SUBJECT: Investing a portion of the Rainy Day Fund under prudent investor standard

COMMITTEE: Appropriations — committee substitute recommended

VOTE: 23 ayes — Pitts, Sylvester Turner, Ashby, G. Bonnen, Carter, Darby, S. Davis, Dukes, Giddings, Howard, Hughes, S. King, Longoria, Márquez, McClendon, Muñoz, Orr, Patrick, Perry, Price, Raney, Ratliff, Zerwas

0 nays

4 absent — Bell, Crownover, Gonzales, Otto

WITNESSES: For — (*Registered, but did not testify:* Dale Craymer, Texas Taxpayers and Research Association)

Against — (*Registered, but did not testify:* Chris Cornell, Reece Albert Inc.; Jarrod Atkinson)

On — Paul Ballard, Texas Treasury Safekeeping Trust Co; Bruce Zimmerman, The University of Texas Investment Management Co.

BACKGROUND: Art. 3, sec. 49-g of the Texas Constitution establishes the Economic Stabilization Fund, which was ratified by voters in 1988. The fund, also known as the Rainy Day Fund, receives 75 percent of any oil or natural gas production tax revenue that exceeds the amount collected in fiscal 1987. Additionally, the comptroller must transfer one-half of any unencumbered balance remaining in the General Revenue Fund at the end of a biennium to the Rainy Day Fund.

The amount in the Rainy Day Fund cannot exceed 10 percent of the total amount of general revenue deposited during the preceding biennium.

DIGEST: CSHB 2770 would require the comptroller to change the way it invests the state's Economic Stabilization Fund, better known as the Rainy Day Fund.

The comptroller would invest the balance of the Rainy Day Fund that was higher than 20 percent of the fund's maximum authorized balance, as defined in the Constitution, using the strategy specified in Government Code, 404.24(j). This means the comptroller would invest the funds under the restrictions and procedures for making the investments that people of "ordinary prudence, discretion, and intelligence, exercising judgment and care under the prevailing circumstances would follow in the management of their own affairs." The investments would be made "not in regard to speculation but in regard to the permanent disposition of funds, considering the probable income as well as the probable safety of the capital."

The comptroller would adjust the investment portfolio periodically to ensure that the portion of the fund that was invested did not exceed the level specified in the bill.

This bill would take immediate effect if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2013.

SUPPORTERS SAY:

HB 2770 would implement changes to Rainy Day Fund investment strategies that would ensure the state was a responsible and prudent steward of taxpayer funds. Under current practices, the balance in the fund is generating such a poor return that it is not keeping up with inflation and is therefore losing purchasing power each year.

Currently, the balance of the Rainy Day Fund is in highly liquid, low-yield assets — financial terms to describe what is essentially cash. The Treasury Pool, which is managed by the Texas SafeKeeping Trust Co., yielded an annual return of 0.5 percent last year, and 1.5 percent cumulatively over the preceding five years. While it is prudent to maintain a certain amount of liquidity so that Rainy Day funds may be readily accessed in the event of an emergency, it is unnecessary to subject the entire fund to this standard. With the estimated fund balance approaching $12 billion in the next biennium, there is more than enough to maintain a minimum threshold of liquidity while investing the rest in stable, medium-return securities.

HB 2770 would require the comptroller to use the "prudent reserve standard" as its investment strategy for the majority of the money in the Rainy Day Fund. This strategy is designed to yield a higher rate than the state's current cash-reliant approach. Specifically, this would mean that — with the current maximum authorized balance of the Rainy Day Fund calculated at $14.4 billion in fiscal 2014-15 — 20 percent (at present about $2.9 billion) would not be subject to any change in investment strategy and the remaining balance, currently $8.9 billion, would be invested under the "prudent investor standard."

This prudent investor standard would be similar to the investment strategy used by Intermediate Term Fund of the University of Texas Investment Management Co. This fund yielded close to 6 percent last year, and it has a five-year return of 3.5 percent. The stability of the UT fund is illustrated by the fact that it returned a positive five-year return even factoring in the national economic recession of 2008.

The investments envisioned under the bill would be designed to target a 5 percent annual return, which would result in about $900 million over the next biennium. This would keep the fund from losing purchasing power and make these additional funds available for pressing needs. The medium-term investments could be liquefied relatively quickly if the state needed more than the $2.9 billion that would still be available as cash and cash equivalents.

Few individuals would bury their savings in the backyard just to ensure liquidity and avoid risk. Skilled investors already employed by the state should have the ability to use their judgment and invest according to the needs and potential needs of the state.

OPPONENTS SAY:

HB 2770 would subject the state's emergency cash reserves to unnecessary risk. The Economic Stabilization Fund was set up for the purpose its name suggests — to stabilize state finances in a time of need caused by a recession, depression, or other economic calamity. The trouble of investing the majority of the fund in a more aggressive investment portfolio is that it would expose the state to the risk of losing the very funds on which it would rely in the event of an emergency. The times when the state is in greatest need for an emergency cash reserve are the very times when the market is likely to be shedding value.

While securities markets have performed very well in recent years — the Dow Jones Industrial Average recently surpassed an all-time high — there is no telling when the next crash will occur. Many pension funds took a major hit when the market crashed in 2008. There is no reason to believe this can't and won't happen again. Long-term investments have the opportunity to recover lost value. The same luxury would not apply to the Economic Stabilization Fund if the state were in dire financial straits and needed a large appropriation.

NOTES: The Legislative Budget Board estimates the bill would have an indeterminate revenue gain or loss to the Economic Stabilization Fund.