Texas Public Policy Foundation

House Select Committee on Constitutional Revisions Public Testimony
Article VII, Section 8. State Board of Education
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Testimony by Deborah Powers.

Mr. Chairman, members of the committee.

I am Deborah Powers and I represent the Texas Public Policy Foundation. I am a retired state employee, a CPA, and a part-time research analyst for the Texas Public Policy Foundation. As a state employee, I researched and implemented the state's 401K plan at the Comptroller's Office, where I worked for five years, and afterward was a supervising auditor for eight years at the State Auditor's Office.

Last year, the Texas Public Policy Foundation asked me to research three proposed constitutional amendments that concerned the Permanent School Fund. One of the proposed amendments had to do with total return. Thank you for the opportunity to address the committee in that connection.

- First of all, the issue of total return has nothing to do with a supposed failure of the State Board of Education and the Texas Education staff to wisely invest Permanent School Fund monies. Investment performance of the Permanent School Fund has never been questioned or identified as a problem. In fact, it is the very success of the fund that has drawn such attention to it. In five years, 1995-2000, it went from a $12.3 billion fund to a $22.3 billion fund. The reason: the fund went from a 35% investment in stocks to a 65% investment in stocks, all within the context of the current spending policy.
- Total return is essentially a spending policy. In light of fund performance, how much of the fund may be spent? Under current spending policy, in simplified terms, you may spend only stock dividends and bond interest. Under a total-return spending policy, you may spend all of the above plus any capital gains (or minus any losses).
- It is true that total return makes investment decisions less restrictive (greater freedom in investing according to market returns). But with that freedom comes greater risk. Yesterday, you heard testimony that UTIMCO's investment mix is 80% stocks, 20% fixed-income. The current asset mix in the Permanent School Fund is 55% stocks, 45% fixed-income and no investment in private stocks or venture capital.
- Yesterday, UTIMO also told you that total return allowed them to increase distributions by 12.5% the first year, 6.6% the second year, and 6.7% the third year. Why did the percentages decline? Perhaps because distributions are usually based on fund balances over a rolling period of time, usually three-five years. The first year's increase was more dramatic because there was a record market that lasted well over five years; today the market is considerably different, as demonstrated by the declining percentages and a negative real return in year three.
- In March 2001, Callan Associates, investment advisor to the State Board of Education and the Texas Education Agency investment staff, did a long-term projection for the two spending policies. Their findings were that the overall fund balance was slightly lower under total-return, but overall distributions were greater. But not dramatically greater. With proper management, there can and should be an increase in distributions, but much less dramatic than what the legislature

was looking for in the last legislative session when the issue first arose, and definitely not in sync with the short-term projections used by the respective legislative committees.

- I am sorry that I cannot provide you with a copy of the report, but the Texas Education Agency investment staff or Callan Associates should be able to. I urge you to consider that report and others like it. Another long-term study commissioned by the Council of Michigan Foundations in 2000 cautioned funds on how difficult it is to maintain a constant spending rate of 5% and noted that funds that have taken lower capital markets into account generally lowered their spending rate, even during periods when investment performance was strongest.
- All this is by way of saying that total return is a spending policy that can produce greater distributions, but there is another side to the policy. Greater investment risk, marginal gains, and a vastly different market today than three years ago when the Permanent University Fund adopted the spending policy. The question is, do the advantages justify a constitutional amendment? At this time, in this market, over the long term?
- The Permanent School Fund and Permanent University Fund have the same stated goal, which was reiterated yesterday by UTMICO: intergenerational equity. That is, balancing current needs with future generations with similar needs. Put another way, maintaining a fund balance that will keep ahead of inflation and keep pace with student enrollment, now and forever. That balance can be maintained under both spending policies.
- There is one more consideration. There have been three incursions into the Permanent School Fund by the legislature over the past decade. In 1992-93 and 1994-95, the legislature requested an additional $50 million in earnings each biennium, and in 2001, they asked for and got an additional $150 million. In each instance, the State Board of Education, as managers of the fund, had to readjust their long-term asset-allocation plans; i.e. sell off stocks to purchase additional fixed-income investments. In the year 2001 the Board was in the peculiar position of having to purchase additional junk bonds they had previously voted to divest themselves of completely just seven months before.
- Will a new total-return spending policy satisfy the short-term needs of the legislature, or will the legislature continue to demand more and more of the fund? What constitutional safeguards are needed to ensure the long-term goal of intergenerational equity? Under current spending policy, the corpus of the fund must remain inviolate, but not so with total return. This is one more thing to consider when contemplating a constitutional amendment.

Overall conclusion: Total return is the prevailing spending policy among endowment funds and can produce greater distributions, a desirable goal for the Permanent School Fund. However, a constitutional amendment should be structured with full knowledge of the policy's limitations and to ensure the fund's long-term financial goals as opposed to any short-term financial goals set by the legislature, now or in the future.

- The other question I would like to address is whether Texas should alter the administration of the Permanent School Fund to more closely match the administration of the Permanent University Fund? Should a structure similar to UTMICO be established to make investment decisions?
- In our April 2, 2001 report about the permanent school fund, we recommended just that; that the State Board of Education contract with a non-profit corporation in which the chief administrator and investment staff would report directly to the corporation board of directors. The corporation's board of directors would consist of members of the State Board of Education, and the State Board could add financial expertise by appointing at least three outside advisors with substantial background and expertise in investments. If such a non-profit corporation were to look exactly like UTIMCO, the corporation board of directors would have at least three members (not all) of the State Board appointed as directors, with the remaining members with substantial financial expertise appointed by the State Board.
- This reorganization does not appear to require a constitutional amendment. A statute already exists to allow it: Section 43.006 of the Texas Education Code, the same statutory authority given the Permanent University Fund in Section 66.06 of the code. The mirror-like composition of the board of directors for the Permanent School Fund may require statutory revision, which would be far easier to accomplish than a constitutional amendment. Should the reorganization require a constitutional amendment, however, it is an important enough change to warrant it. Like the University of Texas Board of Regents, the State Board of Education would enjoy clear lines of

authority over the fund, yet be relieved of some of the burden of management through greater reliance on the financial expertise of the corporation's board of directors.

Overall Conclusion: A management structure for the Permanent School Fund similar to UTIMCO at the Permanent University Fund would be a positive step toward maintaining the integrity of the fund. It would give the State Board of Education authority over the fund commensurate with their responsibilities and provide them the necessary financial expertise.

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