The Texas Permanent School Fund: An Overview

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The Texas Permanent School Fund (PSF) was established in 1854 with an initial appropriation of $2 million and today has assets that total $36.2 billion. PSF receives revenue from mineral-related royalty payments and rental fees from land held in trust and investment returns. These funds serve as a guarantee for bond payments owed by participating local school districts. The PSF program maintains an "AAA" rating from all three major ratings agencies. Currently, the PSF fund guarantees bonds with a total principal outstanding of $68.2 billion, resulting in a 180% leverage rate. No school district participating in the PSF guarantee program has ever defaulted on its debt service payments.

Despite the inherent strengths of the PSF program, C.W. Henderson and Associates, Inc. (CWH) only purchases Texas school district bonds that maintain strong underlying credit profiles. We view the PSF-guarantee as added security for bondholders, not the primary source of security. In general, school districts in Texas benefit from positive demographics, including healthy population gains and above average socio-economic profiles. Unemployment is typically low, and local economies and tax bases, especially those around Austin, Dallas, Houston and San Antonio, tend to be strong and expanding. This drives healthy property value gains and, in turn, increases in property tax revenue, one of the two primary funding sources for school districts. Growing tax bases and population also tend to spur increases in enrollment, which results in increased state payments, the other major funding source for school districts. In spite of rapid growth, most districts maintain strong financial profiles, including robust reserves and healthy liquidity levels. One drawback tends to be high debt levels, although this is not unusual for rapidly expanding districts where infrastructure demands are high. Pension are generally well funded, unlike many other states, as Texas makes contributions to the Teachers Retirement Fund pension plan on-behalf of the districts.

Approximately 25% of the money CWH manages is invested in Texas municipal securities – with many of those bonds having the PSF enhancement. Below are several market related comments on some of the features and benefits of PSF bonds.

Yield Enhancements and Geographic Diversification

Due to significant in-state demand, bonds issued by states with high state income tax rates typically offer lower yields than bonds issued by states with low or no income taxes. PSF bonds are issued by State of Texas – a state with no income taxes. We utilize in-state municipal bonds on the longer end of portfolio structures in accounts of high state tax residents. However, PSF bonds often provide comparable or enhanced returns – even for clients that reside in a high tax state. For example, as of 11/17/16, ten year AAA rated PSF bonds were trading at 2.51% or +30 to the AAA municipal yield curve. AAA rated California bonds were trading at 2.31% or +10 to that same curve. A California resident in the 13.3% state tax bracket would be subject to the state income tax on the income earned from the PSF bond. However, deductibility of state income taxes on federal tax returns would reduce the California resident's effective tax rate to 8.03%. The net return, (2.51 x (1-0.083)) = 2.31%, makes the PSF investment a comparable

investment on an "after state-tax" basis. The client also receives the benefit of geographic diversification. The breakeven rate between in-state and out of state municipals is something we monitor closely at CWH.

Liquidity

PSF bonds are very liquid. Liquidity is imperative in the municipal market for many reasons. First, when clients need cash it is important that we obtain fair market prices. Second, when opportunities arise liquidity permits us to advantageously trade in client portfolios. In fourth quarter 2008, when 10 year prime municipal/Treasury yield ratios exceeded 170%, CWH was able to react swiftly to the market dysfunction and take advantage of the tremendous buying opportunity. We were aggressive in extending Intermediate Product portfolio durations from a neutral duration of 4.00 years to a more aggressive 5.00 years. When municipal rates declined several years later we rather easily shifted back to a more defensive posture – remaining cognizant of the tax ramifications involved in a portfolio restructuring. Maintaining liquidity in client portfolios allows us to shift duration in anticipation of interest rate moves – which has the potential to meaningfully enhance overall returns.

Liquidity also allows us to take advantage of market anomalies. SEC Rule 2a-7 requires money market funds to restrict their underlying holdings to highly rated investments with maximum maturities of thirteen months. Because of this, the yield curve is typically steep beyond thirteen months due to lessened demand beyond the money market sector. Most PSF bonds with maturities less than 13 months, that have strong underlying ratings, are eligible money market investments. Our approach is to purchase PSF bonds maturing between fifteen to sixteen months and then sell them when their maturities shorten to about a year. In effect we "ride down the yield curve."

To quantify, assume that we purchase fifteen month PSF bonds at a yield of 0.90%. In three months they are sold at a 0.70% yield resulting in a 20 basis point short-term profit. If we do four transactions a year, the total after-tax return would be 1.38% (a yield return of 0.90% plus 0.80% capital gains taxed at 40%). If the client has tax loss carry forwards that offset the capital gains tax, the tax free rate of return rises to 1.70%.

Defensiveness

As a defensively styled manager, our investment philosophy is focused on never having a negative year on a total return basis. We utilize only high quality securities to reduce the risk of both rating downgrades and credit spread widening. Over the last several years ten year PSF bonds with good underlying ratings have traded between +20 to +30 off the AAA municipal yield curve. This spread, despite several periods of market volatility (year-end 2008, summer 2013, year-end 2016), has remained consistent. It is typical for lower rated general obligation debt and non-essential service securities, such as airports, hospital bonds and appropriated debt, to be adversely affected by spread widening in a rising interest rate environment. There is typically a "flight to quality" that takes place as interest rates move higher causing lower quality securities to underperform.

C.W. Henderson and Associates, Inc. considers the Texas Permanent School Fund (PSF) to be the "gold standard" in municipal credits. Securities with this enhancement provide many market related benefits as well. We anticipate that PSF bonds will remain a favored component in our portfolio constructions.

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