories, how much should be allocated to the various asset classes.⁶ By 1994, the asset mix in equities had risen to 35 percent of total assets; in 1995, it rose to 63 percent; and in 1997 to 65 percent, where it remained until May 2001.

Due largely to the strength of domestic and foreign stock markets, the market value of total Fund investments almost doubled from 1995 to 2000, going from \$12.3 billion to \$22.3 billion. In fiscal year 2000, enough equities were sold to reallocate \$1.3 billion to fixed-income securities. Due to a decline in the same markets during the past 12-15 months, the current market value of the Fund fell to \$20.1 billion.⁷

A large portion of Fund income is transferred to the State Textbook Fund,⁸ and for this reason the Permanent School Fund is more popularly known as “the textbook fund.” The remaining Fund income is distributed to school districts on a per-student basis, based on average daily attendance of the previous year.

Before each legislative session, the Comptroller of Public Accounts issues on January 1 a revenue estimate of projected income from the Fund over the next biennium (a biennial revenue estimate). The legislature relies on this estimate in setting the state budget and related appropriations. Over the current biennium, the Comptroller’s projected Fund income is \$1.583 billion, or 6 percent of all state funding for education.

⁴ Tex. Const. Art. VII, sec. 5(a).

⁵ *Annual Report, Texas Permanent School Fund* (August 31, 1999). p. 4.

⁶ In fiscal year 2000, equity classes included domestic small-mid cap and large cap, and international equities; fixed-income securities included domestic fixed-income (corporate bonds, government securities, and mortgages), and high-yield fixed-income (corporate bonds).

⁷ Permanent School Fund Asset Allocation Mix Statement as of May 31, 2001.

⁸ In fiscal year 2000, \$303.3 million, or 43 percent of total Fund income, was transferred to the State Textbook Fund.

III. The 77th Texas Legislature and the Permanent School Fund

Three major changes to the Permanent School Fund were proposed in the last legislative session (2001), all of which would have required amendments to the Texas Constitution. One was to remove management of the Fund from the State Board of Education to a separate board, composed primarily of financial experts; another was to base Fund income on total return in lieu of allowing payment of dividends and interest only;⁹ the third was to dedicate a portion of the Fund income to a public school employees' health benefit plan then before the legislature.

Changing the management of the Fund was part of a larger, decade-long effort to weaken Board authority and transition the Board from an elected body to an appointed body.¹⁰ The apparent reason is that an appointed Board with less authority would perhaps be more amenable to some of the education reforms enacted by the legislature and implemented by the Texas Education Agency. Because of the extraordinary growth of the stock markets over the past decade, and the corresponding increase in the market value of the Fund, it was expected that the change to a total return spending policy would permit the Board to make greater payouts of income. The third change would have provided a constitutionally mandated source of funding for the public school employees' health insurance plan.

None of the bills that would have required an amendment to the Texas Constitution passed the legislature. The legislature did pass Senate Bill 512; however, it was vetoed by the Governor. Senate Bill 512 would have given the State Auditor's Office greater investigative authority over the Fund and would have established a nine-member investment-advisory committee to assist the Board. The committee would have consisted of three members appointed by the Governor, three by the Lieutenant Governor, and three by the Speaker of the House of Representatives. The bill also would have repealed Section 43.003 of the Education Code, the significance of which will be discussed later.

The General Appropriations Bill, which amounts to the state budget, did become law. It contains a rider that directly impacts the Fund, and reads as follows:

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 2002-2003 biennium over the Comptroller's official estimate of Permanent School Fund interest, dividend, and other revenue earnings as reported in the 2002-2003 Biennial Revenue Estimate, or, if applicable, in the latest succeeding official revenue estimate issued by the Comptroller prior to the date of the agreement.

⁹ A total return spending policy makes no distinction between Fund income and corpus, but calls for spending a percentage of total return: dividends and interest, *plus any capital gains or losses*.

¹⁰ *At Risk, the Public School Fund* (Texas Public Policy Foundation, April 2001).

The Comptroller's biennial revenue estimate of \$1.583 billion for the current biennium (2002-2003) already represents a 19 percent increase over the biennial revenue estimate of \$1.331 billion for the previous biennium (2000-2001). With the additional \$150 million mentioned in the rider, the total projected income for the current biennium is 30 percent greater than that of the previous biennium.

The rider to the appropriations bill is a cooperative attempt by the Board and the legislature to provide additional funding to the legislature. One of the new expenditures for education over the next biennium is a public school employees' health benefit plan that passed the legislature and will require \$1.3 billion in state funding during the current biennium. Although the plan is only funded for the year 2003, or the second year of the biennium, subsequent bienniums will require an additional \$2.6 billion in state funding.

IV. Management of the Permanent School Fund

The appropriation rider raises numerous questions about management of the Fund. Is the Board under a legal duty to provide the memorandum of commitment required by the rider? Would providing the memorandum be consistent with the prudent-persons standard established by the Texas Constitution? Would Board investment in high-yield (junk) bonds be a legal investment? Do the answers to these questions – or lack of answers – seriously affect public policy? We emphatically believe they do and should be addressed by the Board in open debate before any decision is reached concerning whether to provide the memorandum of commitment. To date, it has not been provided. A motion to do so was tabled for further consideration in a July, 2001 meeting of the Board.

A. Memorandum of Commitment: Questions and Recommendations

Does the State Board of Education have a legal duty to provide the memorandum of commitment, and, if so, is the commitment irrevocable during the next biennium? According to Texas Education Agency legal counsel, the answer is no. The rider is only a legislative request. This answer has not yet been made clear to the Board by the Texas Education Agency.

By stating the Board "shall provide" the memorandum of commitment to the Comptroller, the legislature is attempting to do indirectly what it cannot do directly. The Texas Constitution places in the Board the authority and the power to manage the Fund; and, with one minor exception, the Board manages the Fund *through procedures and subject to restrictions it establishes and in amounts it considers appropriate*, subject to a prudent-persons standard established in the Constitution itself.¹¹

¹¹ Tex. Const. Art. VII, sec. 5(d). The single exception authorizes the legislature to provide for using the corpus of the Fund to guarantee the bond of school districts issued for certain education purposes described in Article VII, Sec. 5(b) of the Constitution.

Under the foregoing constitutional provision, the legislature could not directly require the Board to adopt any particular asset allocation plan in its management of the Fund. In order to generate the additional \$150 million in the current biennium, however, the Board would have to change its asset allocation plan, and only one such plan could possibly generate the additional \$150 million: a new plan in which 10 percent of Fund assets are invested in high-yield (junk) bonds. By requesting the Board to commit voluntarily to the \$150 million figure and the asset allocation plan it necessitates, the legislature has indirectly dictated a particular asset allocation plan if the Board provides the memorandum of commitment.¹²

The rider states no consequence if the Board fails to provide the memorandum. Notwithstanding the word “shall,” if only the Board has the constitutional authority to manage the Fund and the rider states no consequence, the rider can only amount to a legislative request. Because the rider evidently results from letters written by three individual Board members toward the end of the last legislative session, suggesting the Board would provide additional revenue to the legislature, the only consequence of failing to provide the commitment would be political, not legal.

When Board members met in July 2001 and were asked to sign a memorandum of commitment,¹³ there arose considerable confusion among some Board members concerning the amount of additional funding the Board was committing to, and at least two Board members stated erroneously that the memorandum was “law,” and the “law” required that members to sign the document. Whether the Board was legally required to provide the commitment was never fully discussed, and the issue of whether it would be legally binding on the Board was never raised at all. The Agency chief investment officer assured the Board that any delay in executing the memorandum would not change the new asset allocation plan approved in May 2001; nor would the delay affect the Agency investment staff’s ability to make the necessary investment changes. Based on that assurance, the Board voted eight to seven to table a motion that members sign the memorandum. The Board wanted additional time in which to consult the Legislative Budget Board and the Comptroller to clear up any misunderstanding or miscommunication about the amount of additional funding originally suggested to the legislature.

Recommendation: Before the Board votes on whether to provide the memorandum of commitment to the Comptroller, legal counsel for the Texas Education Agency should make it clear to the Board that the rider is a request only and that the legislature has no legal authority to compel the Board to adopt a particular asset allocation plan either before or after providing the memorandum. Knowing this, the Board might well ask, why is a memorandum of commitment even necessary when the Board had already changed its asset allocation plan before the appropriation bill was enacted?

¹² The Board, in fact, has already changed its asset allocation plan to include 10 percent high-yield bonds. It did so in May, 2001, just weeks before the end of the last legislative session. The argument is presented here to demonstrate that the Board had no legal duty to do so, and if the Board were to change its asset allocation plan in any way, it could do so without legal consequence. The fact that the Board adopted the May 2001 plan is the subject of Section IV B.

¹³ Who wrote the memorandum has yet to be determined.

B. Prudent Investments: Questions and Answers

Was the new asset allocation plan adopted in May 2001, which includes a \$2 billion investment in high-yield (junk) bonds, consistent with the prudent-persons standard of the Texas Constitution? Should the Board believe itself obligated to provide the legislature in future bienniums with additional funding beyond the Board's current asset allocation plans? These are complex questions that the Board should address before they execute the memorandum of commitment. Even though the memorandum is not legally binding, it is a signal to the legislature that the Board will continue to respond to future legislative requests and reflects a Board attitude that their supposedly long-term plans may yield to legislative dictation and amendment every two years.

Two questions concern the prudent-persons standard of the Texas Constitution:¹⁴ are high-yield bonds a prudent investment in the sense of the Constitution, and did the Board act prudently when they adopted an asset allocation plan for the short-term goal of providing the legislature additional funding?

First, what are high-yield bonds? Corporate bonds considered to have an acceptable risk of default are "investment grade" and have a bond rating of BBB or better by Moody's Investor Services; bonds BB and lower are called "speculative grade" and have a higher risk of default. Most institutional investors were formerly restricted to investment-grade bonds, sometimes by government rule. As a result, speculative bonds soon developed negative connotations and became known as "junk bonds," since few investors would accept the risk of owning them. In the 1980s and 1990s, however, financial analysts began to observe that the credit risk of these bonds was more than compensated for by their higher yields. On September 13, 2000, for example, the Agency investment staff reported to the Board that the yield of the high-yield bond portfolio exceeded that of the high-grade bond portfolio by 3.9 percent (10.8 percent versus 6.9 percent). There remain, however, several concerns about high-yield bonds: possible default (failure to pay interest or repay principle timely), volatility (propensity of price to rise or fall sharply), and liquidity (ability to trade bonds efficiently without causing any major changes in their prices).¹⁵ And bond losses are often not limited to the factual issues of default, but may pertain to the esoteric political and emotional issues surrounding junk bonds.¹⁶

¹⁴ The prudent-persons standard, established by amendment in 1988 to the Texas Constitution, declares that prudent persons should make their investment decisions "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." (Tex. Const. Art. VII, sec. 5(d). Speculation is the buying and selling of commodities, stocks, and other like investments in the expectation of profit through a change in their market value or to engage in any business transaction involving considerable risk or the chance of large gains. (Random House Dictionary of the English Language, Unabridged Edition [New York: Random House, 1967]). Permanent disposition means over the long term.

¹⁵ www.bondresources.com/corporate/education/guide_to_high_yield_bonds/glossary.

¹⁶ www.efmoody.com/investment/junk.html, p. 1/7.

(1) Based on the following Fund history, high-yield bonds do not appear to be an investment the Board has been comfortable with in the past, nor does it appear that the product is very well understood. This latter observation is based on the Board's apparent unwillingness to take the advice of its investment staff and two other consultants concerning the liquidation of high-yield bonds previously invested in the Fund. How can any investment the Board is not comfortable with, or does not fully understand, be considered a prudent investment?

July 1997: The Board elected to invest 10 percent of Fund assets in high-yield bonds. During the five months of discussion preceding the adoption of a new asset allocation plan, there were Board meetings and workshops to discuss the plan, and the investment advisory committee specifically answered the question "Are high-yield bonds a prudent investment?" The answer was yes. After considerable deliberation and a choice of three alternative asset mixes, the finance committee voted unanimously to recommend a plan to the Board that would include 10 percent of Fund assets in high-yield bonds, and that raised the equities target mix to 65 percent (up from 35 percent in 1994). There was also an incentive to adopt a plan having high-yield bonds because some of the professional fees owed the Board's external money managers would not otherwise be covered, a situation that existed in May 2001 as well.¹⁷ When it came time for the whole Board to vote on the plan, however, at least three of the Board members expressed concern about high-yield bonds, and all but one of the committee members voted to keep the investment in high-yield bonds at five percent until a later vote at some future date. There never was a later vote until July 2000.

March 2000: The Board engaged a new asset allocation consultant. The following month discussions began concerning modifications to the asset allocation plan. Although no debate is recorded in any of the Board minutes from April through July concerning high-yield bonds, according to the new consultant, the Board "had no appetite" for high-yield bonds. One of the concerns was publicity. In July 2000, the Board voted unanimously to adopt one of the seven alternative asset mixes presented, none of which included high-yield bonds. The plan primarily restructured equity investments and the equity mix remained at 65% equity and 35% fixed-income securities. At the same July meeting, the Board asked the Agency investment staff to produce a liquidation plan to sell all currently held high-yield bonds.¹⁸ If the Board was not going to be more fully invested in high-yield bonds and did not need the income, it was felt that keeping the high-yield bonds was not worth the risk.

September 2000: By memorandum, the Agency investment staff presented a liquidation plan, but urged the Board not to consider selling the bonds for another 12-18 months because of low bond prices, which would mean a loss in principle. Should the Board decide nevertheless to sell the high-yield bonds, there were certain trades in the final quarter of 2000 that could be made with the Texas Teacher Retirement System and others that would save transaction costs. The

¹⁷ The legislature appropriates a certain amount for professional fees for external money managers. If the fees are greater than the appropriation, they may be paid from Fund income in excess of the Biennial Revenue Estimate. The Fund first hired outside money managers in 1995.

¹⁸ 2.88% percent of total assets were in high-yield bonds, down from 5 percent because of the drop in high-yield bond prices [*Annual Report, Texas Permanent School Fund* (August 31, 2000)].

entire trade could be accomplished in four months, by January 2001. The memorandum was presented at the Board finance committee meeting in September, but further action was deferred until November. At the September meeting, the asset allocation consultant and the investment-staff consultant also advised the Board to wait until the high-yield bond market improved; only the performance consultant argued against holding the bonds.

November 2000: The performance consultant proposed that one of the three high-yield bond managers assume management of the other two managers' share of the high-yield bond portfolio and that the sole remaining manager submit a transition plan in January; the surviving manager would also be the new manager for the investment-grade bonds purchased with the sale proceeds.¹⁹ The Board voted unanimously to accept the consultant's proposal, and the two managers' shares of the portfolio were transferred to the surviving manager.

December 2000: An issue arose concerning whether the Board should submit a request-for-proposal for external management of the investment-grade bonds, and the matter was referred to the Legislative Budget Board for a decision.²⁰

February 2001: The State Board of Education voted to accept the high-yield manager's transition plan subject to approval by the Legislative Budget Board. The Board never received a reply from the Legislative Budget Board.

May 1, 2001: Two Board members wrote a letter to the chair of the Senate Education Committee proposing a new asset allocation plan in which 5 percent of total Fund assets would be transferred from equities to investment-grade bonds in order to produce additional revenue to the legislature; the target mix for equities would be reduced from 65 percent to 60 percent. Consistent with Board policy at the time of the proposal, there would be no investment in high-yield bonds. A similar letter was sent on April 30, 2001, to the same Senate committee chair by the Fund chair, but no specific proposal was mentioned, only a proposal that "we shall look at several ways to modify the allocation in order to provide more funds." Toward the end of April, however, the chief investment officer of the Agency investment staff was testifying before the legislature on how much additional income the Fund could produce under a revised asset allocation plan with 10 percent of plan assets invested in high-yield bonds, presumably with the full knowledge and consent of the Fund chair.

¹⁹ All other investment-grade bonds are managed by the Agency investment staff.

²⁰ The rider to the General Appropriations Bill concerning external managers (see footnote 17) is written by the Legislative Budget Board. The rider further states *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.*

May 11-12, 2001: The Agency investment staff presented to the Board a new asset allocation plan with a single choice of asset mix that would allocate 10 percent of total fund assets to high-yield bonds. The equity asset mix would be reduced to 60 percent, and the 40 percent in fixed-income securities would be 30 percent investment-grade securities and 10 percent high-yield bonds. The asset allocation consultant was notified of the newly proposed plan about two weeks before the May Board meeting, and he provided support for the plan with an analysis of the long-term effects of this asset-mix change. The consultant's findings were that total return would be slightly lowered, but overall investment risk would also be slightly lowered. There was little discussion, and the plan passed unanimously. Like the asset allocation plan in July 1997, this new plan was presented in a context that included a need for additional Fund income to pay external managers. One-fourth of the projected professional fees for external managers would not be covered by appropriation.

May-August 2001: Since the May meeting, at which some Board members believed they were voting for a plan proposed in the May 1 letter to the Senate committee chair, serious doubts about the prudence of high-yield bonds have again arisen, to the point that some of the same members want the Board to reconsider the asset allocation plan at the next Board meeting in September 2001.

Are high-yield bonds a prudent investment in the constitutional sense? That is for the Board to decide, but it should consider its past history with this kind of investment and be willing to recognize and accept the real and perceived risks that are associated with high-yield bonds and commit to the investment for the long term, if at all. Another question the Board might well ask during its deliberations is an issue that was not successfully established during the course of our research: How much of an investment in high-yield bonds is "enough" to justify the risk? Are there other asset mixes to be considered in which high-yield bond investment is not at 10 percent, but somewhere between 3 and 10 percent?

(2) This brings us to the second question concerning consistency of Board policy with the prudent-persons standard. Did the Board act prudently when they adopted an asset allocation for the short-term goal of providing the legislature additional funding? Has it designed an asset allocation that meets the prudent-persons standard concerning permanent disposition of its funds as the Texas Constitution requires? Again, it is instructive to look at the history of the Fund. This legislative request for additional sums from the Fund is not without historical precedent.

1992-93 and 1994-95 Bienniums: The legislature requested, and got, \$50 million in additional funding each biennium. In order to accommodate the legislature, the Board changed its asset allocation plans by decreasing its equity holdings and purchasing additional fixed-income securities. The need then for additional funding arose from the Edgewood School District judicial decision and a legislative response in the form of statutes requiring wealthier districts to transfer a part of their revenue to poorer districts, often referred to as the "Robin Hood Plan." There was also a serious decline in property tax values during this period that increased the amount of state funding needed for education. In both bienniums, the appropriation bill included a rider requiring a memorandum of commitment in the same language as the 2001 rider.

1996-1997 Biennium: The Board decided to restructure its asset allocation plan to include more equities as a way to increase total return. Realizing this would reduce temporarily the revenue available to the legislature, the legislature took the unusual step of fixing a specific (and reduced) income target instead of basing the target on the Comptroller's biennial revenue estimate. Included in the income target of 1996 was an amount by which the Fund fell short the previous year.

2002-2003 Biennium: It appears that the grounds for the legislative request for additional funding was the \$10 billion growth in the Fund corpus over the past five years (the same five years in which the legislature made no requests for additional funding) and the need for additional sums to pay for the new public school employees' health benefit plan. When a statute was not enacted to implement a total-return spending policy, allowing the Board to spend a part of the enlarged Fund corpus, the legislature resorted once again to a memorandum commitment.

Years Previous to 1990s: The legislature attempted to divide oil and gas royalties between the Permanent School Fund and another fund, and suggested that the realized gain from the sale of Fund assets did not accrue to the Fund corpus. These claims met with stiff resistance from previous Boards and never came to anything.

In light of this Fund history, can the Board reasonably expect that the legislature will come back again the next legislative session with an equally reasonable request for additional funding? The legislature sees things very differently, as reflected in the language of the 2001 memorandum of commitment, which refers to its request as a "two-year special program." That cannot be the Board perspective. In fact, there is nothing to suggest that the Board adopted the current asset allocation plan with the intent of amending it again in two years, but should members provide a memorandum of commitment with that kind of language?

The *Management Discussion and Analysis* section of the 1998 annual report for the Fund summarizes very well the inherent conflict between the short-term income objectives of the legislature and the long-term objective of protecting the purchasing power (corpus) of the Fund:

"A perpetual endowment fund typically sets as a primary investment objective the protection of inflation-adjusted purchasing power over the long term, and therefore, the asset allocation of the Fund is the single most important policy decision approved by a Fund's governing board. An asset allocation plan designed to maximize the total return of the Fund will normally subordinate the income component of return to the desire for capital appreciation. Meeting the challenge of legislative expectations for current income in an environment of declining interest rates is somewhat in conflict with a long-term objective of protecting purchasing power. It requires to Fund to focus on short-term income objectives at the expense of a long-term objective of protecting purchasing power. Despite these seemingly incompatible objectives, recent shifts in the equity and fixed-income allocations have allowed the Fund to meet previous legislative expectations. There can be no assurance, however, that the level of future legislative expectations for investment income and constraints imposed by the legislature will be compatible with actual capital market conditions experienced. This possibility may serve to further limit flexibility in managing the Fund's assets in the future."

Did the Board act prudently, in the constitutional sense, when it adopted the May 2001 asset allocation plan? Perhaps the best answer would be that the Board should reconsider the plan at the September meeting in light of the questions raised below and the long-term consequences of the Board's answers to these questions.

- 1) The current asset allocation plan does not reduce total return by much, but why should it be reduced at all? If the Board has already assumed a higher risk in hope of a higher return, why should it then consider a lower return?
- 2) Does the Board intend to return to the 65/35 percent asset mix of equities and fixed-income securities, and how difficult and detrimental to the Fund would that be? How significant is this change in direction after several years of commitment to increasing the asset allocation mix for equities? This question is asked in full recognition of the fact that due to the recent fall in market prices, the actual asset mix for equities is already at 60 percent.
- 3) The most notable modification to the year 2000 asset allocation plan was an increase in allocation to international stocks, an increase from approximately 9 percent to 22 percent of total assets.²¹ Yet a year later, the new asset allocation plan calls for the sale of five percent of the same international stocks in order to purchase high-yield bonds. Why were these particular stocks chosen for sale?
- 4) How can a long-term asset allocation plan keep up with inflation and student population growth, but continually fail to provide an income sufficient to pay all external managers' fees incurred by the Board?

Recommendations: We recommend that the Board give serious consideration to all the questions raised here; and, as proposed by certain Board members, that the Board revisit the whole issue of whether its asset allocation plan meets the constitutional standards of prudent-persons, both as to product and the long-term aspects of the plan.

C. Legal Parameters for Fund Investments: Questions and Recommendations

The Board's re-adoption of an asset allocation plan that includes high-yield bonds has raised anew the question of whether the purchase of such bonds is a legal investment for the Fund. There is a statute in the Education Code, as well as an agency rule, that expressly prohibits such investments.

Section 43.003 of the Education Code expressly declares as follows: "In compliance with this section, the State Board of Education may invest the permanent school fund in the types of securities, which must be carefully examined by the State Board of Education and be found to be safe and proper investments for the fund as specified below: (3) corporate bonds, debentures, or

²¹ Annual Report, Texas Permanent School Fund (August 31, 2000).

obligations of Unites States corporations of at least ‘A’ rating.” Counsel for the Texas Education Agency maintains that the foregoing statute is unconstitutional or ineffective, in effect, because the statute has been superseded by the 1988 constitutional amendment that established and defined a prudent-persons standard for Fund investments. Agency counsel maintains as well that the constitutional standard also renders ineffective any agency rule that prohibits any particular kind of investment. The first contention may or may not be correct; the second is doubtful.

Agency counsel evidently relies upon a 1992 Attorney General’s opinion.²² This opinion holds that the Board may adopt a securities-lending program, even though no statute authorized the Board to make investments of that kind. This opinion does not address the very different question of whether the prudent-persons standard of the constitution condemns as unconstitutional a statute, such as section 43.003(3) of the Education Code, which expressly prohibits the Board to make a particular kind of investment. This question raises complex issues not addressed in the 1992 opinion of the Attorney General because they were irrelevant, such as: a statute is presumed to be constitutional and will not be held unconstitutional unless absolutely necessary; the statute must be given an interpretation that will sustain its constitutionality if it is possible to do so; and whether the legislature may define more particularly by statute the very general terms qualifying the prudent-persons standard of the Constitution.²³ If the Agency wishes to resolve these issues, it should seek a new Attorney General’s opinion.

This same legal issue arose in a 1996 audit by the State Auditor’s Office²⁴ concerning Fund investment in international securities. The same statute, Section 43.003(7)(B), limits Fund investments to stocks issued by companies incorporated in the United States. Although the State Auditor’s Office agreed with the Agency’s reliance on the same 1992 Attorney General’s opinion, the auditor nevertheless recommended that the Agency work in the next legislative session to resolve differences noted in the statutes that govern the Fund and to eliminate any inconsistencies. That was made three legislative sessions ago but evidently not followed.

The Texas Education Agency believes, in addition, that the same 1992 opinion of the Attorney General also renders inoperative section 33.25(b)(13) of the Texas Administrative Code which prohibits Fund investment in corporate bonds having less than a BBB- credit rating. It is the Agency’s position that the prudent-persons standard of the Constitution authorizes the board to ignore that section of the Administrative Code. Nothing in the prudent-persons language of the Constitution prohibits the Board from voluntarily restricting by rule the kind of investments it may make. In fact, the constitutional provision expressly states that the board may make

²² Opinion No. DM-175, October 21, 1992.

²³ The prudent-persons standard defined in the constitution has an important qualifying phrase as noted above -- *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*. There is nothing here that would necessarily preclude the legislature from clarifying or further defining what *probable income* means or what investments are *probably safe* for purposes of the Fund.

²⁴ *A Review of Controls over Investment Practices at Six Major State Investing Entities*. (Report 97-014, November 1996).

investments through procedures and subject to restrictions it establishes in amounts it considers appropriate.²⁵ It is true that a Board may not restrict future Boards regarding their investments, but that is not to say that future Boards may ignore valid rules adopted by their predecessors. Succeeding Boards are bound by Agency rules until they are repealed.

Recommendations: We recommend that the Texas Education Agency seek an Attorney General opinion concerning the validity of the statutory and rule provisions mentioned above, and that the Agency inquire into the Board's liability if it signs a memorandum of commitment that requires the Board to violate those provisions to meet its commitment. We further recommend that a thorough review of all the statutes and rules governing Board investments be conducted to eliminate any other inconsistencies.

V. Recommendations for Further Research

In addition to the foregoing legal and financial issues raised by the memorandum-of-commitment request, we noted three other important financial issues that deserve further study:

- 1) *Board Update to a 1996 Comptroller's Report* – The Board should do a follow-up study comparable to the Comptroller's evaluation and comparison of investment results obtained by Agency investment staff and outside money managers.²⁶ With as many as 11 outside money managers,²⁷ and the attendant decisions brought before the Board, is the Board buried in investment detail beyond its capacity; is the Fund retaining sufficient control of its investments; and are Fund earnings produced by outside managers worth the expense? Once embarked on a course of hiring outside managers in 1995, these inquiries and comparisons should be made periodically by the Board.
- 2) *Securities Lending* – Management of the securities-lending program, which produced \$11.1 million in net Fund income in fiscal year 2000, appears to be a recurring debate among Board members.
- 3) *Total-return* – Total-return is an issue that was recommended by the Comptroller in December 2000,²⁸ raised by the State Auditor's Office in its January 2001²⁹ audit, almost imposed on the Board during the last legislative session, and most recently recommended for additional study in an April 2001 report by the Texas Public Policy

²⁵ Tex. Const. Art. VII, sec. 5(d).

²⁶ "Reevaluate Management of Permanent School Fund." *Disturbing the Peace* (Texas Performance Review, Vol. 2, Chapter 1, Education Issues #10, 1996).

²⁷ *Annual Report, Texas Permanent School Fund* (August 31, 2000). p. 36.

²⁸ <http://www.e-texas.org/recommend/ch06/ed02.html>.

²⁹ *A Follow-Up Report on Two Reviews of Controls Over Investment Practices at State Investing Entities* (Report No. 01-017, January 2001).

Foundation. This issue will not disappear, and the Board has a duty to engage in serious debate concerning this policy, if for no other reason than to prepare for the next legislative session when state finance reform will be a primary focus of the session.

VI. Conclusion and Recommendations for Policy

The Fund has long served as an important resource for financing public education, especially for purchasing textbooks. It is the Board's duty to manage the Fund, protect the Fund, and dedicate the use of the Fund expressly for students of Texas public schools. Rising textbook costs, coupled with a growing student population, make judicious investment decisions increasingly critical to the vitality of the Fund.

Recognizing the Board's earnest efforts to be careful stewards of the Fund, the following recommendations are offered to the Board:

- 1) To create an investment advisory council;
- 2) To schedule regular, in-depth information meetings with the asset allocation counselor;
- 3) To conduct periodic evaluations of rules, practices, policies, and compliance;
- 4) To establish investment policies that focus on long-range investment strategies; and
- 5) To broker a formal understanding with the legislature about the proper use of the Fund.

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