TEXAS GENERAL LAND OFFICE
GEORGE P. BUSH, COMMISSIONER

REPORT ON THE AUDIT OF THE PERMANENT SCHOOL FUND EXTERNAL PORTFOLIO

JULY 2018

OVERALL CONCLUSION

The externally-managed Texas General Land Office ("TXGLO") Permanent School Fund ("PSF") Real Assets Investment Portfolio ("Portfolio") has experienced good, solid performance results in the last five years. The Portfolio's strategic allocation has focused primarily on new investments in the energy and infrastructure spaces, with a secondary focus on the commercial real estate sector. While the Investment Management Division handles the investment process extremely well on a day-to-day basis, there is a need for additional independence in the management of the Portfolio. In the last year, progress has been made in moving certain middle- and back-office responsibilities to the Financial Management Division, such as establishing new external investment manager accounts and wiring instructions with the Portfolio's external investment custodian. In addition, reconciliations of critical financial information are progressively getting stronger as an independent control.

However, there are still areas that should be addressed by TXGLO to ensure that the Portfolio adheres to policy, legal and contractual requirements and that processes and controls are enhanced to achieve the objectives of the Portfolio for the Permanent School Fund:

1. The Investment Advisory Committee ("IAC") should be formalized as an advisory committee of the SLB for the PSF investments. A formal charter outlining the responsibilities of the IAC should be established.

2. Investment Management should determine the scope of services required by the Portfolio's external Investment Advisors. This should be a collaborative effort with involvement from Investment Management, the IAC, the SLB and other key members of GLO management. In addition, the fiduciary role, reporting structure and key responsibilities of the Advisor should be clearly defined to maximize the benefit of engaging an Advisor and to verify the scope of services required by the PSF Advisor's contract are satisfied and utilized by management.

3. The Agency should develop a program to independently monitor investment compliance for both the internal and external PSF investments. This compliance program should complete "at random" validations of critical key controls within the investment processes to validate compliance with internal policies, mandated regulations, and contractual requirements. In

addition, to validate key accounting and reporting information, Financial Management should establish a process to perform “flux” analysis[1] in the areas of management or partnership fees and expenses, reconciliations, and performance to identify any significant deviations that may need further analysis or explanation from Investment Management.

4. The TXGLO PSF Real Assets Investment Policy Statement (“Policy”) should more clearly define the basis for calculating Policy allocation targets and limits, including the Real Estate, Infrastructure, and Energy asset allocation targets, the single manager limit, geographic diversification targets, the single metropolitan statistical area limit, and the debt to equity ratio limit. Specifically, the policy should address whether Net Asset Value (“NAV”), NAV plus Unfunded Capital Commitments, or another methodology should be used as the basis for the calculation of the allocation targets and other Portfolio-related limits.

5. Capital concentration with individual investment managers should be clearly and consistently reported to the IAC, School Land Board (“SLB”) and management. This information should be presented at the time new investment opportunities are presented for approval, as well as on an ongoing basis for management and oversight committees to monitor investment manager concentration risk.

6. A policy should be established to define the expected due diligence for re-ups and co-investments. The policy should define what due diligence procedures should be performed for each type of investment and procedures should also define if, and when due diligence performed from a previous fund may be relied upon.

7. Procedures should be enhanced to include documented analytical reviews and reasonableness checks around NAV fluctuations, quarterly capital statements and financial statement disclosures[2]. A reasonably expected range for periodic fluctuations, for swings in NAV, should be established and explanations should be documented for variances exceeding the established threshold.

MANAGEMENT’S SUMMARY RESPONSE

Management ***generally concurs*** with the recommendations. The “Detailed Results” section of this report contains management’s response to each observation.

[1] Flux, or fluctuation analysis is the analysis of the change to investment valuation, management fees and expenses, and performance from period to period.

[2] A government is permitted in certain circumstances to establish the fair value of an investment that does not have readily determinable fair value by using the net asset value per share (“NAV”) (or its equivalent) of the investment (GASB 72). For the Portfolio, the investment managers report the NAV of each capital account to the investment custodian.

ACKNOWLEDGEMENTS

We appreciate the assistance and cooperation provided to us by the Commissioner, Chief Clerk, General Counsel, management and staff of Investment Management led by Rusty Martin, Chief Investment Officer (CIO), and Financial Management led by David Repp Chief Financial Officer (CFO). For questions about this report, please contact Sharon Matthews at 512-463-5346 or Tracey Hall at 512-463-6078.

Tracey Hall

__________________________ July 16, 2018

Tracey Hall, CPA, CISA Date
Chief Auditor
Office of Internal Audit

AUDIT OBJECTIVE

The objective of the audit was based on the results of a risk assessment performed during the planning phase of the audit. The overall objective of the audit was to provide assurance that the Agency has established and effective internal controls to meet the objectives of the PSF real assets investment portfolio and to reduce financial, credit, operational, regulatory, compliance, accounting, and reporting risks associated with the portfolio. The audit objectives also included ensuring the Agency performed proper due diligence in the selection and management of the specific investments maintained in the PSF real assets external portfolio and has complied with established policies, guidelines, and regulatory requirements.

The audit was completed under a co-source arrangement with the Investment Training and Consulting Institute, Inc. (ITCI, Inc.) of Topeka, Kansas.

SCOPE & METHODOLOGY

The audit covered policies and procedures in place during the period from December 15, 2015 through August 31, 2017. This audit specifically focused on the investment assets that are externally managed by Investment Managers for the agency. These assets are comprised of real assets investments in private-equity type commingled funds (closed end and open end), separate accounts, and co-investments in real estate, infrastructure and energy.

The scope of this review included the "life of a trade/transaction" methodology thereby reviewing such areas as:

- Investment Governance and Oversight
- Investment Management Initial Due Diligence
- Investment Ongoing Due Diligence
- Independent Review of Performance, Valuation, Management Fees
- Investment Accounting
- Independent Risk Management, Compliance and Reporting
- Limited Information Systems Review (i.e., Data Access)
- Conflicts of Interest Attestations

The scope did not include an evaluation of the investment strategy decisions made by the SLB or an onsite review of the external investment managers. The scope also did not include the validation of any key modeling systems that may be used by TXGLO or the external investment managers. The audit methodology included observing processes, interviewing and surveying employees, reviewing information, and performing substantive procedures and analyses.

This audit was conducted in accordance with the *Generally Accepted Government Auditing Standards* and in conformance with the *International Standards for the Professional Practice of Internal Auditing*. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.