


Commonwealth of Pennsylvania Public School Employees' Retirement System

DATE: June 21, 2007

SUBJECT: Brigade Capital Management, LLC

TO: Members of the Board

FROM: Alan H. Van Noord, CFA
Chief Investment Officer 

Staff and Wilshire are seeing a high yield market that has tight credit spreads and that may be nearing a top. Therefore, we would ideally like to have a manager that has the flexibility to go short segments of the credit market in order to generate alpha and protect capital in unfavorable markets. In addition, we believe that there are large alpha opportunities in the high yield asset class that can be exploited by managers with skill in evaluating credit and the capital structures of corporations. This is the premise behind the following recommendation to hire Bridge Capital Management, LLC.

At the Finance Committee meeting on June 21, 2007, staff and Wilshire will be recommending that the Board make an investment of \$500 million in the Brigade Leveraged Capital Structures Fund. Brigade is a company that was founded by Don Morgan. PSERS has a long history with Don. He was the lead portfolio manager of our high yield account at MacKay Shields from 2000 until he left in March 2006 to start Brigade. The team at Brigade is composed of six of the seven senior professionals within MacKay's High Yield division plus two new strategic hires.

The Brigade Leveraged Capital Structures Fund is a multi-strategy long/short fund investing throughout the capital structure of U.S. and non-U.S. leveraged companies. Its primary investment universe includes any issuer with debt or debt-like obligations rated below investment grade, or securities trading at yields comparable to the high yield market. The fund seeks long-term growth of capital through all market environments, while emphasizing the preservation of capital. The fund managers utilize a bottoms up, fundamental research based process which focuses on free cash flow generation and asset coverage to uncover profit opportunities.

The fund employs four investment strategies as follows:

- Long/short high yield;
- Distressed debt;
- Capital arbitrage; and
- Long/short leveraged equities

Their objective is to generate 15% net of fee returns with a focus on capital preservation. The team at Brigade has a history of running similar portfolios as they managed the MacKay Shields Long/Short Fund from its inception in October 2001 through January 2006. This team was also responsible for \$17 billion in high yield assets at MacKay Shields, mostly long-only portfolios. Brigade is currently limiting the amount of money raised to around \$1.0 to 1.5 billion. Currently, they have \$500 million in assets under management.

This will be the first investment in the public market portfolio that has terms closer to private equity and hedge funds. In fact, the profile of this fund fits a traditional hedge fund profile. The global macro funds in which we are invested also fit the definition of hedge funds. We have attached the term sheet to this memo for your review prior to the meeting. The two terms that differ significantly from the global macro program are the five-year soft lock and the liquidity parameters (quarterly vs. monthly). Given the instruments traded, we feel that quarterly liquidity provides us protection as long-term investors versus monthly liquidity. In cases of market dislocations, "hot" money tends to be liquidated first from funds that have generous liquidity parameters and second from underperforming funds. While staff and Wilshire believe monthly liquidity is preferred, we do not believe it is preferred when it is offered pari passu to other fund investors who may have shorter time horizons than PSERS.

Staff and Wilshire believe that this fund will be an excellent compliment to our long-only high yield portfolio managed by MacKay Shields and recommend that it be included in the high yield allocation. We believe that this fund will perform well in all market environments, especially in environments of widening credit spreads.

If you have any questions or comments, please contact me at 717-720-4702.