

A STUDY OF THE STATUTES THAT GOVERN THE INVESTMENT OF  
\$45 BILLION DOLLARS  
IN THE PERMANENT SCHOOL FUNDS IN TWENTY STATES  
WITH SUGGESTED MODEL LEGISLATION  
TO IMPROVE RETURNS AT PRUDENT LEVELS OF RISK

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Today it is estimated that about ten percent of the U. S. economy is driven by investments made by large and powerful endowments and foundations.<sup>1</sup> Most people are aware of the existence of large endowment funds such as the Carnegie Foundation, the Bill and Melinda Gates Foundation, the S. Robert Wood Foundation, the Annenberg Foundation, and others. These foundations do their work behind the scenes, financing public causes such as world health, public television, art museums, etc. Few education leaders, on the other hand, have any idea that they are the beneficiaries of some of the largest trusts in America. If you live in Arizona, New Mexico, Oregon, Texas, or Wyoming, your school trust is among the top one percent of all trusts in the nation.

The legislators elected to statehouses are managing or setting the rules for how endowments in excess of \$45 billion to school children are managed. Amazingly, most legislators themselves are equally unaware of these funds. Through statute they are setting the parameters under which the endowment funds of \$45 billion are invested. Legislators have not been informed that they are bound by a duty of undivided loyalty to those trusts. When they were sworn in to uphold the U.S. Constitution and their state constitution, they may have had no idea that they were sworn to protect that trust, to hold it inviolate, to guarantee it against loss or diversion, including their own diversion, and to use the proceeds from that trust for the sole benefit of public schools. Legislators may not know that prudent investor rules can be adopted into their statutes and may generate millions more than is currently being generated annually through investment check lists.

### Scope of Research

This paper researched the legal parameters that govern these sacred trusts and endowment funds in twenty, mostly western, states.<sup>2</sup> The enabling acts, or statehood acts, that granted over 134 million acres to schools were studied, along with state constitutions, and state statutes. Research included the 1911 seminal work, A History of Public Permanent Common School Funds in the United States, 1795-1905, by Dr. Fletcher Harper Swift of Columbia University.

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<sup>1</sup> The Foundation, a Great American Secret, Joel L. Fleishman, PublicAffairs Books, 2007.

<sup>2</sup> Alaska, Arizona, California, Colorado, Idaho, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Texas, Utah, Washington, Wisconsin, and Wyoming.

## Brief History of School Land Grants

The founding fathers of this nation recognized the importance of education to the lives of individuals and to the success of democracy. Over 134 million acres of land were granted to states as they joined the union by Congress to support schools. At one time every state in the nation had either school trust lands or school funds or both. On May 20, 1785, the Continental Congress adopted an ordinance that provided for the survey and sale of the unsettled lands outside of the original 13 colonies, ambitiously stretching from the Atlantic to the Pacific Ocean. The territory was to be divided into square townships, each six miles on a side. Each township was to be subdivided into 36 one-mile square lots, which are called sections today. Lot 16, which was 640 acres in the center of the township, was reserved “of each township, for the maintenance of public schools within the said township.”<sup>3</sup>

The original thirteen states had no federal lands to be granted, so the states themselves granted certain state lands for education or set up a permanent school fund and created a revenue stream to build the fund. Many did both. Texas, which entered the union as an independent republic, also had no federal lands within its borders. So, in 1839, Texas reserved 13,284 acres within each county for education, and the next year increased the grant to 17,712 acres.<sup>4</sup>

By 1850, Congress began granting two sections per township for schools, doubling the grant to 1280 acres in each township, because the lands in the new states were less capable of producing revenue due to their mountainous or dry conditions. Then beginning in 1894, Congress granted four sections to the arid states of Utah, Arizona, and New Mexico.

Those states receiving the grant from Congress received their grant in their statehood or enabling act. The lands, however, were not a magnanimous gift. There were strings attached. In order to receive the granted school lands, the state had to agree not to tax federal lands. It was believed that ultimately all federal lands within a state’s borders would be sold, but Homestead Act provisions for settling a 160 acre parcel and making it support a family were not realistic in the arid or mountainous west. Today those untaxed federal lands within a state remain a significant tax burden and a drain on education budgets in mostly western states. Untaxed federal and state lands comprise 96% of Alaska, 88% of Nevada, and about half or more of seven other states in this study.<sup>5</sup>

Courts have concurred with this assessment that school lands were part of a bargain between the incoming states and a federal treasury that was ill-equipped to pay taxes on immense spreads of lands. The United States’ District Court<sup>6</sup> has held:

The state school land grants were not unilateral gifts made by the United States Congress. Rather, they were in the nature of a bilateral compact entered into between two sovereigns. In return for receiving the federal

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<sup>3</sup> Laws of United States of America, 1789-1815, Vol. I, Chapter 32, pages 563-569.

<sup>4</sup> The original grant was for three Spanish leagues, which is 13,284 acres. The grant was expanded to four Spanish leagues, or 17,712 acres.

<sup>5</sup> Arizona, California, Idaho, New Mexico, Oregon, Utah, and Wyoming.

<sup>6</sup> United States v. Cotter Corporation, Nos C 79-0307. United States District Court, D. Utah, C.D. (October 1, 1979).

lands ...[the state] disclaimed all interest in the remainder of the public domain, agreed to forever hold federal lands immune from taxation, and agreed to hold the granted lands, or the proceeds therefrom, in trust as a common school fund. Thus, the land grants involved here were in the nature of a contract, with a bargained-for consideration exchanged between the two governments.

### Establishment of Permanent Education Endowment Funds

The Statehood or Enabling Acts passed by Congress not only granted school lands but also set up permanent school funds from the proceeds of the lands in all of the states in this study except Mississippi, Oregon and Wisconsin. State constitutions then accepted the lands and made provisions for the management of the permanent school funds.

The language in state constitutions may vary but most constitutions contain strong and forceful language. Many state constitutions refer to the funds as “perpetual funds”<sup>7</sup> or funds held in “perpetuity.” This is the case in Arizona, South Dakota, Texas, Utah, Washington and Wyoming. Washington’s constitution also adds that the school fund is “permanent and irreducible.” Other state constitutions provide that the fund must be “inviolable and intact,” as in the constitutions of Colorado, Idaho, Montana, New Mexico, and Oklahoma. As if “inviolable and intact” were not clear enough, Montana adds that the fund is “irreducible and permanent.” North Dakota and South Dakota add that “. . . no part of the fund shall ever be diverted [“diverged” in North Dakota’s constitution]. . .” Idaho adds that the fund is of the “highest and most sacred order.” Strangely, California, where the permanent fund has been abused and continues to not be used to support schools today, acknowledges in its statutes that past policies have resulted in significant depletion of the inventory of lands and recognizes that the lands should be used to provide an economic base for the support of schools.<sup>8</sup>

State constitutions also provide various protections to the permanent funds. Colorado, Idaho, Minnesota, Montana, Oklahoma, South Dakota, Utah, and Washington all have specific provisions to protect against loss or diversion. Of course, if beneficiary representatives of the schools in a state are not aware of the permanent funds and are not following investments, they will be ill-prepared to enforce these constitutional protections. In some states, education leaders may be reluctant to enforce the repayment of losses to their funds, as the majority of the funding for education comes from the state against which suit for loss must be enforced. Such constraint might not apply to others.

Most of the statehood or enabling acts that established a permanent school fund required that the “proceeds” from the grant lands be deposited in the permanent school fund. Black’s Law Dictionary defines proceeds as:

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<sup>7</sup> Arizona, South Dakota, Texas, Utah, Washington, and Wyoming.

<sup>8</sup> California statute 8702. The statute goes on to appropriate all moneys in the fund to the State Lands Commission without regard to education.

Issues; income; yield; receipts; produce; money or articles or other thing of value arising or obtained by the sale of property; the sum, amount, or value of property sold or converted into money or into other property. Proceeds does not necessarily mean only cash or money. *Phelps v. Harris*, 101 U.S. 370, 25 L.Ed. 855. That which results, proceeds, or accrues from some possession or transaction. *State Highway Commission v. Spainhower, Mo.*, 504 S.W.2d 121, 125. The funds received from disposition of assets or from the issue of securities (after deduction of all costs and fees). As used in context of debtor's sale of collateral, "proceeds" includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds. Insurance payable by reason of loss or damage to the collateral is proceeds, except to the extent that it is payable to a person other than a party to the security agreement. Money, checks, deposit accounts, and the like are "cash proceeds." All other proceeds are "non-cash proceeds." U.C.C. '9-306.

Where statehood or enabling, acts require "all proceeds" to be deposited to the permanent fund, legislatures are then bound by that requirement and are not at liberty to then selectively choose only certain revenue streams to be deposited in the fund.

#### Additional Deposits to the Permanent School Funds

Many states deposit additional sources of revenue in their permanent school fund besides the proceeds from land sales and mineral royalties. These additions may be delineated in the state constitution or statute. Most states deposit the 5% of the revenue from federal land sales in their school fund.<sup>9</sup> Many states also include escheated property or unclaimed property.<sup>10</sup> Several states include gifts and bequeaths and grants to states when the purpose of the grant is uncertain.<sup>11</sup>

New Mexico, with the second largest permanent fund, deposits all interest, dividends, and capital gains from the investment of the fund, and then distributes a designated percentage depending on the fiscal year. At statehood, Oklahoma received an additional \$5 million because the state did not receive lands in-lieu of those already occupied by Indian tribes at the time of statehood. Oregon adds the net proceeds from the state tax on extraction, production, storage, use, sale distribution, or receipt of oil or natural gas and the tax on the ownership of oil or natural gas.<sup>12</sup>

There are a plethora of other very specific additions to some funds. Alaska includes "federal mineral revenue-sharing payments or bonuses"<sup>13</sup> and pays 0.5% of total receipts derived from the management of state lands. Arizona includes the "residue of lands granted for the payment of

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<sup>9</sup> Arizona, North Dakota, Nebraska, Nevada, New Mexico, Oklahoma, South Dakota, Utah, Washington, Wisconsin, and Wyoming.

<sup>10</sup> Arizona, Colorado, Idaho, Montana, North Dakota, Nebraska, Nevada, Oklahoma, South Dakota, Washington, Wisconsin, and Wyoming.

<sup>11</sup> Colorado, Idaho, Montana, North Dakota, New Mexico, Oregon, South Dakota, Utah, Washington, and Wyoming.

<sup>12</sup> Oregon Constitution, Article VIII, Section 2.

<sup>13</sup> AS 37.14.150.

bonds” in certain counties. Nebraska requires, “All money arising from collections on judgments in favor of the state, shall be transferred and paid into the permanent school fund and become a part thereof.” Nevada and Wisconsin require that all net penal law penalties be added to their school fund.<sup>14</sup> South Dakota adjusts its funds for inflation using net capital gains to first make the payment for inflation and then using interest and dividends. Consistent with the enabling act and constitution, Utah deposits all net proceeds from the lands in the permanent fund. Texas deposits all mineral development income from over 13 million mineral acres. In addition, any land recovered by the state by lawsuit, except pine forested lands, become a part of the Texas permanent fund.

### Name of Permanent School Fund

The name of the fund created from the proceeds of the federal land grants for education varies slightly from state to state. The name of the fund is established by the state constitution or statute.

AK	Public School Trust Fund	NM	Permanent School Fund
AZ	Permanent Common School Fund	NV	Permanent School Fund
CA	School Land Bank Fund Permanent Fund	OK	Common School Permanent Fund
CO	Public School Fund	OR	Common School Fund
ID	Public School Permanent Endowment fund	SD	Permanent Trust Fund
MN	Permanent School Fund	TX	Permanent School Fund
MS	Education Improvement Trust Fund	UT	Permanent State School Fund
MT	Public School Fund	WA	Permanent Common School Fund
ND	Common School Trust Fund	WI	School Fund
NE	Permanent School Fund	WY	Public School Fund

### Investing Authority

Most states in this study task the State Treasurer with investing the large permanent school funds. Colorado, Idaho, Mississippi, Montana, and Nevada all have their State Treasurer alone invest their funds. Nebraska, New Mexico, Oregon, Utah, and Wyoming have their funds invested by their state treasurer, yet advice and direction comes from an investment council.

The second most frequently used model is that of an investment board; Arizona, North Dakota, South Dakota, and Washington follow this Board of Investors model. However, not all investment boards are comprised of knowledgeable investors. The voting members of Washington’s State Investment Board are not knowledgeable investors, though the non-voting members are investment professionals. This may, in part, explain Washington’s lower performance in comparison to other states and may significantly hamper efforts to generate the greatest return at their chosen level of risk.

Two of the states, California and Oklahoma, empower the Commissioners of the Land Office to invest the funds. California’s State Land Commission does not seek or implement professional

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<sup>14</sup> Nevada constitution, Article XI, Section 3.

investment advice, resulting in their return on a \$54 million fund being one of the lowest. Oklahoma, on the other hand, has an investment committee that makes recommendations to the Commissioners, but has no authority to act. Oklahoma’s school fund is one of the larger funds and closed FY 2006 with \$949 million with a total return of 11.62%--the highest of all states in the study.

Alaska’s fund is invested by their Commissioner of Revenue who receives advice from the Public School Fund Advisory Board, whose members are primarily non-investment individuals. Wisconsin’s fund is invested by the Board of Commissioners, comprised of three statewide elected officials—the State Treasurer, the Secretary of State, and the Attorney General. Not surprisingly, these funds are not known for higher returns.

The largest permanent fund, Texas, does not follow the State Treasurer model or the Investment Board model. Texas is the only model in which the investing authority lies with the beneficiary of the trust. The Texas Education Agency (TEA), under the direction of the State Board of Education, is charged with the investment of their permanent fund which exceeded \$23.9 billion at the close of FY 2006. Professional investors at or employed by TEA handle the investment of the permanent fund, while additional real estate investments are handled by the professional development staff at the Texas Land Office. Over the last few years, the TEA has generated the highest, or among the highest, annual total rate of return of the 20 funds in this study.

#### Market Value of Permanent School Fund

The market value of each state’s permanent school fund, as reported by the office responsible by statute with the investment of the funds, is as follows:

STATE	MARKET VALUE	STATE	MARKET VALUE
AK	unknown	NM	\$10,000,000,000
AZ	\$1,873,142,000	NV	\$273,429,158
CA	\$54,446,521	OK	\$949,257,957
CO	\$454,000,000	OR	\$1,013,862,000
ID	\$581,893,579	SD	\$116,380,993
MN	\$612,000,000	TX	\$23,900,000,000
MS	\$127,493,869	UT	\$705,034,100
MT	\$427,559,274	WA	\$171,003,906
ND	\$759,975,860	WI	\$596,413,605
NE	\$397,131,360	WY	\$2,084,418,893

#### Statutory Restrictions to Investment

Legislatively imposed restrictions to investments greatly impact the rate of return a state receives on its investment of the permanent school fund. These restrictions determine the investment objectives, impose restrictions on the asset allocation, and determine the acceptable asset categories. Hence, beneficiaries and legislators alike should give careful and attentive scrutiny to the statutes governing the investment of the permanent school funds. Such scrutiny, with the help of professional financial advisors, should yield statutory changes that should generate greater

returns at acceptable levels of risk reasonably suited to the trust objectives outlined in the enabling acts.

A majority of the states in this study impose the prudent investor or prudent person rule on the investing authority for the permanent school fund. The eleven states in this study using the prudent investor or prudent person rule are Alaska, Arizona, Idaho, North Dakota, New Mexico, Oklahoma, Oregon, South Dakota, Texas, Utah, and Washington. Use of this rule allows the flexibility investing authorities need to respond to changing financial markets and changing economic times. For those not familiar with these terms, both the prudent investor rule and the prudent person rule are quite similar though the prudent investor rule requires a greater level of care and sophistication in investment. The specific language for the eleven states governed by the prudent investor or prudent person rule is listed at the end of this paper under Appendix A. States not having this rule may want to peruse the language of various states to consider the language most applicable to the needs of their state.

These school trust funds are permanent and should be managed with the degree of sophistication used in the management of the large endowment funds of universities and foundations. The prudent person or prudent investor rule is used by many of these large endowment funds. In this study, the exact language of the Prudent Investor rule varies from state to state in its wording. This example from the North Dakota Statute provides the reader with a typical sample:

The "prudent investor rule" means that in making investments the board shall exercise the same judgment and care, under the circumstances then prevailing and limitations of North Dakota and federal law, that an institutional investor of ordinary prudence, discretion, and intelligence exercises in the management of large investments entrusted to it, not in regard to speculation but in regard to the permanent disposition of funds, considering probable safety of capital as well as probable income.<sup>15</sup>

Most state treasurers and investment boards are risk averse, and rightly so. They are bound by trust law to protect the corpus of the trusts. In an attempt to protect the corpus of the trust, some state statutes restrict the investment of the school funds to fixed income. Unlike a well managed endowment or foundation, California<sup>16</sup>, Mississippi, Montana, Nevada, and Wisconsin are statutorily restricted to fixed income investments. Not even all the fixed income investments are open to these states, as most of them have a statutory listing of acceptable investments. The problem with bonds and other fixed income investments is inflation. For example, \$50 million invested in a bond is still only \$50 million 30 years later at maturity. Thus, though school expenses have increased significantly over the 30 year period, the purchasing power of the invested funds has dropped. Yes, on paper the state can show that the \$50 million is still there; however, in purchasing power, schools have suffered a significant loss.

There are four states that do not use the prudent investor or prudent person rule but provide a list of acceptable investments; they are Colorado, Nebraska, Minnesota, and Wyoming. The

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<sup>15</sup> North Dakota Statute 15-03-04.

<sup>16</sup> California's statute is complex and the researcher believes that CRS 16470 restricts all investments to the Pooled Money Investment Fund that is invested in bonds. If this is incorrect, the researcher begs California's forgiveness.

Colorado statute lists acceptable investments then impose restrictions that make those investments impossible. Colorado is permitted to invest in equities but then the statute provides that there will be no sales at a loss unless the general assembly “has previously appropriated a sum to the public school fund equivalent to the anticipated loss of principal. . . .”<sup>17</sup> Wyoming is invested half in fixed income and half in domestic equity.

### Model Legislation

Highly restrictive statutes and specific lists of acceptable investments are time specific. What may seem appropriate during one economic time may not be prudent, appropriate, or profitable a decade or more later. Given the heightened awareness of school trust lands by education leaders and legislators alike, current statutes regulating the investment of \$45 billion in permanent school funds should be carefully scrutinized. Many states could substantially increase returns from permanent funds without increasing their risk by adopting the prudent investor rule. Since economic times change, it is important for a state to adopt statutory language that can adjust with changing economic opportunities. The prudent investor/person rule has such flexibility built in.

The prudent investor rule holds investments to a higher standard than does the “prudent person” rule because it requires the investor to use investment skills that an ordinary person would not be expected to have. Of the eleven states with “prudent investor” or “prudent person” rules governing the investment of their permanent funds, only Oklahoma, South Dakota, Texas and Washington have the “prudent person” rule. The states currently governed by the Prudent Investor Rule are Arizona, Idaho, North Dakota, New Mexico, Oregon, and Utah.

The “prudent investor” rule may vary slightly in the wording, but rules often require some combination of the following:

- Judgment and care similar to institutional investors
- Reference to circumstances prevailing at the time
- Use of “prudence, discretion, and intelligence”
- Reference to not being speculative in investments
- Safety of capital or preservation of purchasing power
- Probable income consideration
- Maximizing appreciation of capital
- If the investor has special skills, the duty to use those special skills
- Investment not evaluated in isolation but in the context of the whole portfolio
- Risk and return reasonably suited to the purpose of the trust
- Duty of loyalty and impartiality.

The following examples taken from the states in this study illustrate why specific lists of acceptable investments may not be prudent, profitable, or consistent with a state’s fiduciary duty to act with undivided loyalty to the beneficiaries and to protect the principal of the permanent school fund:

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<sup>17</sup> Colorado Revised Statute 22-41-104(2).

- 1) Investments solely in bonds means the principal fails to keep pace with inflation, losing value each year in purchasing power. California, Mississippi, Montana, and Wisconsin all require only investments in fixed income. It must be remembered that many types of bonds also include risk to principal. A quick perusal of returns on page 13 explains the financial impact of an all-bond policy.
- 2) Sometimes statutory lists of acceptable bond investments may be furthering other state objectives and may not be consistent with the high fiduciary duty of undivided loyalty to the beneficiary as a few selections from those state investment lists indicates:
  - Mississippi's Veterans' Home purchase Bonds, highway bonds, and city bonds for cities with a population over 25, 000.
  - Montana's public securities or those of its subdivisions or local government.
  - Wisconsin's state bonds, bonds of towns, villages and cities, bonds of local exposition districts, University of Wisconsin hospital and clinic bonds, bonds of local professional baseball park district, bonds by a local professional football stadium district, Wisconsin Aerospace Authority bonds, public inland lake protection loans, joint sewer system loans, etc.
  - Nevada's state and county bonds.
  - Colorado's statute allowing investment in World Bank securities.
  - North Dakota's requirement that at least one-half of the permanent funds must be invested in first mortgages in North Dakota if the demand for loans exists, if the borrower is a resident of North Dakota and if the borrower is actively engaged in farming or ranching.
  - Washington's State Investment Board must have funds in the Emergency Reserve Fund, but it is unclear if trust funds must also be invested in this emergency fund.
- 3) Though Colorado Statute allows investments "through an investment firm offering for sale corporate stocks, bonds, notes, debentures, or a mutual fund,"<sup>18</sup> it also requires that no sale of securities at a loss may occur unless the general assembly "has previously appropriated a sum to the public school fund equivalent to the anticipated net loss of principal from such exchange or sale."<sup>19</sup> This being the case, a Colorado State Treasurer needing to sell a security that was losing value would have to wait for the legislature to meet, get a bill passed to appropriate the loss, then after passage, manage to sell at exactly the appropriated loss. Needless to say, the smart Colorado State Treasurer does not invest in equities.

#### Other Statutory Components Included in Some State Statutes

Besides the Prudent Investor rule or statutory lists of acceptable investment instruments, several states included other provisions that may be of interest to a state considering making changes to its statutes controlling the investment of the permanent school fund.

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<sup>18</sup> Colorado Revised Statutes 24-36-113.

<sup>19</sup> Colorado Revised Statutes 22-41-104 (E).

Using the Permanent Fund to Guarantee School Bonds at Lower Interest Rates. Several states are able to guarantee school bond payments using their permanent school fund. Thus, school districts are able to secure bonds at a lower rate, and the permanent fund is not affected unless a district is in danger of defaulting. Draconian consequences befall the district that then so defaults. States using this guaranty power include Texas, Utah, Idaho, and Oklahoma. Oklahoma will only guarantee school bonds that the people of that school district voted to approve.

Audits. Alaska, Idaho, Montana, Oklahoma, and Texas all require outside audits of their permanent funds. States not requiring this may wish to consider such annual audits, as most of the states have constitutional and/or statutory guarantees of the funds and would be responsible for losses to the funds.

Reports to the Legislature and Governor. Only Alaska and Texas require annual reports on their permanent funds to be made to the Legislature and the Governor. Such annual reports would keep legislators informed, as they are ultimately responsible to make up any losses. Such annual reports also provide a forum to educate the media, policy makers, and the public at large.

Risk Return Objectives Suited to Trust. Numerous states include statutory language concerning the balancing of risk and returns such as the following:

- "... with risk and return objectives reasonably suited to the trust." Idaho 68-502
- Oregon requires an overall strategy to incorporate risk and return objectives reasonably suited to a particular fund. (Oregon Revised Statutes 293.726)

Safety of Capital. Some states have language to insure that the investor is making investments that protect the corpus, such as:

- "... considering probable safety of capital as well as probable income ..." North Dakota 15-03-04
- "... not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital." New Mexico Constitution, Article XII, Section 7c, and Texas Statutes 43.003(7)(A)

Individual Securities Evaluated as Part of the Whole. In order to allow a small portion of investments to be invested at a higher risk but also a higher expected return, and in order to carry out an investment strategy that may have private equity, hedge funds, or international investments as a part of the overall strategy, Idaho, Oregon, and Utah include language to ensure that individual securities are evaluated in the context of the whole portfolio and not in isolation.

Duties of Trustees. Idaho lists specific financial and economic conditions that must be considered when making investments including general economic conditions, the effect of inflation and deflation or the value of the fund, the role of an individual investment within the portfolio as a whole, the expected total return and appreciation of capital, and the need for

liquidity. The Idaho statute specifically requires that trustees with special skills and expertise are expected to use that skill, though this is inherent within the Prudent Investor rule.

Diversity of Investments. Oklahoma, in their Prudent Person rule, requires the person investing their fund to diversify “the investments of the trust funds so as to minimize the risk on large losses.”<sup>20</sup> Diversification is, of course, inherent in the Prudent Person or Investor rule; to be invested solely in a few assets or categories would not be prudent.

Custodial Bank. Both Oklahoma and Texas have statutory language governing the custody of their investments.

Ethics. Texas alone has very specific language requiring their State Board of Education to develop an ethics policy with standards of conduct relating to the management and investment of their permanent school fund. This may seem unnecessary to states with a prudent person or prudent investor rule; nothing could be further from the truth. It is important to remember that every state once had a permanent school fund and now 54% of the states no longer have funds. As Dr. Swift of Columbia University a century ago so eloquently stated:

In many states the permanent funds and the proceeds which should have been added to them have been cared for so carelessly diverted, squandered, wasted, and embezzled so shamefully, that what ought to be a magnificent endowment, whose income would to-day [1905] be yielding an appreciable relief from taxation, has dwindled to an almost negligible sum, or exists as a permanent state debt on which interest is paid out of the taxes levied upon the present generation.<sup>21</sup>

The Texas statute is worth quoting in full as every other state needs one as stringent and would wisely incorporate it into their statutes.

PERMANENT SCHOOL FUND ETHICS POLICY<sup>22</sup>.

(a) In addition to any other requirements provided by law, the State Board of Education shall adopt and enforce an ethics policy that provides standards of conduct relating to the management and investment of the permanent school fund. The ethics policy must include provisions that address the following issues as they apply to the management and investment of the permanent school fund and to persons responsible for managing and investing the fund:

- (1) general ethical standards;
- (2) conflicts of interest;
- (3) prohibited transactions and interests;
- (4) the acceptance of gifts and entertainment;
- (5) compliance with applicable professional standards;
- (6) ethics training; and
- (7) compliance with and enforcement of the ethics policy.

(b) The ethics policy must include provisions applicable to:

- (1) members of the State Board of Education;
- (2) the commissioner;

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<sup>20</sup> Oklahoma Constitution, Section XI – 6 and Oklahoma statutes 64-1-51 & 1(b and c).

<sup>21</sup> A History of Public Permanent Common School Funds in the United States, 1795-1905, by Dr. Fletcher Harper Swift of Columbia University, ©1911.

<sup>22</sup> Texas Statutes 43.0031 and 43.0032.

- (3) employees of the agency; and
- (4) any person who provides services to the board relating to the management or investment of the permanent school fund.

(c) Not later than the 45th day before the date on which the board intends to adopt a proposed ethics policy or an amendment to or revision of an adopted ethics policy, the board shall submit a copy of the proposed policy, amendment, or revision to the Texas Ethics Commission and the state auditor for review and comments. The board shall consider any comments from the commission or state auditor before adopting the proposed policy.

(d) The provisions of the ethics policy that apply to a person who provides services to the board relating to the management or investment of the permanent school fund must be based on the Code of Ethics and the Standards of Professional Conduct prescribed by the Association for Investment Management and Research or other ethics standards adopted by another appropriate professionally recognized entity.

(e) The board shall ensure that applicable provisions of the ethics policy are included in any contract under which a person provides services to the board relating to the management and investment of the permanent school fund.

CONFLICTS OF INTEREST. (a) A member of the State Board of Education, the commissioner, an employee of the agency, or a person who provides services to the board that relate to the management or investment of the permanent school fund who has a business, commercial, or other relationship that could reasonably be expected to diminish the person's independence of judgment in the performance of the person's responsibilities relating to the management or investment of the fund shall disclose the relationship in writing to the board.

(b) The board or the board's designee shall, in the ethics policy adopted under Section 43.0031[0], define the kinds of relationships that may create a possible conflict of interest.

(c) A person who files a statement under Subsection (a) disclosing a possible conflict of interest may not give advice or make decisions about a matter affected by the possible conflict of interest unless the board, after consultation with the general counsel of the agency, expressly waives this prohibition. The board may delegate the authority to waive the prohibition established by this subsection.

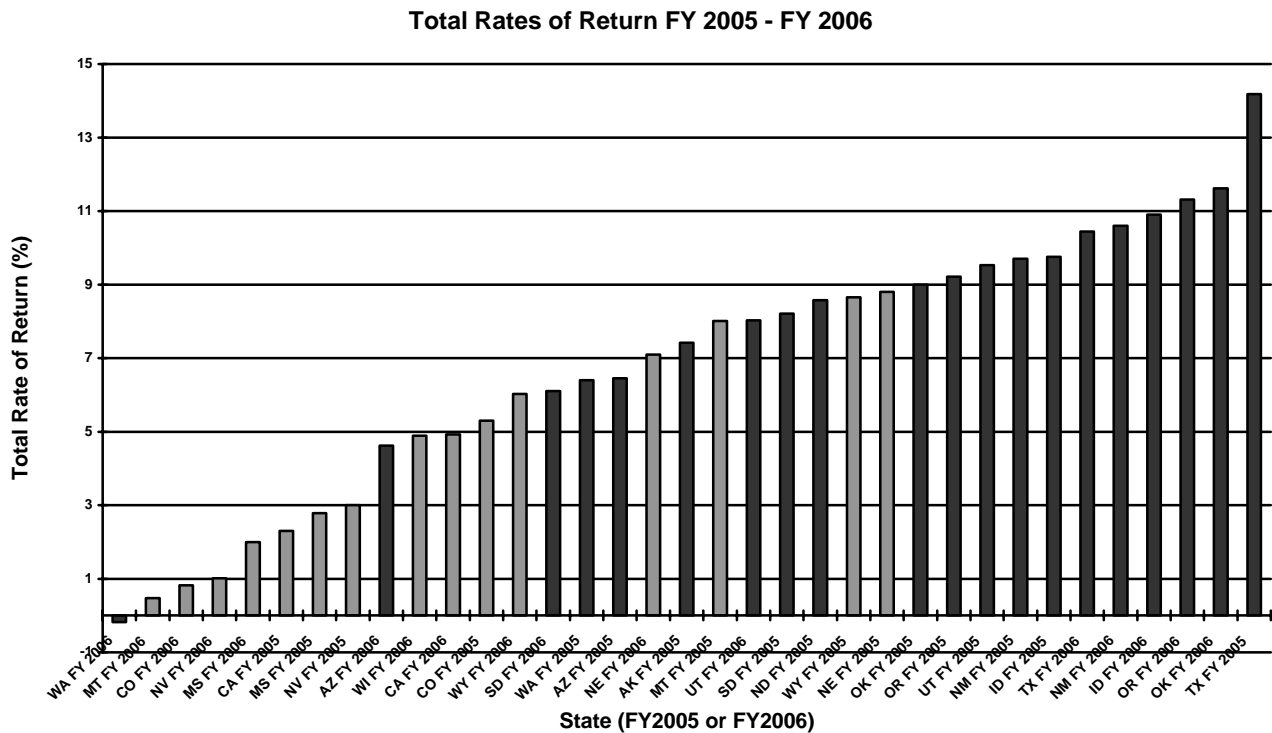
### Total Rate of Return

A professional analysis of where a state's permanent school fund falls as far as the return the fund is receiving for the risk they are exposed to can be telling. Most people know that the greater the risk an investor takes, the greater the return should be. If an investor is getting the maximum return for the risk they are incurring, the investments are considered to be on the "efficient frontier"—in other words, the investment of the fund is generating as much as could be expected for that level of risk. For example, assume both Investment A and Investment B have the same risk. But, Investment B receives twice as much return as Investment A. If statutes only allow investments represented by Investment A, statutory changes allowing prudent investments, like B, can increase the return to schools and/or to the market value of the permanent school fund without increasing the risk. Perusal of the rates of return below, will indicate that many permanent funds are not at the efficient frontier—some abysmally below it.

The returns received on the investment of the \$45 billion of permanent school funds are a telling example of the impact of the investment statutes on the funds.

STATE	FY 2005	FY 2006	STATE	FY 2005	FY 2006
AK	7.42	unknown	NM	9.70	10.6
AZ	6.45	4.62	NV	3.00	1.01 <sup>23</sup>
CA	2.30	4.926	OK	9.00	11.62
CO	5.30	0.821	OR	9.21	11.31
ID	9.75	10.9	SD	8.21	6.1
MN	unknown	unknown	TX	14.18	10.44
MS	2.78	2.00	UT	9.53	8.03
MT	8.01	0.47	WA	6.40	-0.18
ND	8.58	7.51	WI	unknown	4.89
NE	8.80	7.1	WY	8.66	6.02

To find what the students in your state could have had, the reader should subtract their total rate of return from one of the states with a higher return, then multiply the difference times the market value of their permanent fund on page 6 – a humbling exercise. No one can change the past, but anyone may change the future.



<sup>23</sup> This is based on data indicating \$2,745,729 in interest on a fund of \$273,011,485 as of March 31, 2007.

The graph above tells a very compelling story. All of the high performing permanent funds are managed under the prudent person or prudent investor rule. The lowest performance in the twenty states in the two year period of this study was by Washington. Washington does have the prudent person rule, but their investment decisions are made by a non-professional investment board.<sup>24</sup> With the exception of Washington's FY 2006 performance, all of the lowest performing states have no prudent investor rule and are generally forced to select fixed income investments from a shopping list in the statute.

### Strategic Design for Change

Education leaders in each state would be wise to give careful consideration to how they intend to make changes to the statutes governing the investment of the permanent school fund. Some general guidelines to consider incorporating into your strategy may include:

- Carefully compile the Constitutional articles and state statutes that govern the investment of your school fund.
- Identify specific aspects of your code that should be updated.
- Meet with the investing authority to discuss changes that would allow them to generate the greatest return at an acceptable level of risk. Their support is crucial. They may also be willing to share with you the names of leaders in the investment community who could be influential with the legislature.
- Google the largest foundations in your state and call to see who does their investments. Call and ask for an appointment to discuss your issues with their Chief Financial Officer (CFO). Elicit their help. They will also know who the most respected financial, investment, or banking people in your state are.
- Develop a small, effective team of financial people and education community leaders.
- Determine who the successful financial leaders in both houses of your legislature are.
- Carefully approach with your financial education team a few legislators individually and discuss needed changes.
- Select a bill sponsor. Work with them to develop bill language, a strategy of which legislators to contact, when in the session to introduce the bill, whether it will be necessary to run a task force first and who should sit on the task force, how to involve senate and house leadership, etc.
- Identify key legislators and ask them to be co-sponsors on the legislation, if the legislature allows co-sponsors.
- Develop handouts with needed factual information

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<sup>24</sup> Washington has an investment board comprised of 10 voting members representing active public employees, law enforcement and fire fighters, retired teachers, a state representative, a state senator, a retired member of state retirement, the Director of the Department of Labor, the Director of the Department of Retirement Systems, an active member of the school employees retirement system, and the State Treasurer. There are also 5 non-voting members appointed by the Retirement Board who are experienced and qualified in the field of investments.

- Determine a timetable for legislative and gubernatorial contacts. Stick to it, but be willing to amend as new information, concerns, etc. arise.
- Follow-up with policy makers when the bill is in its final form, and explain how the bill language has changed since the original meeting. Shore up their support.

#### Checklist of Investment Issues to Consider Addressing

The following list, though imperfect, may act as a starting point for a state to make their own list of the topics they may want to address in legislation:

- Prudent Investor Rule
- Statutory restrictions to investment
- Ethics rules
- Use of Permanent Fund to guarantee school district bonds
- Annual audit
- Reporting to Legislature, Governor, or State School Board
- Custodial banks or institutions
- Professionals rather than citizen boards investing your fund. Look at your constitution and statutes here, as you may have constitutional provisions that are much harder to change