

Commonwealth of Pennsylvania Public School Employees' Retirement System

DATE: January 9, 2009

SUBJECT: Investment Manager Recommendation

TO: Members of the Board

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

At the Finance Committee meeting in January, staff and Wilshire will be recommending an investment with Sankaty Advisors LLC in a senior loan account. This account will invest in senior secured bank loans on an unleveraged basis. Bank loans are senior loans secured via a lien against the assets of the borrower so they offer superior credit protection. Should any of the companies default on their debt, the bank loans take precedence over other debt since they are senior in the capital structure. They have little interest rate risk as they are floating rate loans so they offer effective hedges against rising interest rates.

Staff and Wilshire believe that there is currently a significant market opportunity to earn superior risk adjusted returns due to the dislocations in the credit markets. As an existing investor in Sankaty's products, they have offered PSERS attractive terms as follows:

- An attractive management fee of 50 basis points with no performance fee;
- Liquidity – PSERS will receive distributions of interest income on the holdings from inception and they will not be recycled into the account; and,
- No lockup – Since this account is a managed account for PSERS, the Fund will be able to liquidate all or a portion of its investment at any time subject to a minimum of two years management fees.

Mark Heppenstall, Managing Director of Fixed Income, and Charlie Spiller, Managing Director of Private Markets and Real Estate, both met with Sankaty in Boston and were very impressed with their credit research capabilities. Given the crossover nature of this investment between private markets, where Portfolio Advisors, LLC is our consultant, and public markets, where Wilshire Associates is our consultant, we had both evaluate Sankaty. Both consultants met with Sankaty and both recommend that the Board commit to invest in a senior loan account. The legal structure of the account will be a limited liability corporation (LLC) or a similar legal entity in which PSERS will be the sole shareholder. Staff and Wilshire are recommending an investment of up to \$500 million in this opportunity as we look to expand our opportunistic fixed income investment allocation.

If you have any questions or comments, please contact me at 717-720-4703.