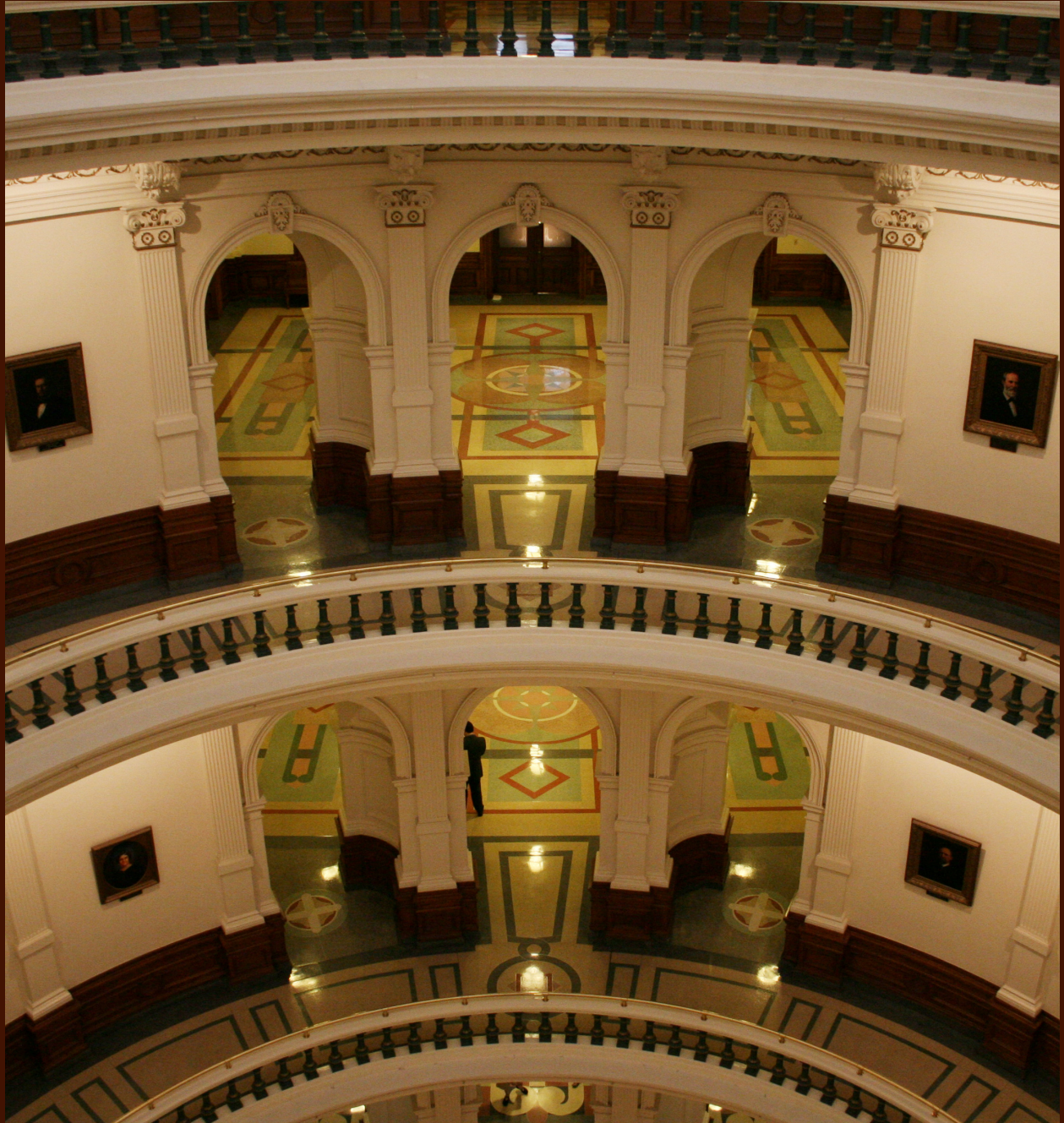


# Annual Report on Major State Investment Funds



LEGISLATIVE BUDGET BOARD STAFF

APRIL 2012

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# **Annual Report on Major State Investment Funds**

**Fiscal Year 2011**

**LEGISLATIVE BUDGET BOARD**

**APRIL 2012**

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## LEGISLATIVE BUDGET BOARD

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April 30, 2012

The Honorable David Dewhurst  
The Honorable Joe Straus  
Members of the Eighty-second Legislature

Dear Governor Dewhurst, Speaker Straus, and Members:

As required by the provisions of Sec. 322.014, Texas Government Code, this report reviews the risk-adjusted performance of the following major state investment funds during fiscal year 2011:

- Teacher Retirement System Pension Trust Fund
- Permanent School Fund
- Employees Retirement System Pooled Pension Trust Funds
- The University of Texas System
  - Permanent Health Fund
  - Permanent University Fund
- Comptroller of Public Accounts
  - Tobacco Settlement Permanent Trust Fund
  - Texas Guaranteed Tuition Plan Fund
  - Permanent Public Health Fund
  - National Research University Fund

The report makes no recommendations regarding portfolio allocations or current management practices. It is intended as an informational resource only.

The LBB staff who developed and produced the report are Kevin Kavanaugh, Scott Dudley, Sherrie Morgan, and Kim Irby.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Ursula Parks".

Ursula Parks, Acting Director  
Legislative Budget Board



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## EXECUTIVE SUMMARY

The fiscal year 2011 *Annual Report on Major State Investment Funds* presents the financial performance for Texas' major investment funds. The report includes the risk-adjusted returns for the funds, as well as other performance and background information for each of the funds. The investing agencies or public institutions of higher education provided all the information in this report (see attachments in Appendix D). The only information the Legislative Budget Board (LBB) staff calculated is the risk-adjusted return and the five-year average total fund rate of return. The report does not include recommendations regarding portfolio allocations or current management practices. It is intended as an information resource only.

### INVESTMENT ENVIRONMENT

All major state investment funds earned strong returns during fiscal year 2011, the second straight year of positive performance following the global financial crisis. The fund's high yields are impressive, even after considering the favorable investment climate for much of fiscal year 2011, with 9 out of the 10 funds covered in this report outperforming their benchmark rate of return.

The financial investment climate was characterized by low volatility and steady growth during the first half of fiscal year 2011, influenced by several factors. First, implementation of the first Greek bailout package by the European Union (EU) and International Monetary Fund (IMF) eased concerns over the European sovereign debt crisis that had plagued financial markets for much of the previous fiscal year. Although worries briefly returned in November when Ireland government bond spreads spiked, the acceptance of a joint EU/IMF package to alleviate their debt burden suppressed concern over the European debt issue for several months.

In addition, improving economic conditions, fiscal policy, and monetary policy all combined in the U.S. to boost financial markets in early fiscal year 2011. After losing jobs for the last three months of fiscal year 2010, the U.S. economy added back 764,000 jobs in the first half of fiscal year 2011. Also, after two years of contraction, the U.S. economy (as measured by real gross domestic product) grew by 3 percent in calendar 2010. On the policy side, in December, Congress and President Obama passed legislation that extended the 2001 and 2003 income tax cuts (set to expire at the end of 2010) for an additional two years, provided a payroll tax rate cut of 2 percent for one year, and extended enhanced federal unemployment benefits for 13 months. Finally, to inject further liquidity into the financial system, the Federal Reserve Bank (Fed) resumed their purchase of U.S. Treasury Securities in November, purchasing \$600 billion by the end of the fiscal year, in a program ubiquitously named "QE2." The Fed pledged to keep interest rates "exceptionally low" for an "extended period" as well, adding to their already accommodative monetary policy. The above three factors combined to increase confidence and

create the aforementioned low volatility and steadily increasing yield environment investment funds faced for much of fiscal year 2011.

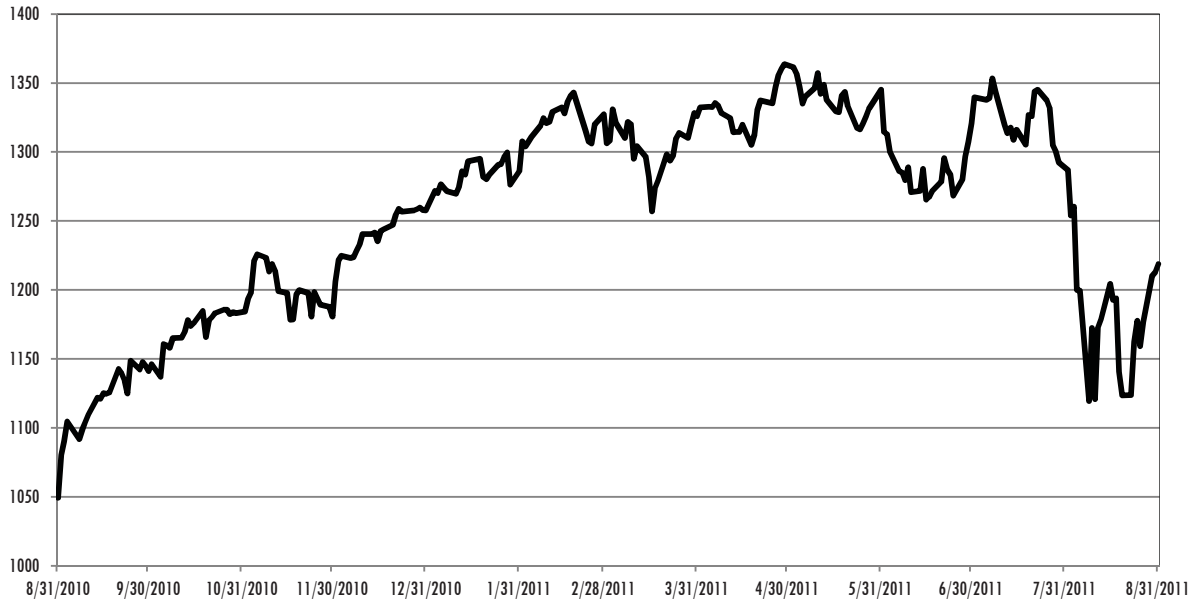
However, several macroeconomic shocks during the latter half of fiscal year 2011 produced a moderating effect on the strong gains of the investment funds. In March, the magnitude 9.0 earthquake that struck the Tohoku region of Japan was estimated to have caused a loss of \$235 billion in economic output, making it the most expensive natural disaster in history. The suspension of some industrial production in the country cause severe supply disruptions to many sectors of the global economy and had a dampening effect on international equity markets. A concurrent and more damaging to the U.S. economy event was the large spike in oil prices induced by political turmoil in the Middle East and northern Africa that has collectively become known as the "Arab Spring." The protests of governments in many of the region's countries, particularly Egypt, Libya, and Tunisia led to fears of oil supply disruptions which peaked in late March when the United Nations intervened in the Libyan civil war and initiated military operations against the Libyan army. By this time, oil prices had increased 47 percent since the beginning of the fiscal year, a dangerous threat to the nascent global economic recovery.

Finally the U.S. debt ceiling debate, a politically rather than economically motivated crisis, led to the highest volatility experienced by equity markets since October 2008, the beginning of the financial crisis. Markets plunged in late July on news of a political stalemate in Washington over lifting the Treasury Department's authority to issue additional U.S. debt. The possible inability of the Treasury to pay debt service led to investor panic and a subsequent downgrade of U.S. credit for the first time in history. An eventual agreement reached in August calmed markets, leading to a rebound where funds regained some, but not all of their investment earnings by the end of fiscal year 2011.

**Figure 1** "shows the daily closing price" of the S&P 500 index throughout fiscal year 2011 while **Figure 2** shows several financial market indicators for the fiscal year. The



**FIGURE 1  
STANDARD AND POOR INDEX  
FISCAL YEAR 2011**



SOURCE: St. Louis Federal Reserve Economic Database.

**FIGURE 2  
FINANCIAL MARKET INDICATORS  
FISCAL YEAR 2011**

MARKET	INDICATOR*	8/31/2010	8/31/2011	CHANGE
Domestic Equity	S&P 500	1049.33	1218.89	16.2%
Domestic Equity	DJIA	10014.72	11613.53	16.0%
Domestic Equity	NASDAQ	2,114.03	2,579.46	22.0%
International Equity	MSCI EAFE	1425.72	1523.58	6.9%
International Equity	MSCI World	1080.7	1211.22	12.1%
Emerging Markets Equity	MSCI Emerging Markets	970.05	1033.15	6.5%
U.S. Treasuries	BC US Treasury AM	192.84	201.05	4.3%
U.S. Corp Debt	BofA Merrill Lynch US Corp Master Total Return Index	2085.47	2183.58	4.7%
U.S. Dollar	Fed Trade Weighted U.S. Dollar Index: Broad	103.06	95.21	-7.6%
Cash Equivalent	Annualized Yield 90 day T-Bill	0.02%	0.14%	
Oil Price	Brent Crude Spot (\$)	75.51	116.48	54.3%
Price Inflation	CPI-U	217.22	222.4	2.4%

\*Financial market indexes are presented on a price return basis.

SOURCE: St. Louis Federal Reserve Economic Database.

investment climate outlook for fiscal year 2012 continues to look positive, although risks do exist. Most economists forecast stronger growth in 2012, improving labor market conditions, and low inflation. As of the date of this publication, after beginning the year in a downward slide, equity markets have rebounded to levels reached in early calendar 2011. While the combination of stronger economic growth and relatively stable political atmosphere should provide an environment conducive to strong returns for state investment funds during the remainder of the fiscal year, the ever lingering European sovereign debt crisis, worries over possible military action by Israel against Iran, or some unforeseen event could emerge to moderate what should be an otherwise strong fiscal year 2012 for the funds.

### ENDING MARKET VALUE

The ending market value of the major investment funds for fiscal year 2011 was \$174.0 billion, \$18.6 billion, or 12.0 percent, more than the value of the funds at the end of fiscal year 2010. The funds and their ending market values are shown in **Figure 3**.

**FIGURE 3**  
**ENDING MARKET VALUE OF MAJOR INVESTMENT FUNDS**  
**FISCAL YEAR 2011**

FUND	VALUE (IN BILLIONS)
Teacher Retirement System Pension Trust Fund	\$107.1
Permanent School Fund – TEA	\$24.1
Permanent School Fund – GLO	\$2.6
Employees Retirement System Pension Trust Fund	\$22.1
Permanent University Fund	\$12.7
Permanent Health Fund	\$1.0
Tobacco Settlement Permanent Trust Fund	\$2.1
Texas Guaranteed Tuition Plan Fund	\$1.3
Permanent Public Health Fund	\$0.4
National Research University Fund	\$0.6
<b>Total Investment Funds</b>	<b>\$174.0</b>

NOTE: PSF-GLO ending market value is Year Ending June 30, 2011.

SOURCE: Investing Agencies and UTIMCO.

### RATES OF RETURN

The average rate of return for the funds was 12.14 percent and ranged from 9.0 percent to 15.61 percent as shown in **Figure 4**.

**FIGURE 4**  
**MAJOR INVESTMENT FUNDS TIME WEIGHTED GROSS**  
**RETURN, FISCAL YEAR 2011**

FUND	RATE OF RETURN TIME WEIGHTED	BENCHMARK*
Teacher Retirement System Pension Trust Fund	15.61%	14.45%
Permanent School Fund – TEA	13.64%	13.15%
Permanent School Fund – GLO	9.52%	16.70%
Employees Retirement System Pension Trust Fund	12.58%	12.02%
Permanent University Fund	15.06%	12.00%
Permanent Health Fund	14.86%	12.00%
Tobacco Settlement Permanent Trust Fund	10.47%	9.91%
Texas Guaranteed Tuition Plan Fund	9.00%	7.60%
Permanent Public Health Fund	10.60%	9.91%
National Research University Fund	10.02%	9.91%

\*Benchmark Adjusted Gross Returns were calculated by the agencies or institutions and are identified in the background information provided for each fund in Appendix B.

NOTE: Each fund has different investment objectives and strategies, some required by law, that affect its benchmarks and performance. PSF-GLO rates of return are based on Year Ending June 30, 2011

SOURCE: Investing agencies and UTIMCO.

The total fund rate of return used in this report is the gross time-weighted rate of return for all investments of each fund. The time weighted rate is calculated before related investment expenses are deducted, and is adjusted to eliminate the effect of timing of cash flows due to contributions and withdrawals. The five-year average rate of return is calculated using a geometric average of the annual rates of return for the five-year period.

The annual rates of return reflect both income earned and change in fund value, without consideration of the risk of fund investments. **Figure 5** shows the average rates of return over five years.

**FIGURE 5  
AVERAGE ANNUAL RATES OF RETURN, FISCAL YEARS  
2007 TO 2011**

FUND	RATE OF RETURN
Teacher Retirement System Pension Trust Fund	4.06%
Permanent School Fund - TEA	3.70%
Permanent School Fund – GLO	1.08%
Employees Retirement System Pension Trust Fund	4.03%
Permanent University Fund	4.97%
Permanent Health Fund	4.82%
Tobacco Settlement Permanent Trust Fund	2.84%
Texas Guaranteed Tuition Plan Fund	3.02%
Permanent Public Health Fund	2.72%
National Research University Fund	N/A

NOTE: Each fund has different investment objectives and strategies, some required by law, that affect its benchmarks and performance. PSF-GLO rates of return are based on a Year Ending June 30 2007 to 2011. The average annual rate of return was determined using the time-weighted rate of return provided by the agencies. SOURCES: Investing Agencies and UTIMCO.

**RISK-ADJUSTED RETURN**

The risk-adjusted return is a tool used to compare the performance of funds that have different types and proportions of assets, and quantifies a fund’s return relative to its risk. The Sharpe ratio determines the risk-adjusted return for each fund. (The calculation of the Sharpe ratio is explained below.) As **Figure 6** shows, the ratios range from 0.172 to 0.376 percent.

A risk-adjusted return is a single statistic that reflects both the return and volatility of returns over time. A generally accepted measure for computing the risk-adjusted return is the “Sharpe ratio,” developed by Nobel Laureate William Sharpe. The Sharpe ratio is often used to rank the risk-adjusted performance of various portfolios over the same period of time. The results of the Sharpe ratio indicate the amount of return earned per unit of risk.

The formula for the Sharpe ratio follows:

$$\frac{\left( \text{Portfolio's Total Return} \right) - \left( \text{"Risk-free" Rate of 90-day Treasury Bills} \right)}{\left( \text{Standard Deviation of the Portfolio's Return Over Time} \right)}$$

**FIGURE 6  
RISK-ADJUSTED RETURN, FISCAL YEARS 2007 TO 2011**

FUND	RATE OF RETURN (SHARPE RATIO)
Teacher Retirement System Pension Trust Fund	0.259
Permanent School Fund - TEA	0.226
Employees Retirement System Pension Trust Fund	0.259
Permanent University Fund	0.376
Permanent Health Fund	0.363
Tobacco Settlement Permanent Trust Fund	0.186
Texas Guaranteed Tuition Plan Fund	0.188
Permanent Public Health Fund	0.172
National Research University Fund	N/A

NOTE: The PSF-GLO invests solely in real estate therefore it is not appropriate to use the GLO's risk-adjusted return as measured by the Sharpe Ratio in comparison to the other funds. SOURCES: The rates of return used in the Sharpe Ratio calculations are the monthly rates of return provided by the investing agencies and UTIMCO.

For example, a portfolio with an average annualized return of 10 percent over the past five years, the growth of which consistently, year after year, fell within a tight range of 7 percent to 12 percent, would reflect a higher (better) risk-adjusted return than another portfolio that averaged the same 10 percent annualized return, but varied wildly year to year (“higher volatility”), with returns ranging from losses of 20 percent to extraordinary gains of 50 percent. Risk-adjusted returns should only be calculated for a minimum period of three years because, for a single year, the statistic is unreliable. For purposes of this report, the Sharpe ratio is constructed for a five-year period of returns.

The Sharpe ratio is a figure used for comparative purposes, and does not reflect different investment objectives and restrictions, which legitimately produce different investment strategies and results for different funds.

The total return amounts used in the calculations were provided by the entities responsible for investing the funds. Each fund provided 60 monthly rates of return that were used to calculate the fund’s return and standard deviation. The risk-free rate used for the calculation is the average of the monthly annualized yield of the 90-day U.S. Treasury Bill throughout the respective fiscal year. All rates come from the Federal Reserve Economic Database.

## USE OF EXTERNAL MANAGERS/ADVISORS FOR INVESTMENTS

Each of the funds varies in its use of external managers or advisors to invest its assets. **Figure 7** shows the portion of assets managed internally and externally for fiscal year 2011.

**FIGURE 7**  
**PORTION OF ASSETS MANAGED INTERNALLY AND EXTERNALLY, FISCAL YEAR 2011**

FUND	INTERNAL	EXTERNAL
Teacher Retirement System Pension Trust Fund	73.30%	26.70%
Permanent School Fund - TEA	64.19%	35.81%
Permanent School Fund – GLO	21.00%	79.00%
Employees Retirement System Pension Trust Fund	78.00%	22.00%
Permanent University Fund	11.10%	88.90%
Permanent Health Fund	11.40%	88.60%
Tobacco Settlement Permanent Trust Fund	0.00%	100.00%
Texas Guaranteed Tuition Plan Fund	0.00%	100.00%
Permanent Public Health Fund	0.00%	100.00%
National Research University Fund	0.00%	100.00%

NOTE: The UT-PHF assets are invested in the University of Texas System General Endowment Fund (GEF). The above percentages reflect the allocation of the GEF assets. The PSF-GLO percentages reflect the management of real estate only.  
SOURCE: Investing agencies and UTIMCO.

## RATES OF RETURN FOR DOMESTIC EQUITY INVESTMENTS

Each of the funds has a significant amount invested in domestic equity investments. The benchmark for this asset group is the Standard & Poor's 500 Composite Index. The S&P 500 Composite Index is the investment industry's standard for measuring the performance of actual portfolios. It is a market-value-weighted index of 500 large-cap stocks that are traded on either the New York Stock Exchange or the NASDAQ National Market System. In fiscal year 2011, the rate of return for the Standard & Poor's 500 Composite Index was 16.16 percent. In addition to domestic equities, the funds invested varying proportions of their funds assets in global equities and private equity. Rates of returns for these asset classes can be found in each funds appendix.

**Figure 8** shows the rates of returns for domestic equity investments for fiscal year 2011. As applicable, the rates are shown for investments managed by external managers and for investments managed internally.

**FIGURE 8**  
**RATES OF RETURNS FOR DOMESTIC EQUITY INVESTMENTS, FISCAL YEAR 2011**

### BENCHMARKS

Standard & Poor's 500 Index 16.16%

FUND	INTERNAL	EXTERNAL
Teacher Retirement System Pension Trust Fund	N/A	N/A
Permanent School Fund – TEA	19.29%	N/A
Permanent School Fund – GLO	N/A	N/A
Employees Retirement System Pension Trust Fund	19.96%	16.81%
Permanent University Fund	N/A	19.14%
Permanent Health Fund	N/A	19.44%
Tobacco Settlement Permanent Trust Fund	N/A	13.70%
Texas Guaranteed Tuition Plan Fund	N/A	22.00%
Permanent Public Health Fund	N/A	13.70%
National Research University Fund	N/A	13.70%

NOTE: N/A = funds that do not have domestic equity investments for the category shown. The UT-PHF assets are invested in the University of Texas System General Endowment Fund (GEF). The above percentages reflect the return of the GEF assets.  
SOURCES: Investing agencies and UTIMCO.

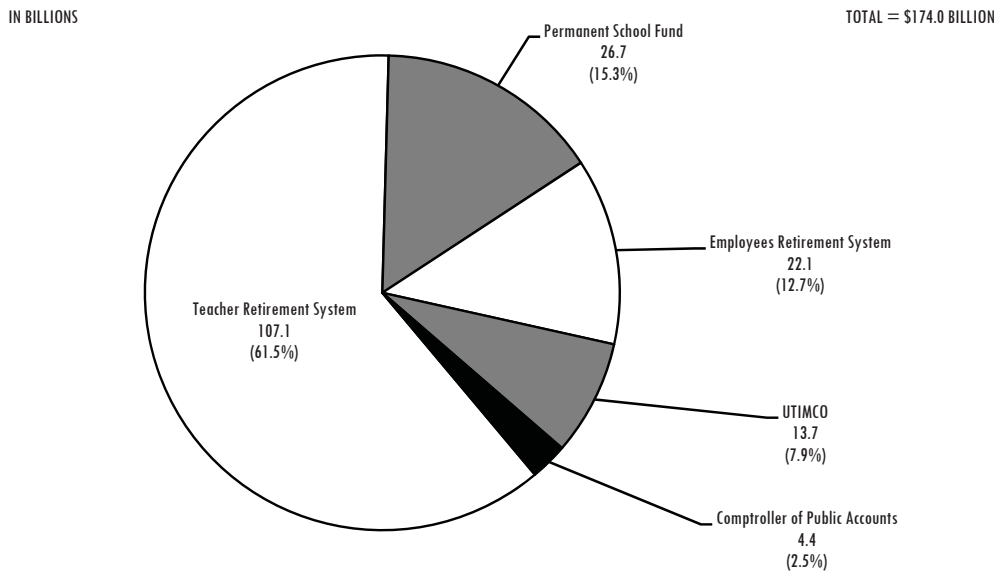
## ACRONYMS

Acronyms used throughout this report follow:

The University of Texas System – UT  
Texas Education Agency – TEA  
General Land Office – GLO  
State Board of Education – SBOE  
State Land Board – SLB  
Employees Retirement System – ERS  
Teacher Retirement System – TRS  
Comptroller of Public Accounts – CPA  
Permanent School Fund – PSF  
Permanent University Fund – PUF  
Permanent Health Fund – PHF  
Tobacco Settlement Fund – TSF  
Texas Guaranteed Tuition Plan Fund – TGTF  
Permanent Public Health Fund – PPHF  
National Research University Fund - NRUF

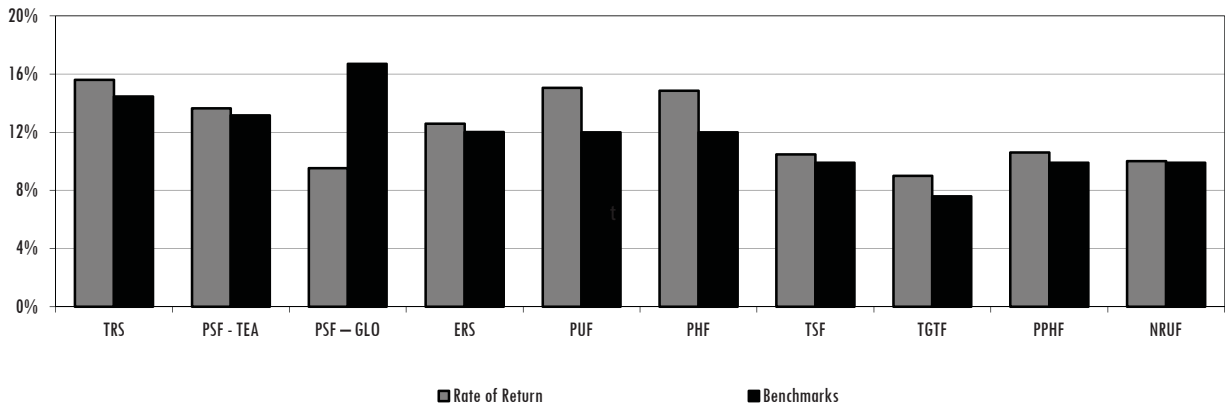
# ALL MAJOR FUNDS

**FIGURE 9**  
**ENDING MARKET VALUE**  
**FISCAL YEAR 2011**



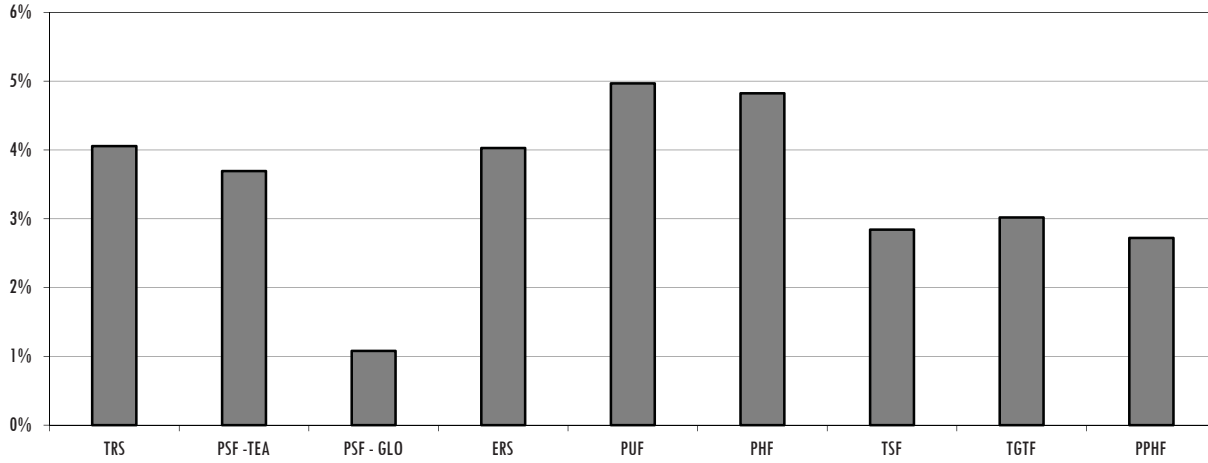
NOTES: UTIMCO amounts included the PUF and PHF. Permanent School Fund amounts include both the TEA and GLO controlled portion. CPA amounts include the TSF, the TGTP, the PPHF, and the NRUF.  
SOURCES: Investing agencies and UTIMCO.

**FIGURE 10**  
**RATES OF RETURN AND BENCHMARKS**  
**FISCAL YEAR 2011**



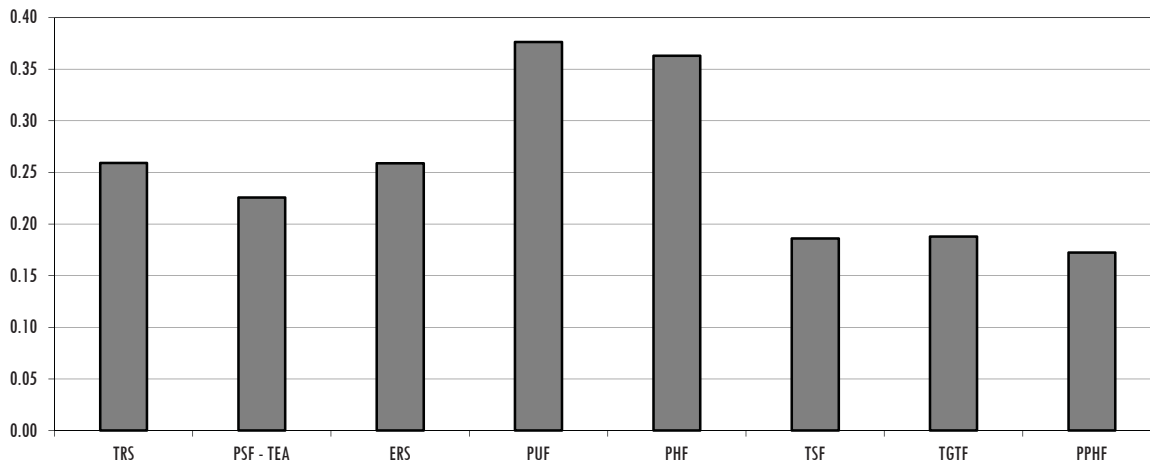
SOURCES: Investing agencies and UTIMCO.

**FIGURE 11**  
**AVERAGE TOTAL FUND RATES OF RETURN, FIVE-YEAR PERIOD**  
**FISCAL YEARS 2007 TO 2011**



SOURCES: Investing agencies and UTIMCO.

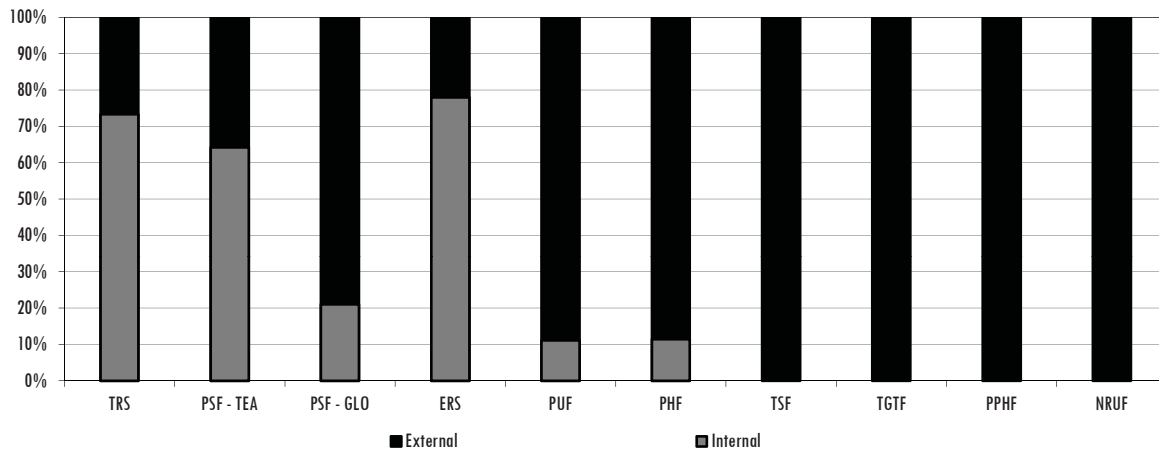
**FIGURE 12**  
**RISK ADJUSTED RATES OF RETURN, FIVE-YEAR PERIOD**  
**FISCAL YEARS 2007 TO 2011**



SOURCES: Investing agencies and UTIMCO.

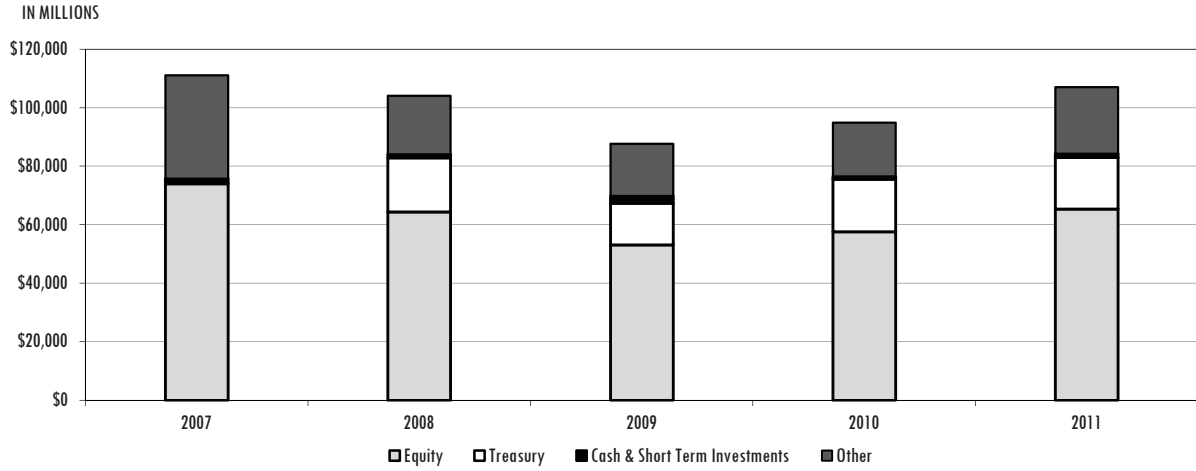


**FIGURE 13**  
**PERCENTAGE OF ASSETS INTERNALLY AND EXTERNALLY MANAGED**  
**FISCAL YEAR 2011**



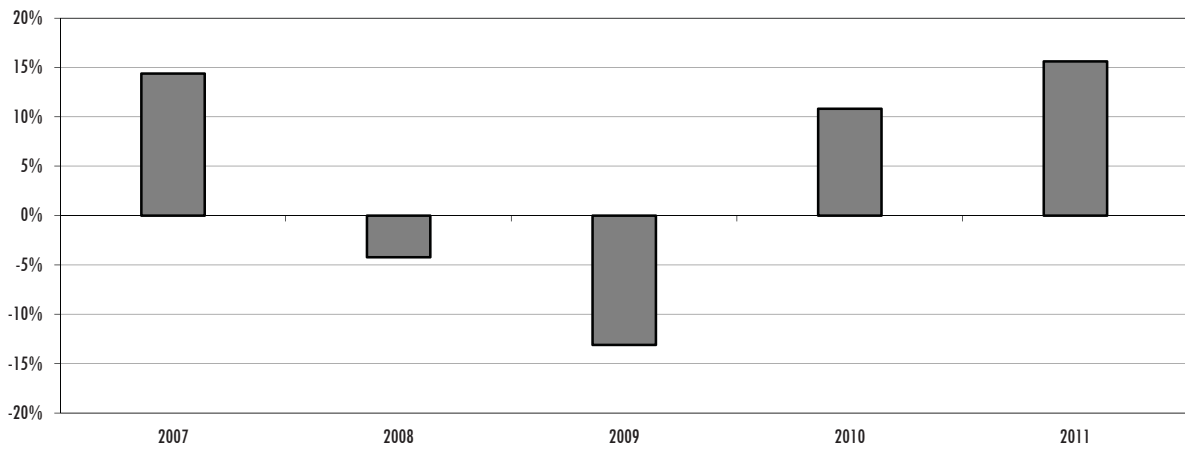
SOURCES: Investing agencies and UTIMCO.

**FIGURE 14**  
**TRS PORTFOLIO DIVERSIFICATION ENDING MARKET VALUES (\$ MILLIONS)**  
**FISCAL YEARS 2007 TO 2011**



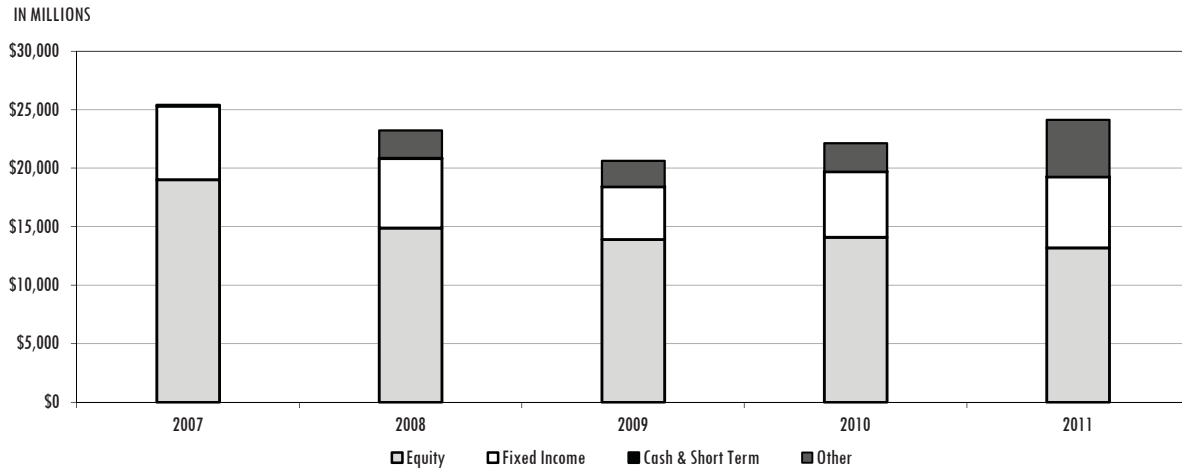
SOURCES: Investing agencies and UTIMCO.

**FIGURE 15**  
**TRS ANNUAL TOTAL RATES OF RETURN**  
**FISCAL YEARS 2007 TO 2011**



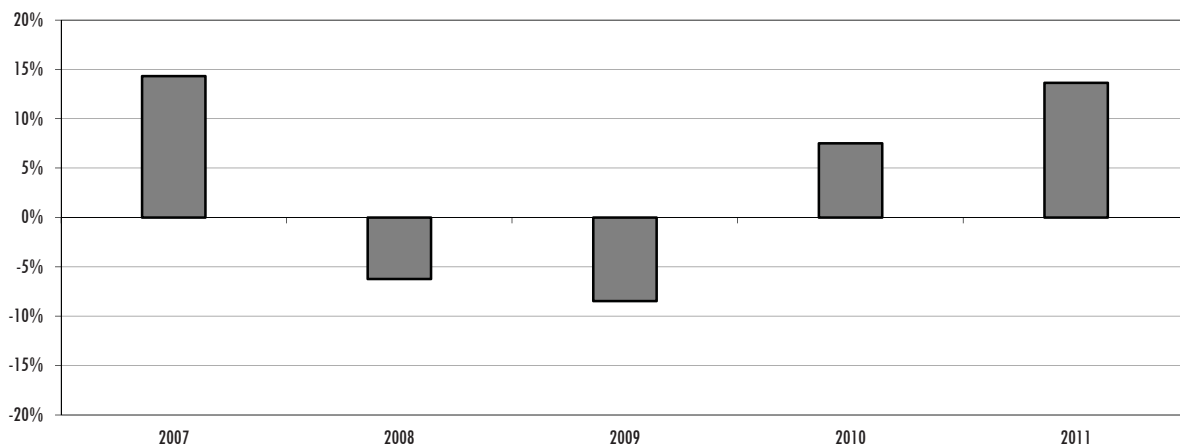
SOURCES: Investing agencies and UTIMCO.

**FIGURE 16**  
**PSF — TEA PORTFOLIO DIVERSIFICATION ENDING MARKET VALUES (\$ MILLIONS)**  
**FISCAL YEARS 2007 TO 2011**



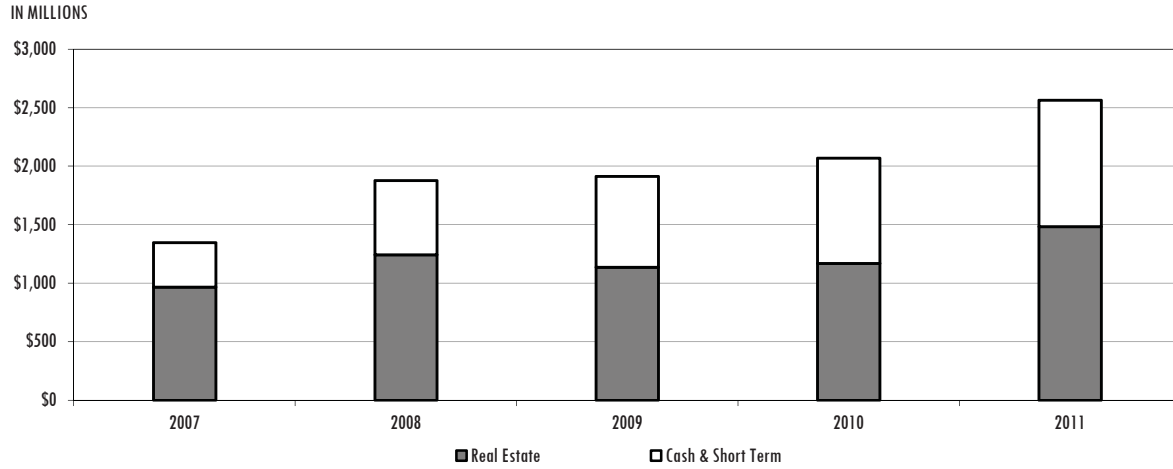
SOURCES: Investing agencies and UTIMCO.

**FIGURE 17**  
**PSF — TEA ANNUAL TOTAL RATES OF RETURN**  
**FISCAL YEARS 2007 TO 2011**



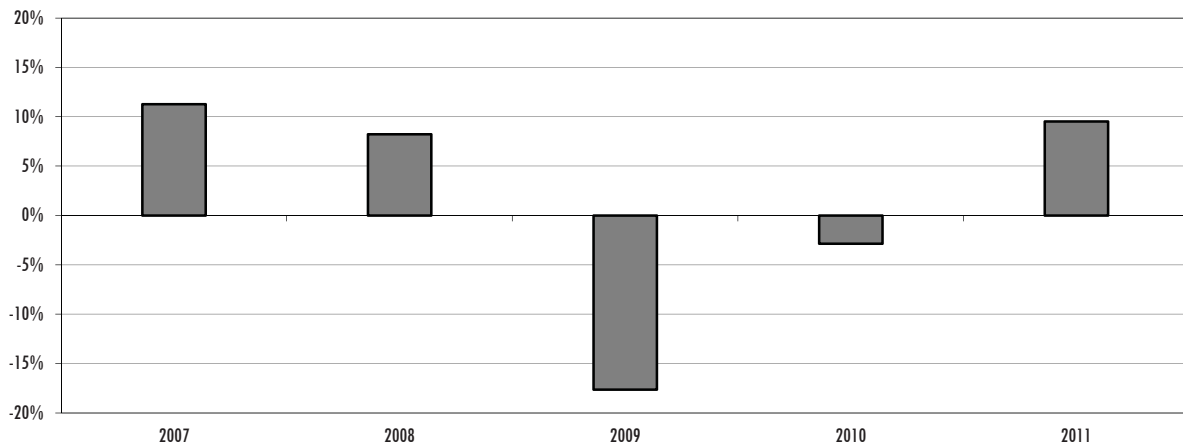
SOURCES: Investing agencies and UTIMCO.

**FIGURE 18**  
**PSF — GLO PORTFOLIO DIVERSIFICATION ENDING MARKET VALUES**  
**FISCAL YEARS 2007 TO 2011**



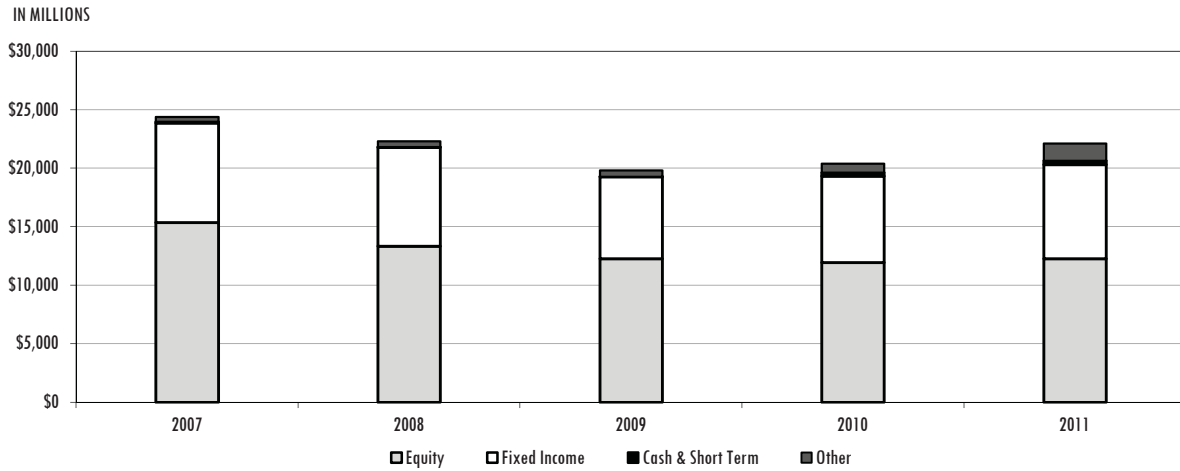
SOURCES: Investing agencies and UTIMCO.

**FIGURE 19**  
**PSF — GLO ANNUAL TOTAL RATES OF RETURN**  
**FISCAL YEARS 2007 TO 2011**



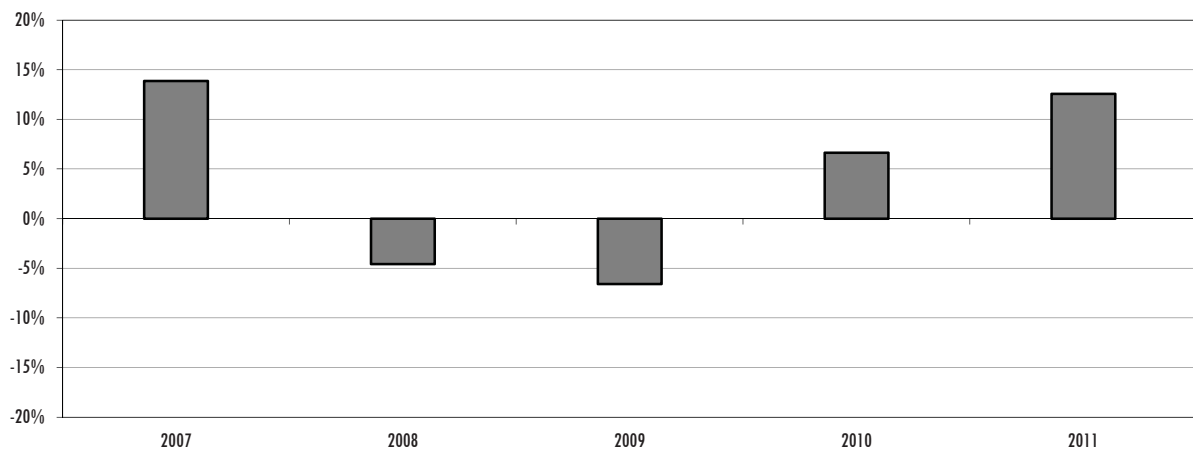
SOURCES: Investing agencies and UTIMCO.

**FIGURE 20**  
**ERS PORTFOLIO DIVERSIFICATION ENDING MARKET VALUES**  
**FISCAL YEARS 2007 TO 2011**



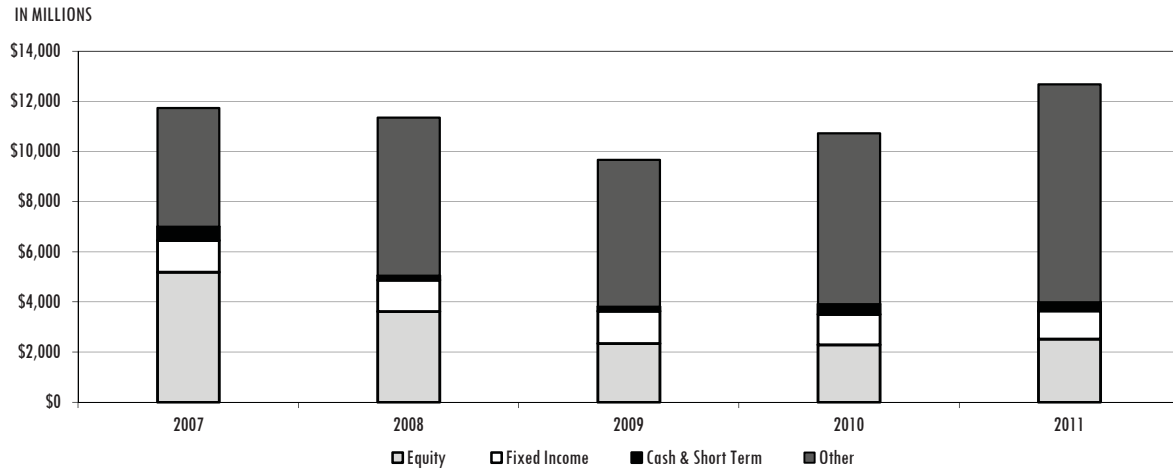
SOURCES: Investing agencies and UTIMCO.

**FIGURE 21**  
**ERS ANNUAL TOTAL RATES OF RETURN**  
**FISCAL YEARS 2007 TO 2011**



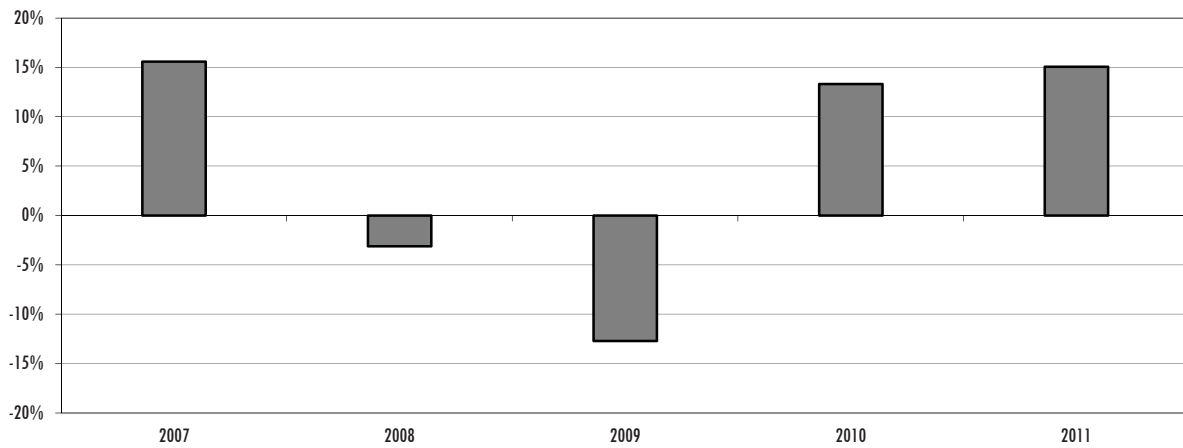
SOURCES: Investing agencies and UTIMCO.

**FIGURE 22**  
**PUF PORTFOLIO DIVERSIFICATION ENDING MARKET VALUES**  
**FISCAL YEARS 2007 TO 2011**



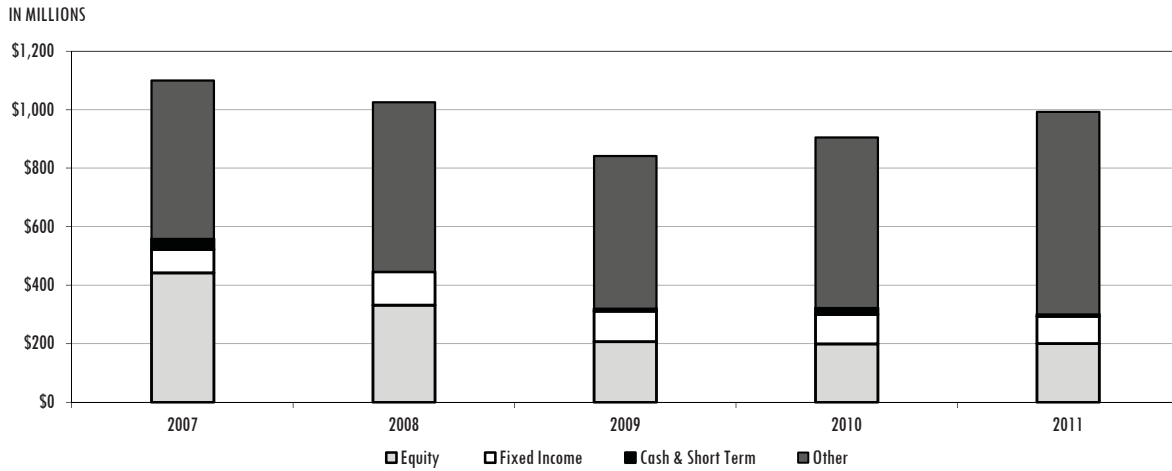
SOURCES: Investing agencies and UTIMCO.

**FIGURE 23**  
**PUF ANNUAL TOTAL RATES OF RETURN**  
**FISCAL YEARS 2007 TO 2011**



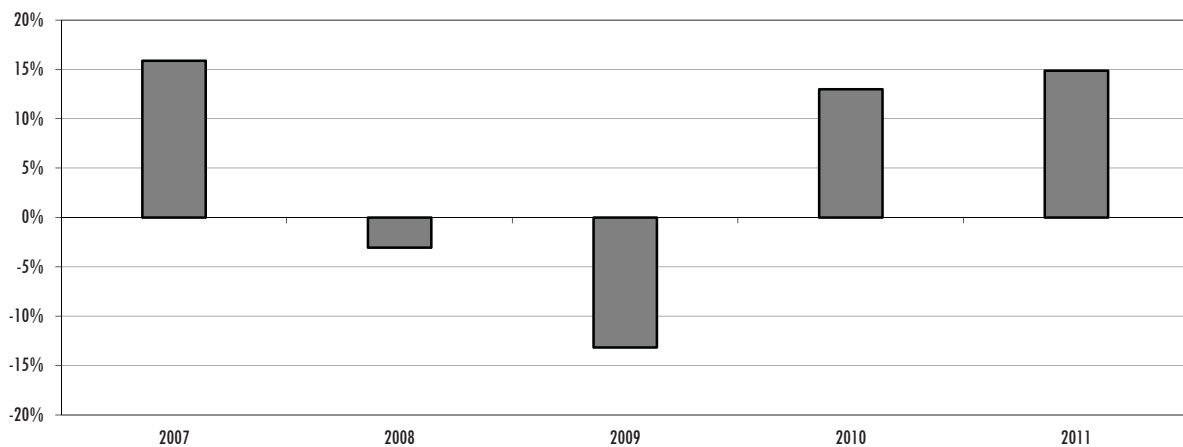
SOURCES: Investing agencies and UTIMCO.

**FIGURE 24**  
**PHF PORTFOLIO DIVERSIFICATION ENDING MARKET VALUES**  
**FISCAL YEARS 2007 TO 2011**



SOURCES: Investing agencies and UTIMCO.

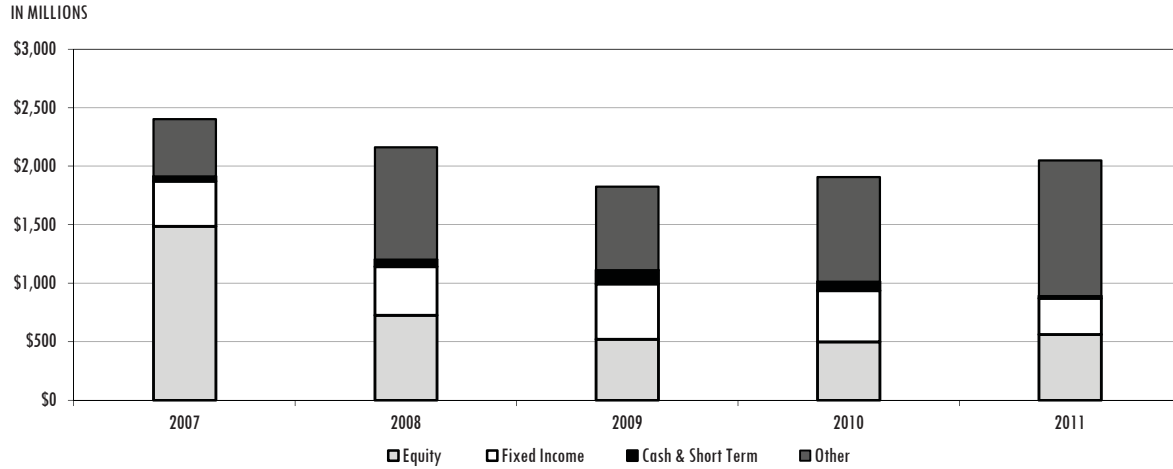
**FIGURE 25**  
**PHF ANNUAL TOTAL RATES OF RETURN**  
**FISCAL YEARS 2007 TO 2011**



SOURCES: Investing agencies and UTIMCO.

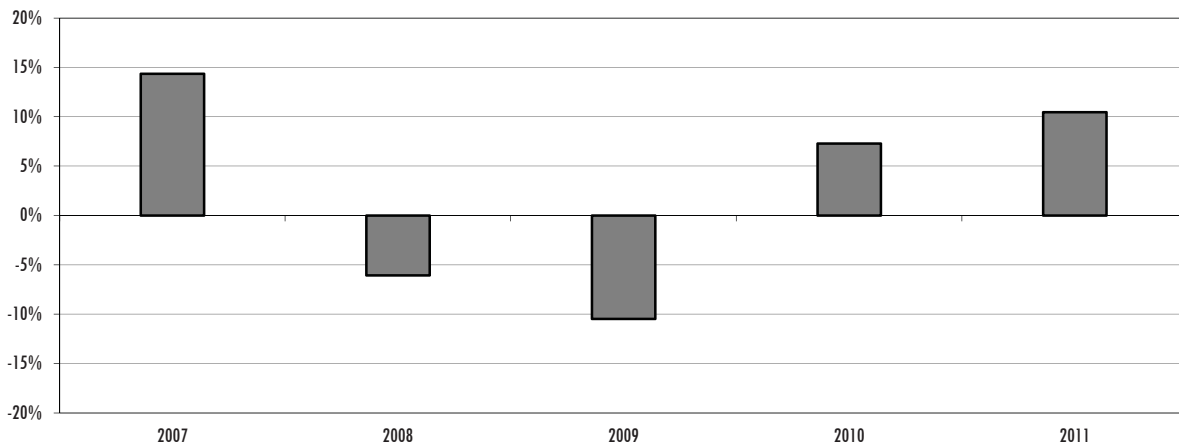


**FIGURE 26**  
**TSF PORTFOLIO DIVERSIFICATION ENDING MARKET VALUES**  
**FISCAL YEARS 2007 TO 2011**



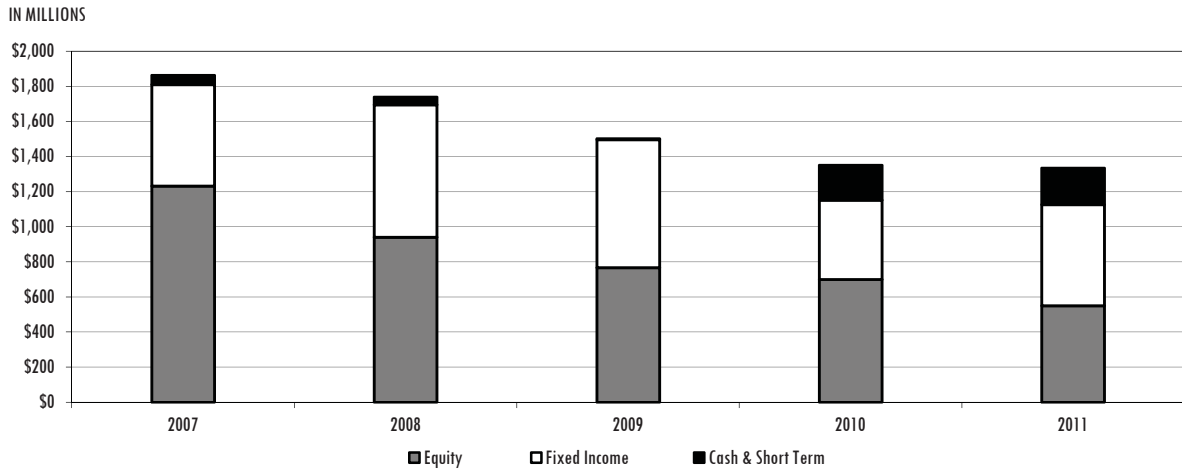
SOURCES: Investing agencies and UTIMCO.

**FIGURE 27**  
**TSF ANNUAL TOTAL RATES OF RETURN**  
**FISCAL YEARS 2007 TO 2011**



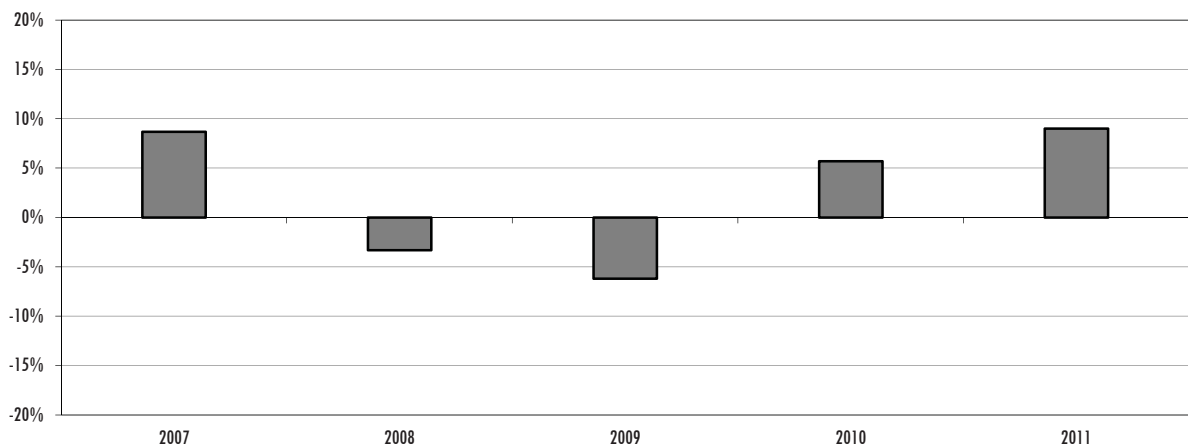
SOURCES: Investing agencies and UTIMCO.

**FIGURE 28**  
**TGTF PORTFOLIO DIVERSIFICATION ENDING MARKET VALUES**  
**FISCAL YEARS 2007 TO 2011**



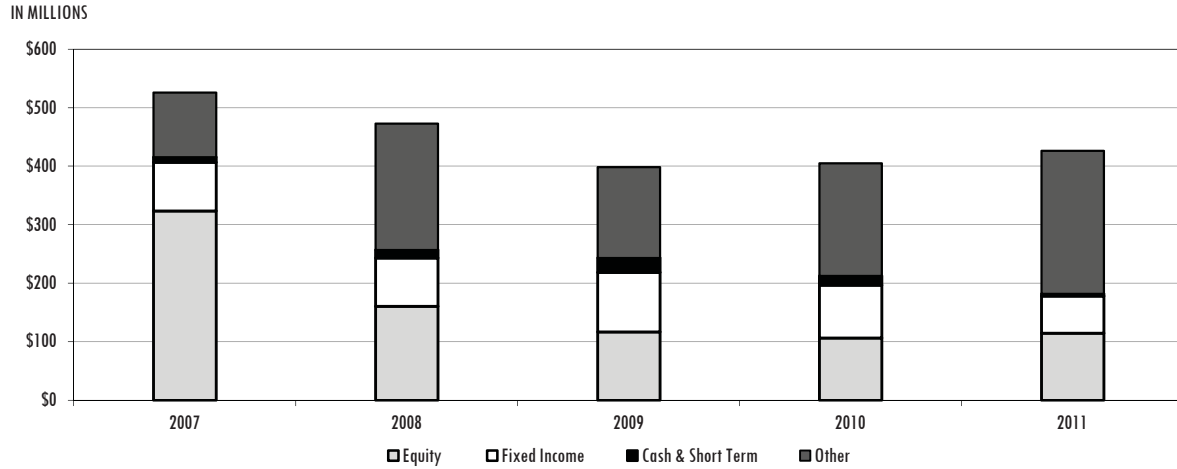
SOURCES: Investing agencies and UTIMCO.

**FIGURE 29**  
**TGTF ANNUAL TOTAL RATES OF RETURN**  
**FISCAL YEARS 2007 TO 2011**



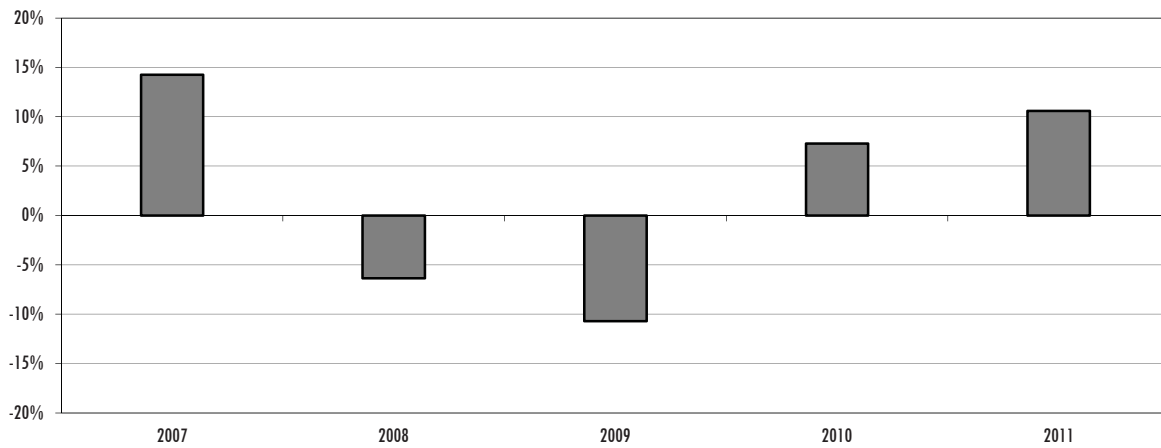
SOURCES: Investing agencies and UTIMCO.

**FIGURE 30**  
**PPHF PORTFOLIO DIVERSIFICATION ENDING MARKET VALUES**  
**FISCAL YEARS 2007 TO 2011**



SOURCES: Investing agencies and UTIMCO.

**FIGURE 31**  
**PPHF ANNUAL TOTAL RATES OF RETURN**  
**FISCAL YEARS 2007 TO 2011**



SOURCES: Investing agencies and UTIMCO.

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## APPENDIX A. AUTHORIZING STATUTE

SECTION 1. Chapter 322, Government Code, is amended by adding Section 322.014 to read as follows:

Sec. 322.014. REPORT ON MAJOR INVESTMENT FUNDS.

- (a) In this section, “state investment fund” means any investment fund administered by or under a contract with any state governmental entity, including a fund:
  - (1) established by statute or by the Texas Constitution; or
  - (2) administered by or under a contract with:
    - (A) a public retirement system as defined by Section 802.001, Government Code, that provides service retirement, disability retirement, or death benefits for officers or employees of the state;
    - (B) an institution of higher education as defined by Section 61.003, Education Code; or
    - (C) any other entity that is part of state government.
- (b) The board shall evaluate and publish an annual report on the risk-adjusted performance of each state investment fund that in the opinion of the board contains a relatively large amount of assets belonging to or administered by the state. The board in its report shall:
  - (1) compare the risk-adjusted performance of the funds; and
  - (2) examine the risk-adjusted performance, within and among the funds, of similar asset classes and comparable portfolios within asset classes.
- (c) Each state governmental entity that administers a state investment fund and each person that administers a state investment fund under contract shall provide the board with the information the board requests regarding the performance of the fund.
- (d) The board shall publish the annual report in a format and using terminology that a person without technical investment expertise can understand.



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## APPENDIX B. MAJOR STATE INVESTMENT FUNDS

### TEACHER RETIREMENT SYSTEM — PENSION TRUST FUND

The Teacher Retirement System of Texas (TRS) administers a defined benefit plan that is a qualified pension trust fund under Section 401(a) of the Internal Revenue Code. The pension trust fund provides service and disability retirement, as well as death and survivor benefits, to eligible employees of public school districts and public institutions of higher education in Texas and their beneficiaries.

#### **FUND CONTRIBUTIONS**

Member contributions, state contributions, reporting entity contributions and member reinstatements increased the fund's value in fiscal year 2011. The state constitution requires the legislature to establish a member contribution rate of not less than 6 percent of the member's annual compensation and a state contribution rate of not less than 6 percent but not more than 10 percent of the aggregate annual compensation of all members of the system during that fiscal year. In fiscal year 2011 the state and member contribution rate was 6.4 percent. The state contribution rate was increased to 6.644 percent, effective January 1, 2010, as a result of a recent Texas Attorney General's opinion concluding one-time supplemental payment to eligible TRS retirees is not permissible under Texas law.

Fiscal year 2011 total contributions increased \$5,343 million, or 38.2 percent, over fiscal year 2010 contributions, due mostly to a \$5,225 million increase in investment income. In fiscal year 2011 member contributions were \$2.2 billion, state and federal/private contributions were \$1.9 billion, reporting entity contributions were \$420 million, and member reinstatements were \$105 million. In fiscal year 2011 investment income resulted in a gain of \$14.6 billion to the fund.

#### **FUND DISTRIBUTIONS**

Deductions from the fund are predominantly retirement, death, and survivor benefits. During fiscal year 2011, the fund paid \$7.2 billion for benefits, \$334 million for members refunding their accounts, and \$36 million for other expenses (net of investing activity expenses). In fiscal year 2011, fund distributions totaled \$7.6 billion.

#### **INVESTMENT OBJECTIVE**

The board governs the investment process by adopting investment policies and objectives, which define the fund's

strategic investment initiatives, and by monitoring performance to measure the results of both tactical and strategic investment strategies. The total investment portfolio is structured to achieve a long-term rate of return that exceeds the assumed actuarial rate of return adopted by the board; exceeds the long-term rate of inflation by an annualized 5 percent; and exceeds a composite index composed of the respective long-term normal asset mix weighting of the major asset classes, operating within the defined risk parameters for the various asset classes. Investment decisions must adhere to the "prudent person" standard. In fiscal year 2008, the board reviewed and adjusted the investment policy to achieve the long-term targeted rate of return of 8 percent. This resulted in a shift to a more diversified investment strategy, which included a change in asset allocation, replacing benchmarks, and development of TRS LABS; a program launched by the Investment Management Division, that aims to continually improve TRS investment management through leadership.

#### **INVESTMENT AND OVERSIGHT RESPONSIBILITY**

The TRS Board of Trustees holds system assets in trust and oversees the investment of the system's funds in accordance with applicable constitutional and statutory provisions. The board is composed of nine trustees who are appointed by the governor to staggered terms of six years. Three trustees are direct appointments. Two trustees are appointed from a list prepared by the State Board of Education. Two trustees are appointed by the governor from the three public school district active member candidates nominated for each position by employees of public school districts. One trustee is appointed from the three higher education active member candidates nominated by employees of public institutions of higher education. One trustee is appointed from the three retired member candidates nominated by retired TRS members. A majority of the board is required to have financial expertise, and is assisted by outside investment consultants and internal and external legal counsel. Appointments are subject to confirmation by the Senate. Board member terms expire August 31 of odd numbered years.

## TEACHER RETIREMENT SYSTEM — PENSION TRUST FUND (CONTINUED)

### PERCENTAGE OF ASSETS EXTERNALLY MANAGED/ ADVISED

According to TRS, internal staff manages 73 percent of TRS assets; the remaining 27 percent are externally managed. External management of funds began in August of 2008.

### INVESTMENT COSTS

The cost of investing the funds for the fiscal year 2011 was \$183 million, or 17 basis points (0.17 percent) of the net assets held in trust for pension benefits at the end of fiscal year 2011. The investment cost consists of \$36 million in direct internal cost and \$9 million in indirect internal cost. According to TRS, direct investment expenses included salaries and operating costs of the investment division. Indirect costs included fees for services such as accounting, purchasing, legal and supplies and security. External investment costs include fees paid to external managers and do not include transaction costs on investments and were \$138 million in fiscal year 2011. Prior year investment costs were \$112 million, or 0.12 percent, of the net assets.

### PERFORMANCE BENCHMARKS

**Figure B1** shows the TRS benchmarks for fiscal year 2011.

### RECENT LEGISLATION

The Eighty-second Legislature, Regular Session, 2011, passed several bills that affect TRS. Among the more significant legislation are House Bill 1061, House Bill 2561, Senate Bill 1667, and Senate Bill 1669.

The enactment of House Bill 1061 broadens the investment authority of the TRS Board of Trustees by authorizing the use of derivatives in its investment portfolio. The bill also authorizes the use of external managers to invest up to 30 percent of the TRS fund and allows for an increase in hedge funds allocations from 5 percent to 10 percent; both provisions expire September 1, 2019.

The enactment of House Bill 2561 establishes a standardized school year of September 1 through August 31 for determining service credit and creditable compensation, beginning with the 2012–13 school year.

The enactment of Senate Bill 1667 allows the state contribution to the Teacher Retirement System Trust Fund for public education and higher education retirement to be less than contributions of active members for the fiscal ending August 31, 2012, and allows the state contribution to the TRS-Care retiree insurance program to be less than 1.0

**FIGURE B1**  
**TEACHER RETIREMENT SYSTEM — PENSION TRUST FUND PERFORMANCE BENCHMARKS**  
**FISCAL YEAR 2011**

BENCHMARK NAME	ASSET CLASS	2011 RATE OF RETURN
MSCI USA Large Cap	US Large Cap	18.76%
MSCI USA Small Cap	US Small Cap	22.63%
MSCI Emerging Markets	Emerging Markets	9.07%
MSCI EAFE + Canada Equity	Non-US Developed Equity	10.73%
State Street Private Equity Index	Private Equity	21.91%
BC Long Treasury Index	US Long Treasuries	4.98%
LIBOR + 200bps	Absolute Return	2.29%
Citigroup 90-day T-Bill	Cash Equivalents	0.15%
BC US TIPS Index	US TIPS	10.80%
NCRIF ODCE	Real Assets	19.01%
Goldman Sachs Commodity Index	Commodities	27.06%
MSCI US REITS	REITS	18.71%

SOURCE: Teacher Retirement System.



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**TEACHER RETIREMENT SYSTEM—PENSION TRUST FUND (CONTINUED)**

percent of total active payroll for fiscal year ending August 31, 2013.

The enactment of Senate Bill 1669 repeals former exceptions that allowed service retirees to work on a full-time basis without loss of annuities in certain circumstances. The legislation allows service retirees who retired before January 1, 2011 to work in Texas public education in any capacity without loss of monthly annuities. The legislation allows any amount of work without loss of annuity only if the retiree has been separated from service with all Texas public education institutions for 12 full consecutive months immediately after retiring.

## PERMANENT SCHOOL FUND — TEXAS EDUCATION AGENCY

The Permanent School Fund (PSF) was established expressly for the benefit of funding Texas public schools. A total return distribution, which was currently 2.5 percent of average market value in fiscal year 2011, along with 25 percent of the state's motor fuel tax revenues are transferred to the Available School Fund (ASF). Monies from the fund are distributed to local public school districts based on the average daily attendance of public school students.

### **FUND CONTRIBUTIONS**

Proceeds from the sale of PSF land, royalty, and other earnings generated by the PSF land are added annually to the fund by the General Land Office (GLO), which manages the real estate assets. In addition to these deposits GLO transfers an authorized amount set by the State Land Board (SLB) each year to the Texas Education Agency (TEA). According to TEA \$100 million was added to the PSF during fiscal year 2011.

### **FUND DISTRIBUTIONS**

The Fund calculates its annual distribution to the Available School Fund (ASF) using a total return methodology, established by constitutional amendment in 2003. Distribution rates are set by a two-thirds (2/3) vote of the State Board of Education (SBOE). If the SBOE does not set the rate before the start of the next legislative session, then the Legislature will set the distribution rate. The distribution rate cannot exceed 6.0 percent of the total market value and the total distribution over the past 10 years cannot exceed the total return for the same period. The distribution rate is set at 2.5 percent for fiscal years 2010 and 2011, or 5.0 percent for the biennium in the event that the full 2.5 percent is not transferred in fiscal year 2010. However, the model utilized to calculate compliance with the total return test includes assumptions and estimates and incorrectly included GLO transfers in the fiscal year 2010 distribution calculation. Such inclusion resulted in an overstatement of funds available for distribution and the actual transfer of \$60.7 million in fiscal year 2010, a violation of the 10-year test. The model has been corrected, its assumptions revalidated and the total amount of ASF distributions allowed for compliance with the 10-year test remains unchanged for the 2010–11 biennium. The SBOE authorized catch up distributions in fiscal year 2011 in order to meet the total payout for the

2010–11 biennium. In fiscal year 2011, \$1,092.9 million was transferred to the ASF. In January 2011, the SBOE approved a distribution rate of 4.2 percent for the 2012–13 biennium.

### **INVESTMENT OBJECTIVE**

The investment objective, according to TEA, is long term and focused on fairly balancing the benefits between current and future generations while preserving the real per capita value of the PSF. Investment decisions adhere to the “prudent person” rule and asset class allocations are adjusted accordingly to meet the investment objectives of the fund.

### **INVESTMENT AND OVERSIGHT RESPONSIBILITY**

The Texas Constitution assigns control of PSF assets to the SBOE while administrative duties related to the PSF reside with the Commissioner of Education and TEA staff. SBOE members are elected from 15 single-member districts with the Governor designating the chairman. No members are required to have experience in investment management. The SBOE appoints a Committee of Investment Advisors (CIA) to provide independent review of the Fund's investment policies, procedures, and nature of investments. Each member of the SBOE appoints a single member to the CIA and these advisors serve at the pleasure of the SBOE member that appointed them.

### **PERCENTAGE OF ASSETS EXTERNALLY MANAGED/ ADVISED**

According to TEA, approximately 35.8 percent of PSF assets were externally managed in fiscal year 2011. Independent firms are used to invest funds, provide custodial and accounting services, provide securities lending services, advise on asset allocation, and evaluate investment performance. TEA reports external managers are used to manage international equities and absolute return investments.

### **INVESTMENT COSTS**

According to TEA, the cost of administering the fund was \$12.5 million, or 5 basis points (0.05 percent) of the ending fund balance for fiscal year 2011. This includes \$12.0 million of internal investment expenses and \$540,000 of external investment expenses. In addition to standard investment

## PERMANENT SCHOOL FUND — TEXAS EDUCATION AGENCY (CONTINUED)

salaries, costs, and allocated agency overhead, TEA reports investment expenses included costs associated with accounting, information technology, compliance and support staff; as well as fees paid for external management. Prior year investment costs were \$10.8 million or 0.05 percent of the fund balance.

### PERFORMANCE BENCHMARKS

Figure B2 shows the fiscal year 2011 performance benchmarks for the Permanent School Fund.

**FIGURE B2**  
**PERMANENT SCHOOL FUND PERFORMANCE**  
**BENCHMARKS**  
**FISCAL YEAR 2011**

BENCHMARK NAME	ASSET CLASS	2011 RATE OF RETURN
Custom Target Policy	Total Fund	13.15
Total Equity	Total Equity	16.61
Domestic Equity	Domestic Equity	19.36
S&P 500 Index	Domestic Equity	18.5
S&P 1000 Index	Domestic Equity	23.36
MSCI All Ctry World Ex US Net	Intl Equity	10.34
BC Aggregate Bond Index	Fixed Income	4.62
Total Absolute Return <sup>1</sup>	Absolute Return	5.36
Real Estate <sup>2</sup>	Real Estate	14.69
Private Equity <sup>3</sup>	Private Equity	20.32

<sup>1</sup>Custom benchmark based on HFRI.

<sup>2</sup>Custom benchmark based on NCREIF.

<sup>3</sup>Custom benchmark based on actual returns.

SOURCE: Texas Education Agency.

An allocation index is calculated for each class of investments (fixed income and equity securities) to measure the overall performance. The allocation index is the weighted average rate of return of each of the above indices.

### RECENT LEGISLATION

On November 8, 2011, Texas voters approved Proposition 6, a constitutional amendment that increases the base amount used in calculating the distribution rate from the PSF to the

ASF by adding certain discretionary real assets and cash in the Fund that is managed by the State Land Board. While the amendment provided for an increase in the base for the calculation, no new resources were provided for deposit to the PSF. The new calculation base is required to be used to determine all payments to the ASF from the PSF beginning with the 2012–13 biennium.

The changes approved by the voters also provided authority to the State Land Board to determine at its sole discretion whether to transfer each year from PSF assets to the ASF an amount not to exceed \$300 million.

## PERMANENT SCHOOL FUNDS — GENERAL LAND OFFICE

The School Land Board (SLB) and the Commissioner of the Texas General Land Office (GLO) possess the authority to manage the state-owned lands dedicated to the Permanent School Fund (PSF). The funds are managed through the Real Estate Special Fund Account (RESFA) and can be used to acquire real estate as well as protect, maintain and enhance the value of the public school land. The real estate portfolio of the PSF is limited by statute to no more than 15 percent of the fund's total market value.

### **FUND CONTRIBUTIONS**

Contributions to the RESFA include revenue from school land sales, oil and gas royalties, surface damage fees, return of capital on real assets investments, mineral lease bonus payments, and various other sources. According to GLO, \$893.6 million was added to the RESFA in fiscal year 2011.

### **FUND DISTRIBUTIONS**

The RESFA distribution to the PSF is authorized annually by the SLB. According to GLO, \$100.0 million was distributed to the PSF in fiscal year 2011.

### **INVESTMENT OBJECTIVE**

The primary investment objective, according to the GLO and the SLB, is to pursue a long-term strategy of investing in a variety of real estate to acquire, manage, and sell Stable Return real estate investments and produce gross total returns that exceed returns on the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index by 100 basis points, measured over a rolling five-year period. Investment decisions must adhere to the "prudent investor standard."

### **INVESTMENT AND OVERSIGHT RESPONSIBILITY**

The Permanent School Fund real estate investment portfolio is managed through a combined effort of the SLB, the Investment Advisory Committee (IAC), TXGLO staff, and external fund managers including a real asset investment advisor. The SLB is comprised of the Land Commissioner, an appointee of the Governor and an appointee of the Attorney General. The IAC is comprised of the GLO Deputy Commissioner of Funds Management, the General Counsel, the Deputy Commissioner of Asset Management, the Chief Clerk and a member of the SLB.

### **PERCENTAGE OF ASSETS EXTERNALLY MANAGED/ ADVISED**

According to the GLO, approximately 79 percent of the PSF real estate assets were externally managed in fiscal year 2011. External investment managers manage a portfolio of commercial real estate in limited partnerships including office, industrial, retail, hotel, and apartment investments. The internally managed portfolio includes direct commercial real estate investments in areas where GLO is the only investor including raw land, industrial, and some mixed-use investments. GLO indicated 100 percent of their cash and short-term securities are externally managed by the Comptroller of Public Accounts.

### **INVESTMENT COSTS**

According to the GLO, total investment expenses for the year ending June 30, 2011, were \$15.9 million or 62 basis points (0.62 percent) of the ending fund balance. This amount includes \$3.1 million for direct internal costs, \$0.6 million in indirect internal expenses, and \$12.2 million for external costs. Internal investment expenses include cost for personnel and operating expenses relating to portfolio management, fees for legal services, procurement, and financial reporting. External expenses include management and incentive fees per limited partnership agreements. Investment costs for year ending June 30, 2010, were \$13.6 million, or 0.66 percent of the fund balance.

### **PERFORMANCE BENCHMARKS**

The following benchmark has been identified by the GLO for year ending June 30, 2011:

NCREIF Property Index 16.70 percent.

### **RECENT LEGISLATION**

House Joint Resolution 109, Eighty-second Legislature, Regular Session, proposed a constitutional amendment, which was approved by voters on November 8, 2011. Proposition 6 provides that discretionary real asset investments and cash in the State Treasury derived from property belonging to the PSF be included in the PSF market value calculation for purposes of the total return distribution made from the PSF to the Available School Fund (ASF). This provision is projected to result in approximately \$75 million per fiscal year in additional funds being transferred from the

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**PERMANENT SCHOOL FUNDS — GENERAL LAND OFFICE (CONTINUED)**

PSF to the ASF in each fiscal year of the 2012–13 biennium. In addition, the resolution provides a provision that allows GLO to distribute up to \$300 million per fiscal year in revenue derived from PSF land or properties directly to the Available School Fund, whereas previously GLO could only make contributions to the corpus of the PSE, with distributions from the PSF to the ASF being solely based on a distribution percentage set by the State Board of Education.

## EMPLOYEE RETIREMENT SYSTEM — PENSION TRUST FUND

The Employees Retirement System of Texas was established by the Texas Legislature in 1947 and is administered in accordance with the Texas Constitution. The agency provides a retirement and disability pension plan for State employees, law enforcement and custodial officers, elected state officials and two classes of judges. The agency administers the trust funds with a fiduciary obligation to the members and retirees of the System who are its beneficiaries. The Employees Retirement System of Texas Plan (ERS), the Law Enforcement and Custodial Officer Supplemental Retirement Plan (LECOS), the Judicial Retirement System of Texas Plan One (JRSI), and the Judicial Retirement System of Texas Plan II (JRS II) are single employer defined benefit pension plans. For investment purposes the trust funds are joined but separate accounting records are maintained.

### **FUND CONTRIBUTIONS**

Member and state contributions are made to the trust funds as a percent of compensation set by state law. For ERS the Texas Constitution provides that the state contribution may not be less than 6 percent nor more than 10 percent and the member contribution may not be less than 6 percent. The state contribution rate for the 2010–11 biennium set by the Eighty-first Legislature, Regular Session, 2009 was 6.45 percent. This rate increased to 6.95 percent for the 2010–11 biennium on January 1, 2010 as a result of a November 23, 2009 Texas Attorney General Opinion that stated the one-time payments in the General Appropriations Act, 2010–11 biennium, to retired state employees and retired teachers may be unconstitutional. The 2010–11 biennium member contribution rate was increased by House Bill 2559, Eighty-first Legislature, Regular Session, 2009, from 6.45 percent to equal the state contribution rate, not to exceed 6.5 percent.

Members of the LECOS are also members of the ERS; subsequently no contributions from either the state or the members have been made to the fund since 1993. However, the provisions of House Bill 2559 authorized a new 0.5 percent contribution to the LECOS for the LECOS members only beginning in the 2010–11 biennium.

JRS I is a pay as you go plan and there is no trust fund to receive contributions. Member contributions of 6 percent are deposited as unappropriated receipts in the states general revenue fund. Annuity payments and refunds for this plan

are appropriated each biennium therefore the fund has no invested assets. Contributions to JRS II are set by general law and the state appropriations act. In fiscal year 2009, the member contribution rate was 6 percent and the state contribution rate was set at 16.83 percent and will remain the same for fiscal year 2010.

According to ERS, total fund contributions in fiscal year 2011 were \$952.7 million.

### **FUND DISTRIBUTIONS**

Distributions from the pension trust fund are based on benefit payments owed and according to ERS, equaled \$1,753 million in fiscal year 2011.

### **INVESTMENT OBJECTIVE**

The primary investment objective, outlined by ERS in the CAFR, is to earn a rate of return that ensures payments due to members and their beneficiaries at a reasonable cost to the members of the retirement plan and the taxpayers. The investment policy is structured around maximizing return while maintaining the safety of principal, reducing risk through diversification, and managing costs associated with implementation. The Board of Trustees sets a long-term asset allocation target which is adjusted to meet the needs of the plan and the beneficiaries. Investment decisions must adhere to the duty of care as set forth in Section 815.307 of the Texas Government Code.

### **INVESTMENT AND OVERSIGHT RESPONSIBILITY**

The Board of Trustees of ERS has general responsibility for investment decisions. Six members serve on the board: three members are elected by participating state employees, one member is appointed by the governor, one is appointed by the chief justice of the Supreme Court of Texas, and one member is appointed by the Speaker of the House of Representatives. The board selects external investment managers and appoints an investment advisory committee. The committee members are investment professionals who are required to meet, at least quarterly, to review ERS investments. An independent consultant is also retained to evaluate and analyze investment results.

## EMPLOYEE RETIREMENT SYSTEM — PENSION TRUST FUND (CONTINUED)

### PERCENTAGE OF ASSETS EXTERNALLY MANAGED/ ADVISED:

According to ERS, approximately 78.0 percent of the agency's invested funds were invested by internal staff in fiscal year 2011. For the remaining 22.0 percent, staff receives counsel from various external fund advisors.

### INVESTMENT COSTS

According to ERS, the cost of investing the funds was \$63.2 million, or 29 basis points (0.29 percent) of the ending fund balance for fiscal year 2011. This includes \$27.9 million in direct internal expenses and \$35.3 million in external investment expenses. Internal investment costs included expenses for materials and supplies, rentals, salaries and wages, professional fees and services, and other operating expenses. External investment expenses do not include investment consulting fees. Prior year investment costs were \$49.1 million or 0.24 percent of the fund balance.

### PERFORMANCE BENCHMARKS

The following benchmarks were provided by ERS for fiscal year 2011.

**FIGURE B3**  
**ERS — PENSION TRUST FUND PERFORMANCE**  
**BENCHMARKS FISCAL YEAR 2011**

BENCHMARK NAME	ASSET CLASS	2011 RATE OF RETURN
S&P 500	Large Cap	18.50
S&P 600	Small Cap	24.44
S&P 400 Mid Cap	Mid Cap	22.89
S&P 1500/S&P 500 Blend	Domestic Equity	19.09
MSCI Europe	Europe International	9.96
MSCI Pacific	Asia International	10.55
MSCI Canada	International Canada	16.97
MSCI EAFE	International Global	10.01
MSCI Emerging Markets	Emerging Markets	9.07
MSCI EAFE/MSCI ACWI ex US Blended	International Equity	10.34
Barclays Capital Aggregate	Investment Grade	4.62

Barclays Capital US High Yield Corp/2% Cap Blend	High Yield	8.39
Barclays Capital Universal/Floating Fixed Income	Fixed Income Total	4.82
FTSE EPRA/NAREIT US	Domestic REIT	18.52
FTSE EPRA/NAREIT US Global ex US	International REIT	13.21
FTSE EPRA/NAREIT Blended Global Real Estate	Global Real Estate	15.49
91 Day U.S. Treasury Bill	Unallocated Cash	0.15
<b>Total Fund Passive Policy Benchmark</b>	<b>GLOBAL TOTAL</b>	<b>12.02</b>

SOURCE: Employees Retirement System.

### RECENT LEGISLATION

The Eighty-second Legislature, Regular Session, 2011, passed Senate Bill 1664, which is the ERS Omnibus Bill. One provision included in that legislation is the requirement that ERS assess a monthly \$30 tobacco user premium differential to GBP participating tobacco users and begin covering tobacco cessation prescription drugs by January 1, 2012. These were recommendations made in the *Texas State Government Effectiveness and Efficiency* report, "Implement a Tobacco User Surcharge on Employees Retirement System Health Premiums." Senate Bill 1664 also provides for an assessment of an employer enrollment fee in an amount not to exceed a percentage of total base payroll as determined in the General Appropriations Act for all general state agencies and public institutions of higher education participating in the GBP to be deposited in the insurance trust fund. In addition, Article IX, Section 18.09 of the 2012–13 GAA identifies the 1.0 percent contribution for group health insurance from all general state agencies and institutions of higher education participating in the GBP.



## THE UNIVERSITY OF TEXAS—PERMANENT UNIVERSITY FUND

The Permanent University Fund (PUF) is a public endowment established by the Texas Constitution in 1876. The PUF contributes to the support of most institutions in the University of Texas System (UT System) and the Texas A&M University System. Distributions from the PUF as well as all surface lease income are deposited in the Available University Fund (AUF) for the benefit of the eligible institutions.

### **FUND CONTRIBUTIONS**

Mineral and other incomes are added annually to the fund. According to the UT System, \$895.6 million in income earned by PUF lands were contributed to the PUF during fiscal year 2011. This represents a 165 percent increase from the 2010 contribution of \$337.9 million.

### **FUND DISTRIBUTIONS**

The PUF is a total return fund and amounts from both income as well as changes in asset values may be distributed. PUF distributions are designed to provide a predictable, stable stream of distributions and ensure the inflation adjusted value of distributions is maintained over time. The UT System Board has established an annual distribution to the AUF of 4.75 percent of the prior three years average net asset value of the PUF. According to the UTIMCO, \$506.4 million was distributed to the AUF in fiscal year 2011.

### **INVESTMENT OBJECTIVE**

According to the UT System, the primary goal is to preserve the purchasing power of the PUF's assets and annual distributions by earning an average annual total return, after inflation, of 5.1 percent over rolling ten-year periods or longer. The objective is dependent on the ability to generate high returns in periods of low inflation that will offset lower returns generated in years when the capital markets underperform the rate of inflation. Investment decisions must adhere to the "prudent investor" rule.

### **INVESTMENT AND OVERSIGHT RESPONSIBILITY**

The Texas Constitution assigns responsibility for managing the PUF's lands and investment to the UT System Board of Regents. The PUF's investment manager is the University of Texas Investment Management Company (UTIMCO). UTIMCO is the first external management corporation

formed by a public university. The UTIMCO Board of Directors includes three members of the UT System Board, the chancellor of the UT System, and five outside investment professionals.

### **PERCENTAGE OF ASSETS EXTERNALLY MANAGED/ ADVISED**

According to the UT System, approximately 88.9 percent of the PUF assets were externally managed in fiscal year 2011.

### **INVESTMENT COSTS**

According to the UT System, total investment expenses were \$45.9 million, or 36 basis points (0.36 percent) of the ending fund balance in fiscal year 2011. This amount includes \$3.9 million for direct internal costs, \$4.5 million for indirect internal costs, and \$37.5 million for external expenses in fiscal year 2011. The investment expenses included costs for management fees and fees related to custodial, auditing, consulting, performance, and risk management. Investment costs for the previous fiscal year were \$38.7 million or 0.36 percent of the fund balance.

### **PERFORMANCE BENCHMARKS**

The Endowment Policy Portfolio return is the total index or benchmark return for the PUF. This return is the sum of the weighted benchmark return for each asset class comprising the endowment policy portfolio.

The UT System provided the following benchmark return for PUF. The benchmark below represents the PUF investment policy for the fiscal year ended August 31, 2011.

PUF Policy Benchmark 12.00 percent.

### **RECENT LEGISLATION**

House Bill 2825, Eighty-second Legislature, Regular Session, 2011, changed the composition of the governing board for the University of Texas Investment Management Company, the firm investing and managing the PUF and other endowments, to require two appointees representing the Texas A&M University System. Further, House Bill 2825 requires at least one of the TAMU appointees and all of the remaining appointees to have knowledge and expertise in investments.



## THE UNIVERSITY OF TEXAS SYSTEM—PERMANENT HEALTH FUND

The Permanent Health Fund (PHF) is a collection of public endowments to support research and other programs at higher education institutions. The consolidated fund includes the Permanent Health Fund for Higher Education, Permanent Funds for Health-related Institutions, and the University of Texas at El Paso. The Permanent Fund for Higher Education Nursing, Allied Health and Other Health Related Programs, and the Permanent Fund for Minority Health Research and Education were transferred to the Comptroller of Public Accounts (CPA) during fiscal year 2002. The endowments were established with proceeds from the comprehensive tobacco settlement between the State and the tobacco industry.

### **FUND CONTRIBUTIONS**

Initially \$890 million of endowment corpus was transferred on August 30, 1999, and another \$25 million was transferred during fiscal year 2000. The Permanent Fund for Higher Education Nursing, Allied Health and Other Health Related Programs, and the Permanent Fund for Minority Health Research and Education, totaling \$88.2 million, were transferred to the CPA during fiscal year 2002. No contributions have been made since then.

### **FUND DISTRIBUTIONS**

The PHF is a total return fund, and distributions from both income as well as capital gains may be distributed. The University of Texas (UT) System Board initially established an annual distribution of 4.5 percent of the beginning value of the PHF. Distributions are increased annually by the average inflation rate, measured by the Consumer Price Index (C.P.I.), provided that the distribution rate remains within a range of 3.5 percent to 5.5 percent of the fund's market value. According to the UT System, \$45.4 million was transferred to eligible institutions during fiscal year 2011.

### **INVESTMENT OBJECTIVE**

According to the UT System, the primary goal is to preserve the purchasing power of the PHF assets and annual distributions by earning an average annual real return of 5.1 percent over rolling ten-year periods or longer.

### **INVESTMENT AND OVERSIGHT RESPONSIBILITY**

The Seventy-sixth Legislature, 1999, designated the UT System Board of Regents as the administrators of the fund. The UT System Board of Regents designated the University of Texas Investment Management Company (UTIMCO) as the investment manager. UTIMCO is the first external management corporation formed by a public university. The UTIMCO Board of Directors includes three members of the UT System Board, the chancellor of the UT System, and five outside investment professionals. The Long Term Fund (LTF) and the PHF are invested in shares of the General Endowment Fund (GEF), an internal mutual fund managed by UTIMCO.

### **PERCENTAGE OF ASSETS EXTERNALLY MANAGED/ ADVISED**

The PHF assets are invested in the UT System GEF. According to the UT System, 88.6 percent of the GEF assets were externally managed in fiscal year 2011.

### **INVESTMENT COSTS**

According to the UT System, total investment expenses for fiscal year 2011 were \$3.3 million, or 33 basis points (0.33 percent) of the ending fund balance. This amount includes \$0.4 million in direct internal investment expenses \$0.5 million in indirect internal investment expenses, \$0.1 million in external investment expenses, and a \$2.3 million allocation from the GEF. The investment expenses included costs for management fees, custodian services and audit fees. Investment costs for fiscal year 2010 were \$2.8 million, or 0.31 percent of the fund balance.

### **PERFORMANCE BENCHMARKS**

The PHF assets are invested in the GEF. The Endowment Policy Portfolio return is the total index or benchmark return for the GEF. This return is the sum of the weighted benchmark return for each asset class comprising the endowment policy portfolio.

The UT System provided the following benchmark return for the PHF in fiscal year 2011.

PHF Policy Benchmark 12.00

## COMPTROLLER OF PUBLIC ACCOUNTS—TOBACCO SETTLEMENT PERMANENT TRUST FUND

The Tobacco Settlement Permanent Trust (TSF) is an endowment to support counties with unreimbursed healthcare expenditures. The Seventy-sixth Legislature, 1999, established the endowment with proceeds from the comprehensive tobacco settlement between the State and the tobacco industry. Although the Comptroller of Public Accounts (CPA) manages the investments, the endowment is classified as a private purpose trust fund.

### **FUND CONTRIBUTIONS**

The initial contribution of tobacco settlement proceeds was made on March 1, 2000. According to the CPA, \$1.683 billion was contributed to the fund through fiscal year 2003. No additional contributions are anticipated.

### **FUND DISTRIBUTIONS**

The TSF is a total return fund and distributions may be made from both income as well as growth in asset values. The investment advisory committee (described below) has approved, and the CPA has adopted, a distribution rule set forth in Title 34, Part 1, Chapter 18, Section 18.2 of the Texas Administrative Code. The rule is designed to meet the investment objective of the trust (described below). According to the CPA, \$51.0 million was distributed during fiscal year 2011.

### **INVESTMENT OBJECTIVE**

The primary investment objective, according to the CPA, is to provide a predictable, stable stream of distributions and to preserve the purchasing power of fund assets and annual distributions by earning an average annual total return, after inflation, of 5.0 percent over rolling ten-year periods or longer. Investment decisions must adhere to the “prudent investor” rule.

### **INVESTMENT AND OVERSIGHT RESPONSIBILITY**

The CPA, through the Texas Treasury Safekeeping Trust Company, is responsible for management and oversight of the fund. An investment advisory committee composed of members from participating entities advises the CPA and approves rules governing the CPA’s duties and responsibilities for the investment of and distributions from the fund. The advisory committee is composed of 11 appointed members. The comptroller appoints one member. One member is

appointed by the political subdivision that, in the year preceding the appointment, received the largest annual distribution paid from the account. The political subdivision that received the second largest annual distribution paid from the account appoints one member. Four members are appointed by the Texas Conference of Urban Counties from subdivisions that received the third through the twelfth largest annual distributions in the preceding year. The County Judges and Commissioners Association of Texas, the North and East Texas County Judges and Commissioners Association, the South Texas County Judges and Commissioners Association, and the West Texas County Judges and Commissioners Association each appoint one member.

### **PERCENTAGE OF ASSETS EXTERNALLY MANAGED/ ADVISED**

According to the CPA, 100 percent of the fund’s assets are externally managed.

### **INVESTMENT COSTS**

According to the CPA, total investment expenses for fiscal year 2011 were \$6.2 million, or 30 basis points (0.30 percent) of the ending fund balance. This amount includes \$4.1 million for direct internal costs and \$2.2 million for external costs. Internal and external investment expenses included costs for salaries, consulting and auditing services, IT systems, compliance monitoring, overhead, risk management services, reporting and investment accounting, and management services. The investment costs for fiscal year 2010 were \$5.7 million or 0.30 percent of the fund balance.

## COMPTROLLER OF PUBLIC ACCOUNTS—TOBACCO SETTLEMENT PERMANENT TRUST FUND (CONTINUED)

### PERFORMANCE BENCHMARKS

The CPA provided the following breakdown of the policy benchmark. The total fund benchmark was 9.91 percent in fiscal year 2011.

**FIGURE B4**  
**CPA — TOBACCO SETTLEMENT PERMANENT TRUST FUND**  
**PERFORMANCE BENCHMARKS**  
**FISCAL YEAR 2011**

STRATEGY	BENCHMARK
Stable Return (Low Beta)	Barclay Global Multiverse
<b>Global Investment Grade Fixed Income</b>	<b>Blend (65% US Aggregate, 35% Global Aggregate ex US)</b>
Short-term Investment Funds	3-month U.S. Treasury Bill
US Core	Barclays US Aggregate
Non-U.S. Developed	Barclays Global Aggregate ex US
<b>Global High Yield Fixed Income</b>	<b>Barclays Global High Yield</b>
US High Yield	Barclays US High Yield
Emerging Market	Barclays Global Emerging
<b>Absolute Return</b>	<b>3-Month T-Bill &amp; HFR FOF: Conservative</b>
Market Return (Beta)	MSCI ACWI
<b>Global Equity</b>	MSCI ACWI
Domestic	<b>S&amp;P 1500</b>
Non-US Developed	<b>MSCI World ex US</b>
Emerging Market	<b>MSCI EM</b>
<b>Hedged Equity</b>	<b>HFR FOF: Strategic</b>
Enhanced Return	MSCI ACWI
<b>Private Equity</b>	<b>MSCI ACWI</b>
<b>Enhanced Return Real Estate</b>	<b>NCREIF NPI</b>
Inflation Protection (Real Assets)	CPI
<b>Stable Value Real Estate</b>	<b>CPI</b>
<b>TIPS</b>	<b>Barclays Global Inflation Linked</b>
<b>Commodities</b>	<b>Dow Jones UBS Commodity</b>

**Bold** indicates components to be included in weighted policy benchmark.

SOURCE: Comptroller of Public Accounts.

## COMPTROLLER OF PUBLIC ACCOUNTS—TEXAS GUARANTEED TUITION PLAN FUND

The Texas Guaranteed Tuition Plan (formerly the Texas Tomorrow Fund) is a fully guaranteed prepaid tuition program, which began in January 1996. Currently the Texas Prepaid Higher Tuition Board has closed the Texas Guaranteed Tuition Plan Fund for enrollment. The plan currently accepting enrollment, The Texas Tuition Promise Fund, went into effect September 1, 2008. The fund is managed by the Texas Prepaid Higher Education Tuition Board. The Board's plan manager, OFI Private Investments, Inc., has invested the assets of the plan in accordance with the investment policy statement adopted by the Board.

### **FUND CONTRIBUTIONS**

Existing member contributions are added annually to the Texas Guaranteed Tuition Plan (TGTP) fund. In fiscal year 2011 contributions totaled \$17.0 million in tuition contract payments and over \$947,000 in fees and other revenue. Investment income resulted in a gain of \$120.2 million to the fund in fiscal year 2011. According to CPA, contributions combined with the changes in future contract benefits resulted in fund increase of \$112.6 million.

### **FUND DISTRIBUTIONS**

According to the CPA, \$140.1 million was distributed to colleges for tuition payments during fiscal year 2011. An additional \$1.9 million was distributed for administrative expenses and \$10.9 million was refunded to contract purchasers. In fiscal year 2011 fund distributions totaled \$151.4 million.

According to the Texas Guaranteed Tuition Plan's 2011 Actuary's Report on Program Soundness, the liabilities of the Plan exceed the value of assets as of August 31, 2011, by \$641.4 million. The funded ratio of the plan is 68.8 percent. Based on actuarial assumptions for expected income and disbursements, TGTP is projected to run out of cash to pay benefits in fiscal year 2019.

### **INVESTMENT OBJECTIVE**

According to the CPA, the investment objective is to accumulate sufficient funds to fully meet current and future obligations to fund participants. To meet this goal, the board has developed four general objectives: preserve the purchasing power of the fund by achieving investment earnings in excess of inflation; protect the fund principal from market value

erosion; keep return volatility low by employing prudent fund diversification; and invest assets in compliance with the "prudent person" standard.

### **INVESTMENT AND OVERSIGHT RESPONSIBILITY**

The Texas Prepaid Higher Education Tuition Board directs the investment policies that are carried out by investment managers. The board is chaired by the Comptroller of Public Accounts and includes two members appointed by the Governor and four members appointed by the Lieutenant Governor. At least two of the Lieutenant Governor's appointees are from a list of persons recommended by the speaker of the House of Representatives.

### **PERCENTAGE OF ASSETS EXTERNALLY MANAGED/ ADVISED**

According to the CPA, 100 percent of the fund's assets are externally managed.

### **INVESTMENT COSTS**

According to the CPA, the costs of investing the fund for fiscal year 2011 were \$2.4 million, or 18 basis points (0.18 percent) of the ending fund balance. This amount consists entirely of external investment expenses and includes securities lending fees. The investment costs for fiscal year 2010 were \$4.3 million or 0.32 percent of the fund balance.

## COMPTROLLER OF PUBLIC ACCOUNTS—TEXAS GUARANTEED TUITION PLAN FUND (CONTINUED)

### PERFORMANCE BENCHMARKS

The CPA provided the following benchmarks for fiscal year 2011. The total fund benchmark was 7.6 percent in fiscal year 2011.

**FIGURE B5**  
**CPA — PERMANENT PUBLIC HEALTH FUND PERFORMANCE**  
**BENCHMARKS**  
**FISCAL YEAR 2011**

BENCHMARK NAME	ASSET CLASS	FISCAL YEAR 2011 RATE OF RETURN
Dow Jones U.S. Total Stock Market Index	U.S. Equity	19.4%
S&P 500 Index	U.S. Equity	18.5%
Russell 1000 Growth Index	U.S. Equity	24.0%
Russell 1000 Value Index	U.S. Equity	14.4%
Russell 2000 Index	U.S. Equity	22.2%
MSCI EAFE Index	Non-U.S. Equity	10.0%
MSCI All Country Ex-U.S. Local Net	Non-U.S. Equity	-0.2%
Barclays Capital Aggregate Bond Index	Fixed Income	4.6%
Barclays Capital Corporate High Yield Bond Index	Fixed Income	8.4%
Citigroup WGBI	Fixed Income	11.2%
S&P Leveraged Loan Index	Fixed Income	2.8%
Barclays Capital U.S. TIPS Index	Fixed Income	10.8%
T-Bills	Cash	0.1%

SOURCE: Comptroller of Public Accounts

## COMPTROLLER OF PUBLIC ACCOUNTS—PERMANENT PUBLIC HEALTH FUND

The Permanent Public Health Fund (PPHF) is a collection of public endowments to support state-administered health-related programs. The consolidated fund includes the Permanent Tobacco Education and Enforcement Fund, the Permanent Children and Public Health Fund, the Permanent EMS and Trauma Care Fund, the Permanent Rural Health Facility Capital Fund, and the Permanent Small Urban Hospitals Funds. The endowments were established with proceeds from the comprehensive tobacco settlement between the State and the tobacco industry.

### **FUND CONTRIBUTIONS**

Initially, \$475 million of tobacco settlement proceeds were contributed in fiscal year 2000. No additional tobacco proceeds have been added to the fund.

### **FUND DISTRIBUTIONS**

The PPHF is a total return fund and distributions may be made from both income as well as growth in asset values. The annual distributions are determined by the Comptroller of Public Accounts (CPA). Annual distributions, paid quarterly, are calculated as 4.5 percent of the twenty-quarter moving-average value of the PPHF as of June 30 for the following fiscal year. The annual distributions may not exceed 7 percent of the average net fair market value of the investment assets of the fund. According to the CPA, \$20.7 million was transferred during fiscal year 2011 to the Texas Department of Health to fund the relevant programs.

### **INVESTMENT OBJECTIVE**

The primary investment objective, according to the CPA, is to provide a predictable, stable stream of distributions and to preserve the purchasing power of each fund's assets and annual distributions by earning an average annual total return, after inflation, of 5 percent over rolling 10-year periods or longer. Investment decisions must adhere to the "prudent investor" rule.

### **INVESTMENT AND OVERSIGHT RESPONSIBILITY**

The CPA, through the Texas Treasury Safekeeping Trust Company, is responsible for management and oversight of the fund.

### **PERCENTAGE OF ASSETS EXTERNALLY MANAGED/ ADVISED**

According to the CPA, 100 percent of the fund assets are externally managed.

### **INVESTMENT COSTS**

According to the CPA, the costs of administrating the fund for fiscal year 2011 were \$1.3 million, or 31 basis points (0.31 percent) of the ending fund balance. Internal and external investment expenses included costs for consulting, auditing, IT systems, compliance monitoring, overhead, risk management, reporting, investment accounting, investment management, and fees paid to money managers and custodians. Investment costs for fiscal year 2010 were \$1.2 million or 0.30 percent of the fund balance.

## COMPTROLLER OF PUBLIC ACCOUNTS—PERMANENT PUBLIC HEALTH FUND (CONTINUED)

### PERFORMANCE BENCHMARKS

The CPA provided the following benchmarks for fiscal year 2011. The total fund benchmark was 9.91 percent in fiscal year 2011.

**FIGURE B6**  
**CPA — PERMANENT PUBLIC HEALTH FUND**  
**PERFORMANCE BENCHMARKS**  
**FISCAL YEAR 2011**

STRATEGY	BENCHMARK
Stable Return (Low Beta)	Barclay Global Multiverse
<b>Global Investment Grade Fixed Income</b>	<b>Blend (65% U.S. Aggregate, 35% Global Aggregate ex US)</b>
Short-term Investment Funds	3-month Treasury Bill
US Core	Barclays US Aggregate
Non-US Developed	Barclays Global Aggregate ex US
<b>Global High Yield Fixed Income</b>	<b>Barclays Global High Yield</b>
US High Yield	Barclays US High Yield
Emerging Market	Barclays Global Emerging
<b>Absolute Return</b>	<b>3 Month T-Bill &amp; HFR FOF: Conservative</b>
Market Return (Beta)	MSCI ACWI
<b>Global Equity</b>	<b>MSCI ACWI</b>
Domestic	S&P 1500
Non-US Developed	MSCI World ex US
Emerging Market	MSCI EM
<b>Hedged Equity</b>	<b>HFR FOF: Strategic</b>
Enhanced Return	MSCI ACWI
<b>Private Equity</b>	<b>MSCI ACWI</b>
<b>Enhanced Return Real Estate</b>	<b>NCREIF NPI</b>
Inflation Protection (Real Assets)	CPI
<b>Stable Value Real Estate</b>	<b>CPI</b>
<b>TIPS</b>	<b>Barclays Global Inflation Linked</b>
<b>Commodities</b>	<b>Dow Jones UBS Commodity</b>

**Bold** indicates components to be included in weighted policy benchmark.

SOURCE: Comptroller of Public Accounts.

### RECENT LEGISLATION

Article 28 of Senate Bill 1, Eighty-second Legislature, First Called Session, 2011, expanded the permissible uses of three of the public endowments in the Permanent Public Health Fund. The Legislature may appropriate money from the Permanent Fund for Health and Tobacco Education and Enforcement, the Permanent Fund for Children & Public Health, and the Permanent Fund for EMS & Trauma Care to pay the principal of or the interest on a bond issued on behalf of the Cancer Prevention and Research Institute of Texas (CPRIT). The Eighty-second Legislature appropriated approximately \$39.0 million from the Permanent Fund for Health and Tobacco Education and Enforcement, \$19.5 million from the Permanent Fund for Children & Public Health, and \$19.5 million from the Permanent Fund for EMS & Trauma Care to pay for CPRIT debt service in the 2012–13 biennium.



## COMPTROLLER OF PUBLIC ACCOUNTS—NATIONAL RESEARCH UNIVERSITY FUND

On November 3, 2009 Texas voters approved Proposition 4, adding Article VII, Section 20 to the Texas Constitution which creates the National Research University Fund (NRUF). Proposition 4 and the enabling legislation, House Bill 51, Eighty-first Legislature, Regular Session, 2009 also transferred the corpus of the Permanent Higher Education Fund (originally intended to be an endowment fund supporting higher education institutions not eligible for distributions from the Permanent University Fund) to the National Research University Fund. The purpose of the NRUF is to provide a dedicated, independent, and equitable source of funding to enable emerging research universities in Texas to achieve national prominence as major research universities.

### **FUND CONTRIBUTIONS**

On January 1, 2010 all assets from the Permanent Higher Education Fund, \$546.3 million, were transferred to the National Research University Fund. No additional contributions have been made to the NRUF since this date.

### **FUND DISTRIBUTIONS**

The Higher Education Coordinating Board is tasked with developing rules for determining the eligibility of institutions to receive money from the NRUF and certifying in each even numbered year which institutions have satisfied those standards. Article VII, Section 20(f) stipulates that the amount appropriated from the fund in any fiscal year may not exceed 7 percent of the average net fair market value of the investment assets of the fund. No distributions were made from the NRUF in fiscal year 2011.

### **INVESTMENT OBJECTIVE**

The investment objective of the NRUF is to earn a long-term annual rate of return of 8 percent to: provide a predictable, stable stream of distributions, ensure that the inflation-adjusted value of distributions is maintained over the long term, and ensure that the inflation-adjusted value of the corpus after distributions is maintained over the long term.

### **INVESTMENT AND OVERSIGHT RESPONSIBILITY**

The CPA, through the Texas Treasury Safekeeping Trust Company, is responsible for management and oversight of the fund.

### **PERCENTAGE OF ASSETS EXTERNALLY MANAGED/ ADVISED**

According to the CPA, 100 percent of the fund assets are externally managed.

### **INVESTMENT COSTS**

According to the CPA, the costs of administrating the fund for fiscal year 2011 were \$1.8 million, or 30 basis points (0.30 percent) of the ending fund balance. Direct internal expenses were \$1.2 million and external investment expenses were \$0.6 million in fiscal year 2011. Internal and external investment expenses included costs for consulting, auditing, IT systems, compliance monitoring, overhead, risk management, reporting, investment accounting, investment management, and fees paid to money managers and custodians.



## COMPTROLLER OF PUBLIC ACCOUNTS—NATIONAL RESEARCH UNIVERSITY FUND (CONTINUED)

### PERFORMANCE BENCHMARKS

The CPA provided the following benchmarks for fiscal year 2011. The total fund benchmark was 9.91 percent in fiscal year 2011.

**FIGURE B7**  
**CPA — NATIONAL RESEARCH UNIVERSITY FUND**  
**PERFORMANCE BENCHMARKS**  
**FISCAL YEAR 2011**

STRATEGY	BENCHMARK
Stable Return (Low Beta)	Barclay Global Multiverse
<b>Global Investment Grade Fixed Income</b>	<b>Blend (65% US Aggregate, 35% Global Aggregate ex US)</b>
Short-term Investment Funds	3 month Treasury Bill
US Core	Barclays US Aggregate
Non-US Developed	Barclays Global Aggregate ex US
<b>Global High Yield Fixed Income</b>	<b>Barclays Global High Yield</b>
US High Yield	Barclays US High Yield
Emerging Market	Barclays Global Emerging
<b>Absolute Return</b>	<b>3 Month T-Bill &amp; HFR FOF: Conservative</b>
Market Return (Beta)	MSCI ACWI
<b>Global Equity</b>	<b>MSCI ACWI</b>
Domestic	S&P 1500
Non-US Developed	MSCI World ex US
Emerging Market	MSCI EM
<b>Hedged Equity</b>	<b>HFR FOF: Strategic</b>
Enhanced Return	MSCI ACWI
<b>Private Equity</b>	<b>MSCI ACWI</b>
<b>Enhanced Return Real Estate</b>	<b>NCREIF NPI</b>
Inflation Protection (Real Assets)	CPI
<b>Stable Value Real Estate</b>	<b>CPI</b>
<b>TIPS</b>	<b>Barclays Global Inflation Linked</b>
<b>Commodities</b>	<b>Dow Jones UBS Commodity</b>

**Bold** indicates components to be included in weighted policy benchmark

SOURCE: Comptroller of Public Accounts.

### RECENT LEGISLATION

House Bill 1000, Eighty-second Legislature, Regular Session, 2011 made several changes to the distribution policy of the NRUF. To be eligible to receive NRUF appropriations, an institution must meet two mandatory criteria and four out of six optional criteria. The mandatory criteria are that the institution is designated as an emerging research university within the THECB's Accountability System, and that the institution reported at least \$45 million in restricted research expenditures in each of the preceding two fiscal years. Optional criteria include the following: possession of an endowment fund with values in excess of \$400 million; awarding over 200 Doctor of Philosophy degrees per year; having an entering freshman class of high academic achievement; recognition of institution's research capability and scholarly attainment; possession of a high-quality faculty; and possession of high-quality graduate education programs.

The bill also stipulates that the total amount appropriated from the fund for any state fiscal year may not exceed an amount equal to 4.5 percent of the average net market value of the investment assets of the fund for the 12 consecutive state fiscal quarters ending with the last quarter of the preceding state fiscal year.



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## APPENDIX C. GLOSSARY

### **ACTIVE PORTFOLIO STRATEGY**

A money-management approach based on informed, independent investment judgment as opposed to passive management (indexing). It attempts to outperform a benchmark index.

### **ALTERNATIVE INVESTMENTS**

Investment opportunities which have not been identified by traditional public or fixed income capital markets. Also may be defined as private, nontraditional, illiquid investments. Alternative investments are accomplished almost exclusively through private offerings of debt equity interest, and are often made through entities organized as limited partnerships. Examples of alternative investments include international and emerging market stocks, hedge funds, event driven strategies, as well as illiquid equity investments such as venture capital, mezzanine financing, private equity and buy-out investing, real estate, and oil and gas.

### **ASSET ALLOCATION**

The process of diversifying an investment portfolio among asset classes (stocks, bonds, real estate, etc.) to achieve a particular investment objective. Asset allocation is used to anticipate the long-term future direction of markets and to deploy assets in a way that will result in superior performance in the context of acceptable risks. Studies have shown that asset allocation has a far greater effect on investment performance than does the selection of investment managers or the selection of individual securities.

### **BASIS POINT (BP)**

The smallest measure used in quoting investment performance or fees. One basis point is 1/100th of 1 percent. Thus, 100 basis points equals one percent. A bond's yield that increased from 8.00 percent to 8.50 percent would be said to have risen 50 basis points. A management fee of 25 basis points represents 0.25 percent of value of the assets managed.

### **BENCHMARK**

A reference that serves as a standard by which others may be measured. In the investment environment, the benchmark may be a common economic or financial index, such as the Consumer Price Index or the Standard & Poor's 500 (S&P 500) Index.

### **BONDS**

Contract to pay specified sum of money (the principal or face value) at a specified future date (maturity) plus interest paid at an agreed percentage of the principal. Maturity is usually longer than one year. The relationship between the bondholder and issuer of the bonds is that of creditor and debtor. Thus, the holder has no corporate ownership privileges as stockholders do.

### **BROKER**

A person who acts as an intermediary between a buyer and seller, usually charging a commission.

### **CASH EQUIVALENTS**

Investment instruments have such high liquidity and safety that they are virtually as good as cash. They typically have a short maturity. Examples include a money market fund, Treasury Bills, and investments in a custodian bank's short term investment fund (STIF) or similar fund. Such securities help minimize risk during volatile market periods as well as to provide cash flow.

### **COLLATERALIZED MORTGAGE OBLIGATION (CMO)**

A security created using the underlying cash flows from mortgage-backed securities as collateral. A CMO shifts the uncertainty regarding the exact timing of principal return in a mortgage-backed security. This uncertainty exists because the timing of mortgage-backed principal payments is influenced by changes in interest rates, the current economic climate, and the geographic makeup of loans.

### **COMMON STOCK**

Share in a public company or a privately held firm. Common stockholders typically have voting and dividend rights. In the event of corporate bankruptcy or other liquidation of assets, common stockholders are paid after secured and unsecured creditors, bond holders, and preferred stockholders.

### **CORPUS**

The principal of a fund or estate as distinct from income or interest.

**CREDIT RISK**

The likelihood that a party involved in an investment transaction will not fulfill its obligations. This type of risk is often associated with the issuer of the investment security and is affected by the concentration of deposits or investments in a single instrument or with a single institution.

**CUSTODIAN BANK**

Used by an entity with large investment holdings to hold securities, record transactions, and collect interest or dividends from investments. The custodian bank is sometimes referred to as the primary or master custodian because it obtains the services of subcontractors and agencies to actually hold and trade the securities.

**DERIVATIVES**

A contract or financial arrangement whose value is based on the performance of an underlying financial asset, index, or other investment. Derivatives are available based on the performance of assets, interest rates, currency exchange rates, and various domestic and foreign indexes.

**DIVERSIFICATION**

The spreading of risk by investing in several individual investments or categories of investments, such as stocks, bonds, cash equivalents, and real estate.

**DURATION**

A concept that measures bond price volatility by measuring the “length” of a bond. It is a weighted average term to maturity of the bond’s cash flows, the weights being the present value of each cash flow as a percentage of the bond’s full price. The greater the duration of a bond, the greater its percentage price volatility. In general, duration rises with maturity, falls with the frequency of coupon payments, and falls as the yield rises.

**ENDOWMENT**

Funds given to an entity, such as a college or university, with donor-imposed restrictions that the funds are not to be expended but are to be invested for purpose of producing income.

**EQUITY INVESTMENT**

Ownership interest processed by shareholders in a corporation.

**EXTERNAL MANAGER**

A person or firm that makes investment portfolio decisions and executes transactions independently, subject to the overall restrictions agreed upon by contract between the fiduciary for the fund and the external manager.

**FIXED INCOME INVESTMENTS**

A security that pays a fixed rate of return in the form of interest or dividends, over a specified period and includes government, corporate, and municipal bonds, preferred stocks, and certain mortgage investments. This asset class is expected to provide regular, predictable income and greater stability of market value than available from equity investments. It is advantageous in times of low inflation, but does not protect holders against erosion of buying power in times of rising inflation because interest or dividend payments do not increase.

**GENERAL PARTNER**

Member of a partnership who is jointly and severally liable for all debts incurred by the partnership; or a managing partner of a limited partnership who is in charge of its operations. A general partner has unlimited liability.

**HEDGE/HEDGING**

A strategy used to offset investment risk. A perfect hedge is one eliminating the possibility of future gain or loss.

**HEDGE FUND**

A hedge fund is typically set up as a private investment partnership that is open to a limited number of investors. The portfolios are typically managed more aggressively and rely on advanced investment strategies to generate high returns. Hedge Funds are not regulated by The Securities and Exchange Commission (SEC)

**INDEMNIFICATION**

An agreement to compensate another party for damage or loss. In securities lending programs, the program administrator may agree to indemnify the lender of securities for any losses caused by the failure of the borrower to return borrowed securities.

**INDEX**

A statistical composite that measures changes in the economy or in financial markets, often expressed in percentage changes from a base period. For example, the Consumer Price Index, which is composed of the prices of key goods and services,

moves up or down as the rate of inflation changes. Other indexes measure the ups and downs of the stock, bond, and other investment markets. Common indexes include the New York Stock Exchange Index, Standard & Poor 500 Index, and the Shearson Lehman Aggregate Bond Index.

#### **INVESTMENT ADVISOR**

A person or service retained by the investing entity to provide investment advice for a fee. The advisors may present economic information such as expected changes in interest rates, current and future national or global economic growth, and other factors that may affect the economy in the future. Investment advisors also present industry information that may affect future decisions in selecting specific securities. The advisor may specialize in a particular kind of investment, such as emerging growth stocks or international stocks.

#### **LARGE/MEDIUM/SMALL CAPS**

Stocks of companies with market capitalization of \$500 million or less are small caps. Such stocks generally represent companies that are less well established, but are often faster growing than mid-caps (market capitalization of \$500 million to \$3-5 billion) or large caps (\$1 billion or more). Small caps are often more volatile than stocks of more well-established companies.

#### **LEVERAGED BUYOUT**

Equity investments in public or private companies that result in the purchase of a significant portion or majority control of the company.

#### **LIQUIDITY**

The ease with which an asset can be converted to money. Also, the ability to buy or sell an asset quickly and in large volume without substantially affecting the price.

#### **MARKET RISK**

The risk that the value of a security will rise or decline as a result of changes in market conditions.

#### **MATURITY**

The date on which a debt's principal is to be repaid.

#### **MEZZANINE FINANCING**

Investment in the subordinated debt of privately owned companies. The debt holder participates in equity appreciation through conversion features such as rights, warrants, or options.

#### **MERRILL LYNCH 90-DAY U.S. TREASURY BILL INDEX**

A benchmark which assumes that treasury bills are bought at the beginning of a period at market value and held to maturity. Upon maturity, it is assumed that additional bills are purchased at market value and again held until maturity. The rollover continues until the end of the period. The calculation includes the sum of the yields earned by the treasury bills.

#### **MODERN PORTFOLIO THEORY**

An investment decision approach that permits an investor to classify, estimate, and control both the kind and the amount of expected risk and return. Portfolio theory quantifies the relationship between risk and return and assumes that investors must be compensated for assuming risk. It departs from traditional security analysis by determining the statistical relationships among securities comprising the overall portfolio rather than analyzing the characteristics of individual investments.

#### **MUTUAL FUND**

Portfolio of securities professionally managed by the sponsoring management company or investment company that issues shares to investors. The major advantages of mutual funds are diversification, professional management, and ownership of a variety of securities with a minimal capital investment.

#### **PASSIVE PORTFOLIO STRATEGY**

A money-management strategy that seeks to match rather than outperform return and risk characteristics of a market segment or index, by mirroring its composition.

#### **PEER GROUP**

One group that is of equal standing with another group. In comparing an investment fund's performance with its peers, the peer group should include other funds with similar characteristics, such as fund size, purpose, and investment restrictions.

#### **PORTFOLIO**

A combined holding of more than one investment. The purpose of a portfolio is to reduce risk by diversification.

#### **PRIVATE INVESTMENTS**

Investment opportunities, which have not been identified by traditional capital markets. Typically more volatile than

traditional securities, private investments require strong due diligence controls.

#### **PRIVATE PLACEMENT**

A securities issuance, which is exempt from registration requirements of the Securities Act of 1933. It generally involves the sale of stocks, bonds, or other investments directly to an institutional investor.

#### **PRUDENT INVESTOR STANDARD**

This standard provides that a board or other fiduciary in making investments, may acquire or retain any kind of investment that prudent investors, exercising reasonable care, skill, and caution, would acquire or retain in light of the purposes, terms, distribution requirements, and other circumstances of the fund then prevailing, taking into consideration the investment of all the assets of the fund rather than a single investment. Generally, this standard assumes that the board or other fiduciary has investment knowledge and expertise, and provides broader investment authority than the prudent person standard.

#### **PRUDENT PERSON STANDARD**

A concept born from the 1830 Massachusetts court decision of *Harvard College v. Armory* that described the duty owed by a trustee to beneficiaries: "All that can be required of a trustee to invest is, that he shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own 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 the capital to be invested."

#### **RISK**

In exchange for a return on investment, the investor may expose assets to possible losses. Risk is the probability or possibility of such losses. Risk is also often defined in terms of market volatility, or standard deviations of returns. The standard deviation is a statistical measure of portfolio risk, which reflects the average deviation of observations from their sample mean. It is used as an estimate of risk because it measures how wide the range of returns typically is. The wider the range of returns, the higher the portfolio risk.

#### **S&P 500**

An index, which measures the performance of the common stock of 500 of the largest U.S. corporations. The S&P 500

represents the aggregate market value changes relative to a base period of 500 stocks primarily traded on the New York Exchange.

#### **S&P 1500**

The S&P 1500 Composite Index, which measures the performance of the top 1500 U.S. companies.

#### **SECURITIES LENDING**

A program in which institutional investors transfer their securities to broker-dealers and other borrowers in exchange for collateral and a promise by the borrower to return the identical securities. The collateral may consist of cash, securities, or letters of credit. The lender agrees to the collateral to the borrower upon maturity of the loan and return of the borrowed securities.

#### **TIME-WEIGHTED RATE OF RETURN**

The total rate of return on an investment adjusted to eliminate the effect of timing of cash flows due to contributions and withdrawals, which are not controllable by investment managers.

#### **TOTAL RETURN**

The annual return on an investment including appreciation and interest or dividends. A "total return fund" is one that is indifferent to whether the return is generated by appreciation or ordinary income because it can spend from both categories

#### **TRANCHE**

A class into which a multi-class security, such as collateralized mortgage obligation (CMO) is split. The different tranches of a CMO, which may range from a fast-pay class to long-term slow-pay class, are designed to meet different investor objectives for portfolio diversification.

#### **VENTURE CAPITAL**

Venture capital is an important source of financing for start-up companies or other embarking on a new or turnaround ventures that entail some investment risk but offer the potential for above average future profits. Sources of venture capital include wealthy individual investors, subsidiaries of banks and other corporations organize as small business investment companies: groups of investment banks and other financing sources that pool investments in venture capital funds or venture capital limited partnerships. Some venture capital sources invest only at a certain stage of entrepreneurship, such as the start-up or seed money stage,

the first round or second round phases that follow, or at the mezzanine level immediately preceding an initial public offering. In return for taking an investment risk, the venture capitalists are usually rewarded with some combination of profits, preferred stock, royalties on sales, and capital appreciation of common shares.

**VOLATILITY**

The extent to which a security or market tends to rise or fall sharply in price within short-term period.

**YIELD**

The annual return on investment (from dividends or interest) expressed as a percentage of either cost or current price. Yield is one component of return.

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PRIMARY SOURCE: "A Summary of the State's Investments," prepared by the State Auditor's Office for the Senate Finance Committee, October 1999.





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## APPENDIX D. REFERENCES

The following investing agencies and public institutions of higher education provided information contained in the Annual Report on Major State Investment Funds.

Teacher Retirement System (TRS)

Permanent School Fund (PSF — GLO)

Permanent School Fund (PSF — TEA)

Employees Retirement System (ERS)

The University of Texas System (UT System)

Permanent University Fund (UT — PUF)

Permanent Health Fund (UT — PHF)

Comptroller of Public Accounts (CPA)

Tobacco Settlement Permanent Trust (CPA — TSF)

Texas Guaranteed Tuition Plan Fund (CPA — TGTF)

Permanent Public Health Fund (CPA — PHF)

Permanent Higher Education Fund (CPA — NRUF)

Remittances of original data from agencies and institutions of higher education for this report are attached.