

**Commonwealth of Pennsylvania
Public School Employees' Retirement System**

DATE: September 27, 2007

SUBJECT: Loan Fund Investment Recommendation

TO: Members of the Board

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



The recent turmoil in the fixed income markets has created some opportunities for long-term investors such as PSERS. While the turmoil began in the sub-prime mortgage sector, it has spread to other areas of the market, including bank loans. Bank loans are generally secured bank debt representing the highest priority over claims in a company's capital structure. Bank loans are also floating rate debt; therefore, there is very little duration risk since the floating rate resets quarterly. According to a recent estimate by Goldman, Sachs & Co., the backlog in the bank loan market currently stands at about \$165 billion. When the high yield bond market is included, the backlog of debt waiting to be placed grows to over \$300 billion. Several large underwriters are carrying funded bridge loans on their balance sheets. As underwriters have become concerned about the liabilities associated with these deals, they have approached large money managers, such as Oaktree Capital Management, to reduce their exposure. The opportunity for PSERS is to invest in a loan fund managed by Oaktree to take advantage of buying bank loans and other senior debt instruments at significant discounts to their underlying value. As you may recall, PSERS recently approved an investment into Oaktree's distressed debt fund. This fund is structured to take advantage of this opportunity which is different from opportunities afforded to it in their distressed debt and high yield funds.

At the upcoming Finance Committee meeting on September 27, 2007, PSERS staff and Wilshire recommend the following:

1. Commit \$350 million to the Oaktree Loan Fund 2x, L.P. This fund will have the ability to leverage its investments in bank loans and other senior debt instruments up to 2 times. However, there is no guarantee that they will be able to obtain this type of leverage. The return estimates, net of fees, for this fund will range from LIBOR plus 280 bps assuming no leverage to LIBOR plus 700 bps assuming full use of the leverage allowed. A term sheet for this Fund is attached. The opportunity in this segment of the market is over the short term. As such, the investment term for this fund is 1 year. Initial closing

of this fund was September 13, 2007; however, they will be having a second closing in October for funds such as PSERS.

2. Actively manage the duration of the investment in this fund with derivative instruments. This allocation will be included in the U.S. fixed income composite. As noted above, this portfolio has essentially no duration. The duration mismatch to the Lehman U.S. Universal index will be corrected by using derivative instruments to increase the duration of this investment to the duration of the Lehman U.S. Universal index. This correction will be done by PSERS Managing Director of Fixed Income. Therefore, the expected return, net of fees, is estimated to be the Lehman U.S. Universal index plus between 280 bps and 700 bps.

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



SUMMARY OF PROPOSED TERMS FOR OAKTREE LOAN FUND

The following summary is intended to illustrate the general terms of the Fund, which will be set forth more fully in the confidential private placement memorandum, the limited partnership agreements, the subscription agreements and related documentation. Any investment decision must be made solely on the final versions of the foregoing documents.

The Fund	Oaktree Loan Fund, L.P., a Delaware limited partnership, with a Cayman Islands feeder fund, Oaktree Loan Fund (Cayman) Ltd., offered for foreign and tax-exempt investors
Investment Objective	The Fund intends to achieve an attractive total return by having ready capital to purchase bank debt, with a 20% basket for other opportunistic investments. The Fund anticipates investing its capital only once and distributing the net proceeds from each investment as soon as such investment is realized.
General Partner	Oaktree Loan Fund GP, L.P., a Delaware limited partnership
Investment Manager	Oaktree Capital Management, L.P., a Delaware limited partnership
Commitment Capital	\$3 - 5+ billion target
General Partner Commitment	\$10 million
Minimum LP Commitment	\$50 million
Investment Period	1 year from the closing date, subject to follow-on investments, if any
Distributions	Capital will not be recycled after the first anniversary. Income and proceeds from sales and maturities will be distributed as received (quarterly), net of fees and expenses.
Closing	Expected single closing, as soon as reasonably practicable, but no later than mid-September 2007
Management Fee	0.65% on gross asset value
Borrowings	Assuming demand, three parallel structures will be offered: (1) one that does not borrow, (2) one that will employ 1x leverage on all invested capital, and (3) one that will employ 2x leverage on all invested capital.
Term	8 years, subject to extension if there are credit issues in order to avoid having to sell at unattractive prices