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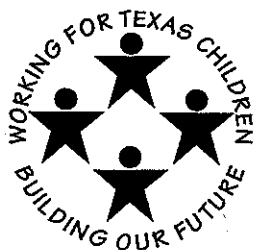
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JAN 24 2011

OPINION COMMITTEE

January 21, 2011

The Honorable Greg Abbott
Attorney General of Texas
Office of the Attorney General
P.O. Box 12548
Austin, Texas 78711-2548

FILE # ML-46658-11
I.D. # 46658

RQ-0941-GA

Re: Permissible Investments of the Permanent School Fund

Dear General Abbott:

I am writing to seek your opinion regarding the scope of permissible investments for the Texas Permanent School Fund ("PSF").¹ As you know, The State Board of Education ("Board") is granted board authority to invest assets of the PSF by Article VII, Section 5(f) of the Texas Constitution.²

(f) 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.

¹ The term "Permanent School Fund" is generally used to refer to a single fund that is also called the "Perpetual School Fund" and the "Public Free School Fund" in sections 2 and 4 of Article VII of the Texas Constitution. See, Texas Attorney General's Opinion GA-617 (2008).

² Section 43.003 of the Texas Education Code authorizes certain investments by the PSF. However, we understand that the Board's authority to make "any kind of investment" is a direct grant of authority under the Texas Constitution. See, Texas Attorney General's Opinion DM-175 (1972).

Each state fiscal biennium, the Board determines a percentage of the investment assets of the PSF that may be used to support education in Texas. Those amounts are transferred to the Available School Fund for appropriation.³

The Board has been asked to consider making certain investments in a manner that would additionally benefit charter schools operating in Texas. Charter schools are public schools created under Chapter 12 of the Education Code,⁴ but are not eligible for state facilities programs available to school districts.⁵

This proposal has raised a question whether the Board may make an investment that has the ancillary purpose of assisting charter schools in acquiring instructional facilities and whether such an investment is consistent with the "prudent person" standard limiting the range of investments authorized in Section 5(f) of Article VII. The Board has established a special asset class for charter schools facilities investment with its own proposed benchmark for returns but has chosen not to fund that asset class without receiving your opinion. Possible investments that could assist charter schools include direct acquisition of real estate or real estate mortgages and bonds issued by the non-profit corporations that hold state charters. For example, the PSF could purchase or construct facilities and then lease them to charter schools, or purchase bonds issued to finance the construction or purchase of facilities by charter schools.⁶ If for some reason the use for a charter school could no longer be sustained, then the property might later be converted to retail leasehold or sold and the proceeds reinvested.

Although the discussion that prompted this request involves charter schools, other potential investments could be presented to the Board as producing a net benefit to the education of students in Texas. Therefore, my question involves the general authority of the Board under the Texas Constitution and the limit imposed on that authority under the prudent person standard. We have assumed that the PSF may be invested in types of assets that could indirectly benefit charter schools. However, the possibility of making a particular investment with a purpose of incidentally benefitting a charter school raises a question of whether the Board can determine to make such an investment under the prudent person standard as part of a prudent asset allocation

³ Your office previously considered aspects of the Board's determination and transfer to the Available School Fund in Attorney General's Opinions GA-617 (2008) and GA-707 (2009).

⁴ Chapter 12 authorizes four types of charters: home-rule school districts, campus, open-enrollment and college or university charters. There are currently no home-rule school district charters. Campus charters are granted by school districts and are treated by the state as campuses of the local district. Open-enrollment and college/university charters are granted by the Board pursuant to subchapters D and E of Chapter 12. For purposes of this request, please assume the term "charter school" applies to an open-enrollment or college/university charter.

⁵ School districts are eligible to have their bonds guaranteed by the PSF under Article VII, Section 5(d) of the Texas Constitution and Chapter 45 of the Education Code, as well as direct financial assistance tied to voter-authorized property taxes to pay facilities bonds under Chapter 46 of the Education Code. Charters receive state average operating revenue per student under Section 12.106 of the Education Code. The 2009 Texas Legislature also adopted Subchapters I and J of Chapter 45 of the Education Code to provide credit enhancement for school district and charter facilities debt.

⁶ The Board has discussed investments to benefit charter school access to facilities at April 30, 2010 (School Finance/Permanent School Fund Committee), June 21, 2010 (School Finance/Permanent School Fund Committee), July 21, 2010 (Committee of the Full Board) and the July 22, 2010 Board meeting. Agendas, minutes and recordings of Board meetings are available on the Texas Education Agency website at <http://www.tea.state.tx.us/index3.aspx?id=1156>

or an individual investment that also benefits an educational entity or advances another state policy.⁷ It may be noted that diversification of any investment portfolio is one of the critical factors in the net overall return pattern for a fund. Modern portfolio theory suggests that diversification occurs when “investments are made in a wide variety of assets so that the exposure to the risk of any particular security is limited” (Bodie,⁸ p. 156). It has been suggested that the proposed investment would be in keeping with this diversification concept.

The language of Article VII, Section 5(f) was adopted as an amendment to the Texas Constitution in 1988.⁹ That amendment greatly expanded the permissible range of PSF investments. The Legislature and the people of Texas in adopting that amendment subjected the Board to the “prudent person” standard while exercising investment discretion. The same amendment also specifically authorized investment in the Texas Growth Fund. A 1983 amendment had previously authorized using the corpus of the PSF to guarantee bonds issued by school districts.¹⁰

The scope of permissible investments was discussed in analyses of the proposed amendment broadening the scope of investments. The Texas Legislative Council related arguments for the Texas Growth Fund that included an inability for certain investments to obtain financing “from traditional sources” and cited opponents as arguing that the amendment “contravenes the long-standing state policy against use of public funds to benefit private entities.”¹¹ The House Research Organization digest of the amendment¹² explained it as allowing the PSF to make any kind of investment but to also “make investments directly related to employment opportunities and economic growth in Texas” via the Texas Growth Fund. Supporters were cited as describing the prudent person limit as a “conservative standard [that] ensures wise investments in the long-term interest of the beneficiaries of the funds” and not authorizing “social investments” based on affiliation with the Republic of South Africa. Opponents expressed concern that the amendment could allow such “social investments.” Proponents stated that the PSF would be able to purchase school district bonds, while opponents expressed concern that the prudent person standard would prohibit that type of investment.¹³

⁷ The scope of the Board’s authority under the prudent person standard was also considered in Texas Attorney General’s Opinion GA-617 (2008, at p. 5), but the discussion in that opinion appears to be based on the text of a Board administrative rule rather than the constitutional language.

⁸ Bodie, Kane, & Marcus Investments, Fourth Edition, 1999. (This is a graduate level text on investments. It is likely the most popular among MBA programs and historically relied upon in the CFA programs required readings for exams.)

⁹ The language of Section 5(f) was adopted as subsection 5(d) in 1988 and redesignated as 5(f) as part of another amendment in 2003.

¹⁰ See, Article VII, Section 5(d) and Subchapter C, Chapter 45, Texas Education Code.

¹¹ See, http://www.lrl.state.tx.us/scanned/Constitutional_Amendments/Amendments70_tlc_1988-11-08.pdf at p. 21.

¹² See, http://www.lrl.state.tx.us/scanned/Constitutional_Amendments/amendments70_HRO_1988-11-08.pdf, at p. 21.

¹³ Id, at pp. 25 and 31. Both of these arguments are couched in terms of a school finance proposal attributed to then-comptroller Bob Bullock. The later passage of an amendment to Article VII, Section 5(b) in 1989 may have been relevant to that discussion in authorizing the PSF to guarantee state bonds issued for the purpose of purchasing school district bonds. See, <http://www.lrl.state.tx.us/legis/constAmends/amendmentDetails.cfm?amendmentID=481&sort=bill&legsession=71%2D0&article=7>.

The purpose of the PSF is to support public education in Texas and so it would appear reasonable to suggest that investments of the PSF can be applied to that role. On the other hand, the decision to specifically authorize investment in the Texas Growth Fund and school district bonds in the constitution may suggest that such a constitutional authorization would be required for any investment that either does not seek to maximize the future value of the fund or that has some ancillary educational benefit. Section 5(c) of Article VII prohibits "appropriation" of the PSF for any purpose not authorized in that section.

The Board has for more than ten years pursued a policy of diversifying PSF assets by examining an "efficient frontier" of investments that seeks to maximize return to the PSF by balancing the relative risks of different asset classes and their probable returns. Professional staff or managers have then selected specific investments within asset categories under a charge to either maximize return to the PSF or to match the performance of a particular market index¹⁴. The focus of investment policy up to this point has been to maximize the long-term value of the PSF by balancing expected returns of different asset categories and the risk inherent in those types of investments. While the Board has recently added new asset classes to include real estate, the Board has not up to this time adopted a policy of making specific investments intended to incidentally benefit a particular recipient of the investment or to serve a state educational or other policy priority. However, we understand that some foundations analyze prospective investments not only from the standpoint of risk and return but also how the prospective investment aligns with and furthers the foundation's purpose. In this respect, the proposed real estate investments discussed here might be likened to the General Land Office's ("GLO") investment in real estate purchased from and leased back to a national retailer as a distribution center, where the rate of return was found acceptable and the development of the real estate was in an otherwise underdeveloped area, and thus its development was beneficial to the State, while at the same time the sale, purchase and lease were on terms that would protect the investment of the assets of the PSF within the GLO.

My questions are:

1. Whether the Board must, consistent with the "prudent person" standard adopted in Article VII, Section 5(f) of the Texas Constitution, determine the asset classes in which it will invest with the sole purpose of maximizing the future value of the PSF, or may the Board also consider benefits to a state policy in making an investment as outlined above which may not have an expected return as high as the expected return of the likely highest returning class of assets within the PSF?
2. Having determined an asset class in which the PSF would be invested, may the Board restrict investment within that class to a group of entities in furtherance of a state policy,

¹⁴ Although the Board does not select specific investments such as a particular stock or bond, staff purchases of fixed-income investments and equities are ratified by the Board at each meeting. The Board also will directly approve investment in real estate funds, the managers of which will then select specific properties to purchase.

or must the Board seek out the highest return commensurate with a given level of risk within each class of investments?

3. If your answer to Question number 1 is that the Board may not consider benefits to a state policy in determining an asset class, or if your answer to Question number 2 is that the Board may not restrict investment within an asset class in furtherance of a state policy, please clarify whether the Board has any greater authority to select an asset class or to make an individual investment decision within an asset class if the purpose of that decision is to benefit an educational entity or education policy within Texas, such as charter schools?

Thank you for your consideration of this request. Should you need any additional information, please feel free to contact me or David Anderson, Texas Education Agency General Counsel, at (512) 463-9720.

Sincerely,



Gail Lowe, Chair
State Board of Education

cc: Members, State Board of Education
Robert Scott, Commissioner of Education

