

Commonwealth of Pennsylvania Public School Employees' Retirement System

DATE: May 28, 2009

SUBJECT: Proposed Revisions to the Investment Objectives and Guidelines

TO: Members of the Finance Committee

FROM: James H. Grossman, Jr., CPA, CFA
Managing Director of External Public Markets, Risk, and Compliance

At the June Finance Committee meeting, we will ask the Committee to adopt the proposed changes to portfolio specific guidelines for U.S. and non-U.S. fixed income mandates, as revised (hereafter referred to as addenda).

The more substantive changes to the Addenda have been black lined for your convenience in reviewing the changes. Substantive changes to the Addenda are based on suggestions made by Investment Office Staff. If you have any questions or comments regarding these changes, please contact me at 717-720-4703.

Addendum I / U.S. Core Plus Fixed Income Portfolios

1. Changed the benchmark index from the Lehman Brothers U.S. Universal Index to the Barclays Capital U.S. Universal Index. Barclays Capital purchased the Lehman Brothers indices in 2008.
2. Reduced the asset backed securities and mortgage loan related tranches minimum credit rating from Baa3/BBB to B3/B- due to rating agencies changing their rating methodology to quickly downgrade a security's credit rating.
3. Eliminated the guideline that prohibited the purchase of convertible bonds trading at more than 110% of par value. Due to the Addendum requirement that the manager sell convertible bonds held in the portfolio that are trading at more than 110% of par value within 60 days or receive written permission from the CIO to continue to hold the security, the guideline is deemed to be redundant.
4. Reduced the total maximum permitted non-U.S. exposure of the portfolio from 35% to 20% of the market value of the portfolio to ensure that the non-U.S. fixed income exposure in the U.S. Core Plus Fixed Income portfolios remains low.

Addendum K / U.S. High Yield Fixed Income Portfolios

1. Changed the benchmark index from the Credit Suisse U.S. High Yield Index to the Barclays Capital U.S. High Yield Index to remain consistent with the benchmarks presented in the Investment Policy Statement.
2. Eliminated the guideline that prohibited the purchase of convertible bonds trading at more than 110% of par value. Due to the Addendum requirement that the manager sell convertible bonds held in the portfolio that are trading at more than 110% of par value within 60 days or receive written permission from the CIO to continue to hold the security, the guideline is deemed to be redundant.
3. Reduced the total maximum permitted non-U.S. exposure of the portfolio from 35% to 20% of the market value of the portfolio to ensure that the non-U.S. fixed income exposure in the U.S. High Yield Fixed Income portfolios remains low.

Addendum K1 / Mortgage and Asset Backed Securities Portfolios

1. No material changes.

Addendum L / Treasury Inflation Protection Securities Portfolios

1. Changed the benchmark index from the Lehman Brothers U.S. TIPS Index to the Barclays Capital U.S. TIPS Index (Series-L). Barclays Capital purchased the Lehman Brothers indices in 2008.
2. Added a guideline to establish a minimum credit rating of Baa3/BBB- for 144A securities without registration rights. This guideline is consistent with the 144A guidelines contained in other fixed income addenda.

Addendum Q / Global Core Plus Fixed Income Portfolios

1. Changed the benchmark index from the Lehman Brothers Multiverse Index to the Barclays Capital Multiverse Index. Barclays Capital purchased the Lehman Brothers indices in 2008,
2. Reduced the asset backed securities and mortgage loan related tranches minimum credit rating from Baa3/BBB to B3/B- due to rating agencies changing their rating methodology to quickly downgrade a security's credit rating.
3. Eliminated the guideline that prohibited the purchase of convertible bonds trading at more than 110% of par value. Due to the Addendum requirement that the manager sell convertible bonds held in the portfolio that are trading at more than 110% of par value within 60 days or receive written permission from the CIO to continue to hold the security, the guideline is deemed to be redundant.

Addendum Q1 / Absolute Return Emerging Markets Fixed Income

1. Added a guideline to establish a minimum rating of B3/B- for asset backed securities. This guideline is consistent with the asset backed guidelines contained in other fixed income addenda.

2. Reduced the mortgage loan related tranches minimum credit rating from Baa3/BBB to B3/B- due to rating agencies changing their rating methodology to quickly downgrade a security's credit rating.
3. Eliminated the guideline that prohibited the purchase of convertible bonds trading at more than 110% of par value. Due to the Addendum requirement that the manager sell convertible bonds held in the portfolio that are trading at more than 110% of par value within 60 days or receive written permission from the CIO to continue to hold the security, the guideline is deemed to be redundant.

Addendum Q2 / Emerging Markets Fixed Income

1. Added a guideline to establish a minimum rating of B3/B- for asset backed securities. This guideline is consistent with the asset backed guidelines contained in other fixed income addenda.
2. Reduced the mortgage loan related tranches minimum credit rating from Baa3/BBB to B3/B- due to rating agencies changing their rating methodology to quickly downgrade a security's credit rating.
3. Eliminated the guideline that prohibited the purchase of convertible bonds trading at more than 110% of par value. Due to the Addendum requirement that the manager sell convertible bonds held in the portfolio that are trading at more than 110% of par value within 60 days or receive written permission from the CIO to continue to hold the security, the guideline is deemed to be redundant.

Addendum Y / Short-Term Investment Pool Portfolios

1. Added a guideline to establish a minimum credit rating of A3/A-.
2. Clarified the guidelines for approved investments in commercial paper, fixed rate corporate bonds, and adjustable rates securities.

Addendum Y1 / LIBOR-Plus Short-Term Investment Pool Portfolios

1. Added a guideline to allow for the investment of up to 10% of the portfolio in Aaa/AAA rated taxable municipal securities.
2. Reduced the total maximum permitted non-U.S. exposure of the portfolio from 35% to 20% of the market value of the portfolio to ensure that the non-U.S. fixed income exposure in the LIBOR-Plus Short-Term Investment Pool portfolios remains low.

Internally-Managed Premium Assistance Program Investment Objectives and Guidelines

1. Changed the name of the guidelines from Internally-Managed Health Options Program to Internally-Managed Premium Assistance Program to more accurately reflect the assets that are subjected to these guidelines.