Texas Permanent School Fund Primer

Ilya Perlovsky, CFA, FCM Market Strategist
Thomas DeMarco, CFA, FCM Market Strategist

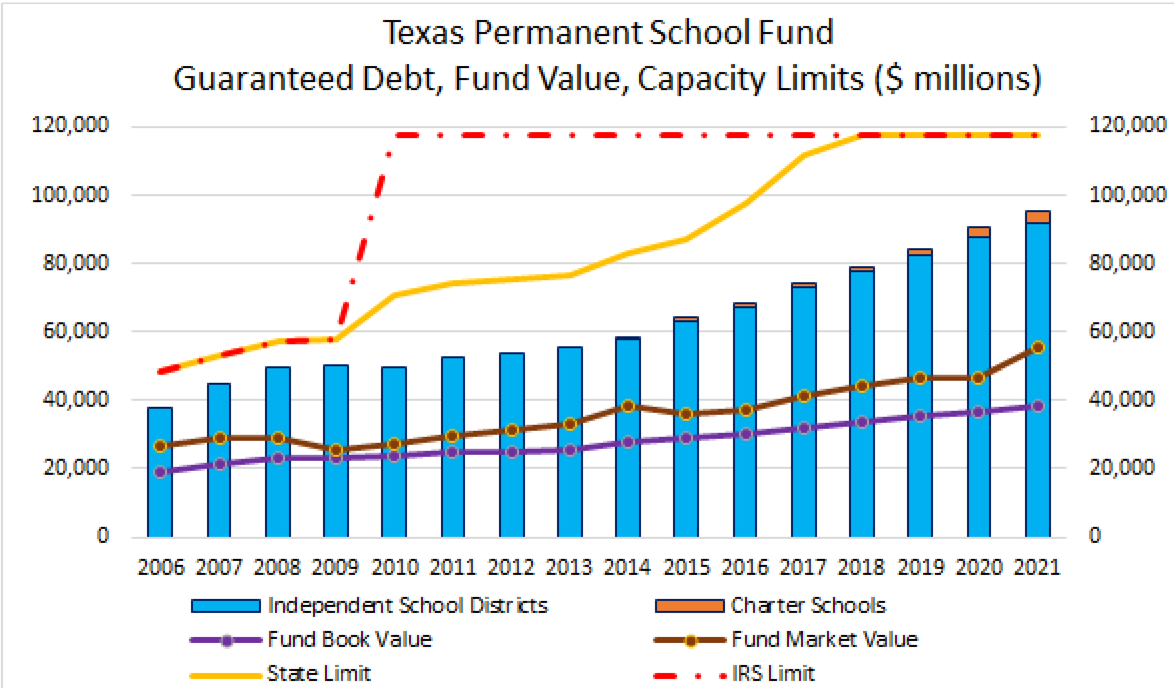
June 16, 2022

The Texas Permanent School Fund (PSF) was created with a $2,000,000 appropriation by the Texas Legislature in 1854 expressly for the benefit of the public schools of Texas. The Constitution of 1876 stipulated that certain lands and all proceeds from the sale of these lands should also constitute the PSF. Additional acts later gave more public domain land and rights to the PSF. Since its initial capitalization, the PSF has grown to $58.5 billion as of fiscal year-end 2021 (August 31). As of June 13, 2022, approximately 28% of the amount of outstanding debt with a CUSIP issued in the State of Texas was PSF-guaranteed. The following points may be of interest to investors in evaluating the credit support provided by the PSF.

- The PSF serves Texas school districts by providing funding for education and guaranteeing debt issued by independent school districts (ISDs) and charter schools that meet program standards.
- The guaranteed bonds of ISDs are unlimited general obligation securities that are secured in the first instance by an annual property tax levied without legal limit against all taxable property within a district.
- The amount of charter school capacity is limited to the percentage of charter enrollment as a percent of statewide enrollment, which was 7.0% at FYE 2021. As of FYE 2021, the program guaranteed charter school debt totaling $3.3 billion, or 3.5% of total PSF-guaranteed debt.
- The fund was created with a $2 million appropriation by the Texas Legislature in 1854 and had grown to $58.5 billion in total assets at FYE 2021. Since the approval of a state constitutional amendment in 1983, which allowed the PSF to guarantee debt, there has never been any call on the guarantee because of the high credit quality of Texas school districts, the fund's credit quality parameters, and the state's strong oversight policies.
- PSF is made up of a diverse mix of assets, and as of FYE 2021 included a largely liquid $47.6 billion portion managed by the State Board of Education (SBOE) and a largely illiquid $8.0 billion portion managed by the School Land Board (SLB).
- The largely liquid portion of the fund provided significant resources relative to guaranteed debt, but did include potentially volatile equities, which represented 32.5% of total fund value, and alternative investments, which accounted for 30.0% of the fund.
- The largely illiquid assets consist of real estate investments, sovereign and other lands, and mineral interests. While largely illiquid, these assets have been considerably more stable and generate income primarily through mineral leases and royalties.
- In addition to providing a guarantee on debt issued by local school districts, the PSF disperses funds from the SBOE portion of the fund to support school district operations. The amount of disbursements is limited by two tests: 1) distributions may not exceed 6% of the average market value of the fund, excluding real property, on the last day of each of the sixteen state fiscal quarters ending in the November before the regular legislative session begins, and 2) on a 10 year rolling average basis, 10 year distributions may not exceed 10 year total return (excluding

income from the SLB portion of the fund); the SBOE portion of the fund disbursed $1.1 billion in fiscal 2021.

- Historically, the SLB has contributed at least $100 million annually to the SBOE for disbursements, although following a constitutional amendment approved by voters in 2019 that permits the SLB to disburse up to $600 million directly, the SLB's direct contribution was $600 million in fiscal 2021.
- The PSF is limited by an IRS ruling that requires the amount of guaranteed debt to not exceed 5 times the book value of PSF assets as of December 16, 2009. The state also imposes a cap that the legislature has changed from time to time, and which stood at 3.5 times at FYE 2021. Due to growth of the fund since 2009, the guarantee capacity is currently capped by the IRS limit unless the IRS revisits the ruling, a change that would require a multi-year process. At FYE 2021, guaranteed debt exhausted only 81.2% of the IRS-imposed cap. The state may increase the capacity of the program up to the IRS limit if it does not prevent the guarantee from maintaining the highest available credit ratings, according to PSF policy.
- To obtain a PSF guarantee, school districts must apply and meet certain criteria, as described in the Texas Education Code. The code requires that school districts notify the PSF five days before a debt service payment if the district expects to be unable to satisfy the payment, and PSF is required to advance funds "immediately upon notice" directly to the paying agent. Once the PSF advances funds on behalf of a district, the code requires the first state monies payable to the district be intercepted to reimburse the PSF.
- The Commissioner of Education can order a school district to set a tax rate capable of reimbursing the PSF and pay future debt service, appoint a new board of managers, or merge a distressed district into another district. If repeated defaults occur, the Commissioner may request the Attorney General to institute appropriate legal action to ensure reimbursement.
- The PSF guarantee has never been tapped as the state has strong oversight of school districts and the PSF program reviews individual audits to ensure districts are financially sound. The PSF guarantee remains in place for the life of the bonds independent of whether the ISD remains in existence. Equally, the guarantee for charter school debt remains in place for the life of the bonds independent of whether the school's charter remains in force.
- The size, diversity and credit quality of the underlying school districts' general obligation debt are important credit considerations for the PSF's Aaa/AAA/AAA credit ratings.
- As of FYE 2021, the PSF guaranteed $95.2 billion in outstanding debt on 855 Texas school districts and 25 charter schools. The weighted average credit quality of guaranteed districts was Aa3/AA-, and the top 10 participants, representing 20.6% of outstanding par, had a median rating of Aa1/AA+.
- State aid as a share of general fund revenue was 30.7% for the ten largest districts, providing access to substantial divertible resources to reimburse the PSF in case of a default.



Source: Texas Education Agency, FCM; as of FYE 8/31

10 Largest Total Debt Outstanding Guaranteed Under the Program at August 31, 2021

District Name	Moody's/S&P Rating	Moody's/S&P Outlooks	Balance	% total PSF Guarantee
Cypress-Fairbanks ISD	Aa1/AA	stable/Stable	$3,104,330,000	3.26%
Dallas ISD	Aa1/AA+	stable/Stable	$2,985,880,000	3.13%
Northside ISD (Bexar)	Aa1/NR	stable/Stable	$2,237,280,000	2.35%
Frisco ISD	Aa1/AA+	stable/Stable	$2,135,120,696	2.24%
Houston ISD	Aaa/AA+	stable/Stable	$2,045,435,000	2.15%
Katy ISD	Aa1/AA	stable/Stable	$1,774,185,230	1.86%
Fort Bend ISD	NR/AA+	Stable	$1,402,803,767	1.47%
Lamar CISD	Aa2/AA	stable/Stable	$1,337,905,000	1.40%
Conroe ISD	Aa1/AA+	stable/Stable	$1,334,295,000	1.40%
North East ISD	Aa1/NR	stable/Stable	$1,290,875,000	1.36%

Source: Texas Education Agency, Bloomberg, FCM; as of August 31, 2021

Fidelity Investments
Fidelity Capital Markets

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation risk, liquidity risk, call risk, and credit and default risks for both issuers and counterparties. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Interest income generated by municipal bonds is generally expected to be exempt from federal income taxes and, if the bonds are held by an investor resident in the state of issuance, from state and local income taxes. Such interest income may be subject to federal and/or state alternative minimum taxes. Investing in municipal bonds for the purpose of generating tax-exempt income may not be appropriate for investors in all tax brackets. Generally, tax-exempt municipal securities are not appropriate holdings for tax-advantaged accounts such as IRAs and 401(k)s.

The content in this piece is provided for informational purposes only, and any references to securities listed herein do not constitute recommendations to buy or sell. The content herein is valid only as of the date published and is subject to change because of market conditions or for other reasons. Fidelity disclaims any responsibility to update such views. The information presented herein was prepared by Fidelity Capital Markets based on information obtained from sources believed to be reliable but not guaranteed. This white paper is for informational purposes only and is not intended to constitute a current or past recommendation, investment advice of any kind, or a solicitation of an offer to buy or sell securities or investment services.

Fidelity does not provide legal or tax advice. The information herein is general in nature and should not be considered legal or tax advice. Consult an attorney or tax professional regarding your specific situation.

The Chartered Financial Analyst (CFA) designation is offered by the CFA Institute. To obtain the CFA charter, candidates must pass three exams demonstrating their competence, integrity, and extensive knowledge in accounting, ethical and professional standards, economics, portfolio management, and security analysis, and must also have at least four years of qualifying work experience, among other requirements. CFA® and Chartered Financial Analyst® are registered trademarks owned by CFA Institute.

Fidelity Capital Markets is a division of National Financial Services LLC, a Fidelity Investments company and a member of NYSE and SIPC.
Fidelity Brokerage Services LLC, Member NYSE, SIPC, 900 Salem Street, Smithfield, RI 02917

935002.2.0