

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

DATE: September 22, 2015

SUBJECT: OWS Credit Opportunity Offshore Fund III, Ltd. Recommendation

TO: Members of the Board

FROM: Robert E. Little, CPA 
Portfolio Manager, Non-Traditional Investment Strategies

At the October Finance Committee meeting, staff and Aksia will recommend that PSERS invest in the OWS Credit Opportunity investment strategy, within which One William Street Capital Management, LP (OWS) will create the OWS Credit Opportunity Offshore Fund III, Ltd. (Fund). This Fund, managed by OWS, will invest in the structured credit markets.

OWS was founded in 2007 by David Sherr and a group of investment professionals from Lehman Brothers. When this group left Lehman Brothers, they were able to bring to OWS the technology infrastructure used while they were at Lehman Brothers. The structured credit markets are inefficient and complex. OWS believes that with a combination of experience and technology infrastructure, they can identify opportunities to build a diversified portfolio where returns are driven by security specific risks rather than market risks.

Staff recommends that the Board invest \$200 million in this Fund, an amount which is within the target ranges established in Exhibit E of the Investment Policy Statement, Objectives and Guidelines as amended from time to time.

Included for your review are Aksia's recommendation letter, an investment memorandum prepared by staff, and the resolution recommending the investment in the Fund.

If you have any questions or comments prior to the meeting, please contact me at 717-720-4707.

Manager Recommendation Memo

September 15, 2015

Board of Trustees
 Pennsylvania Public School Employees' Retirement System
 5 North Fifth Street
 Harrisburg, PA 17101

Re: OWS Credit Opportunity strategy

Dear Trustees:

Aksia LLC, having been duly authorized by the Board of PSERS, has evaluated and herewith recommends a direct allocation to the OWS Credit Opportunity strategy ("OWS"), within which One William Street Capital Management, LP will create the OWS Credit Opportunity Offshore Fund III, Ltd. This recommendation is made in line with PSERS Investment Policy Statement, Objectives, and Guidelines.

David Sherr founded One William Street in 2007 after running Lehman's global securitized product business. David had a key role at Lehman Brothers and had overseen the growth of Lehman's origination and securitization business through 2006-2007. As a part of this role, David was responsible for managing the residential mortgage backed securities business. The rest of the OWS team had also been involved in structuring, trading and originating a variety of asset backed products.

OWS trades asset backed credit, including residential mortgage-backed securities, commercial mortgage-backed securities, whole loans and other asset backed securities with an investment strategy that attempts to identify cross asset class opportunities. The manager has a more flexible approach to investing in asset backed markets than many of its peers, in terms of its opportunity set as well as investment strategy. Broadly, the strategy is to invest based on the relative attractiveness of all asset backed asset classes and then to identify those securities within each asset class which appear to have attractive expected return characteristics. The manager's approach is relative value oriented and emphasizes individual security selection over thematic positioning.

We believe that the depth and experience of the manager's team, and the robustness of its quantitative analytics, allow it to successfully execute a broad range of strategies from security specific, credit-intensive to relative value, trading-oriented, across a similarly broad range of sub-sectors within securitized credit. Furthermore, its approach to investing and the resulting portfolio construction is less thematic than those of its peers, which should allow OWS to consistently execute its strategy in a wide range of market environments.

Aksia's recommendation is based upon the following analytical factors and is made within the context of PSERS' investment guidelines:

- Investment Due Diligence of OWS Credit Opportunity Offshore Fund, Ltd., including a review of their investment strategy, investment team and structure, and risk management process;
 - Most recent on-site Investment Due Diligence visit conducted December 14, 2014.
 - The following is a listing of the relevant points of contact with the manager since the most recent on-site due diligence visit in December 2014:

Date	Nature of Contact	Aksia Points of Contact
February 18, 2015	Portfolio Review Call	J. Hemley
May 14, 2015	Portfolio Review Call	J. Hemley
June 30, 2015	Portfolio Review Call	J. Hemley
July 15, 2015	Joint Onsite Due Diligence Meeting with PSERS	J. Hemley
August 17, 2015	Due Diligence Meeting	P. Adelsbach
August 28, 2015	Portfolio Review Call	J. Hemley

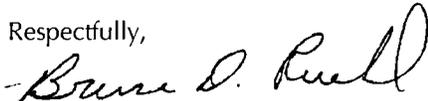
- Operational Due Diligence of OWS Credit Opportunity Offshore Fund, Ltd., including an operations and infrastructure review, regulatory and compliance review, PPM review, Form ADV review, and Financial Statement Review;
 - Most recent on-site Operational Due Diligence visit conducted February 11, 2015.

- Evaluation of OWS' strategy within the context of the current investment environment; and
- Appropriateness of OWS as a component of PSERS' portfolio.

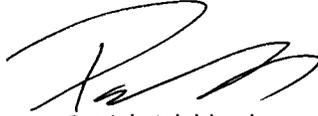
This recommendation is given solely for the benefit of PSERS and cannot be relied upon by other investors considering an investment in OWS, since their needs, objectives and circumstances may not be identical to those of PSERS. The scope of this recommendation is limited to the investment merits of OWS. Aksia manager recommendation memos should be reviewed with other Aksia due diligence materials, including the full Investment Review and Operational Review. In addition, please consult your tax, legal and/or regulatory advisors before allocating to any private investment fund.

Please feel free to contact us should you have any questions about this recommendation.

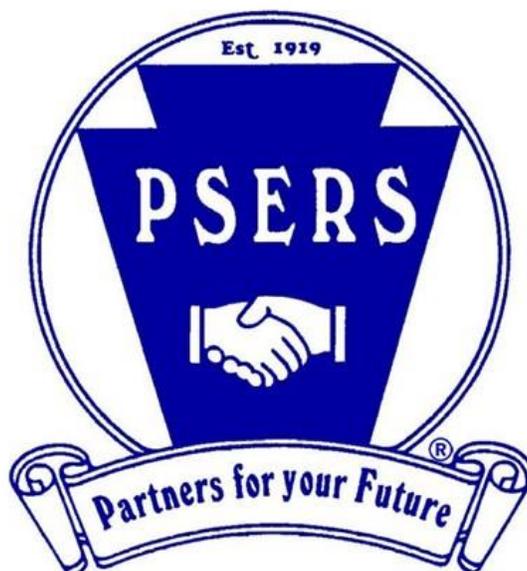
Respectfully,



Bruce Ruehl
Partner, Global Portfolio Strategist



Patrick Adelsbach
Partner, Head of Credit Strategies



COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

Public Investment Memorandum

OWS Credit Opportunity Offshore Fund III, Ltd.

Absolute Return Portfolio

Robert E. Little, CPA
Portfolio Manager

October 5, 2015



Firm Overview

Founded in 2007, One William Street Capital Management, LP (OWS) focuses on investing in the structured credit markets. The founding investment partners had previously worked together at Lehman Brothers. David Sherr (CEO, Chief Investment Officer, and Managing Partner) was the Global Head of Securitized Products at Lehman Brothers. When David left Lehman Brothers, he brought with him the technology infrastructure and five senior employees to launch OWS.

As of July 2015, the firm has 59 employees (including 29 investment professionals). The firm's proprietary valuation, analytics, and risk models are supported by 10 analysts. OWS manages three distinct investment vehicles focusing on the structured credit markets with assets under management in excess of \$2 billion as of July 2015.

Investment Strategy

The Fund will focus on the structured credit markets. These credit markets are inefficient, complex, and offer high risk-adjusted returns. OWS attempts to identify cross asset class opportunities and minimize market risk through selecting a diversified portfolio where returns are driven more by fundamental/idiosyncratic risk than the market. OWS believes that value can be extracted through a combination of bottom up security selection and top down sector allocation. Once the overall risk allocation and top down sector allocations are determined, the portfolio managers fill in the portfolio through bottom up security selection looking to identify those securities within each sector with attractive expected return characteristics and avoid those securities that are levered to the overall market direction. Diversification within sectors is done at the subsector, security name, and individual security level. Portfolio level hedging is done to limit the maximum one month portfolio drawdown to targeted risk limits. Hedging is primarily done through combination of index shorts, single name shorts, and options.

Investment Team

OWS' investment activities are led by David Sherr, Khalil Kanaan, Frank Prezioso, and Matthew Ziffer. OWS has an experienced team of 29 dedicated investment professionals focused on structured credit. The table below highlights the experience of OWS' key investment professionals:

Name	Title	Yrs. Experience OWS / Total	Prior Experience
David Sherr	CEO, Chief Investment Officer, and Managing Partner	8 / 28	Lehman Brothers
Khalil Kanaan	Senior Portfolio Manager, RMBS	8 / 18	Lehman Brothers, Deloitte & Touche
Frank Prezioso	Senior Portfolio Manager, CMBS	8 / 21	Lehman Brothers, Prudential Securities
Matthew Ziffer	Senior Portfolio Manager, Residential Performing / Non-Performing loans	8 / 18	Lehman Brothers, Deutsche Bank

In addition to the key investment professionals listed above, OWS' investment committee is comprised of three additional members of senior management who bring a mix of risk, legal, compliance, and business development experience.

Investment Instruments

The Fund will primarily invest in residential mortgage-backed securities (RMBS), performing and non-performing mortgage and consumer loans, commercial mortgage-backed securities (CMBS), commercial real estate loans, collateralized debt obligations (CDO), and whole loans in the U.S. and Europe.



Market Opportunity

Coming out of the credit crisis, the increased regulatory environment, leverage constraints, legacy liability exposures, and regulatory uncertainty have disrupted the normal lending model. With this background, investment opportunities have evolved beyond simple mispriced assets to event-driven situations in legacy bonds, tactical relative value trades, and origination and lending opportunities as traditional institutional lenders have withdrawn from the credit markets. Investors with credit underwriting, deal structuring, and origination expertise are being compensated for providing capital. Lending to the commercial real estate, residential real estate, and specialty asset backed markets will provide attractive investment opportunities for non-traditional lenders. The current value offered via structured credit markets provides attractive investment opportunities for an investment manager with expertise, infrastructure, and flexibility to evolve with the changing landscape.

Investment Considerations

<p>Experienced and Cohesive Senior Management Team</p> <p>OWS' investment activities are led by David Sherr, Kahlil Kanaan, Frank Prezioso, and Matthew Ziffer, who have extensive experience in the structured credit markets dating back to their time together at Lehman Brothers. In addition, there are 25 investment professionals to support the investment process and maintain / enhance the valuation and risk models. The investment team has significant experience analyzing complex structures in the structured credit markets. The complexity of these markets continues to increase due to factors such as increasing government regulations, changing government roles, changing borrower behaviors, changing servicer behaviors, and traditional lenders exiting these markets.</p>
<p>Technology Infrastructure</p> <p>When David Sherr and the team left Lehman Brothers, they brought with them the technology infrastructure that was developed at Lehman. OWS uses this proprietary system as their portfolio and risk management system. A 10 person risk management team focuses on analytics, model building, data management, and risk management. This team continues to develop the system to enhance the analytical, data collection, and risk management capabilities. The system allows the portfolio managers to explore numerous 'what-if' scenarios in real time. OWS obtains a yearly SSAE 16 letter to provide a third party verification of the integrity of the system.</p>
<p>Investment Process</p> <p>Research is driven by the portfolio and risk management system. As part of the real-time evaluation process, OWS can assess the impact of trade opportunities on the overall portfolio and risk profile. Analytical tools allow OWS to analyze collateral under base case and stressed scenarios, track actual principal and interest payments to predicted values, identify assets that need reunderwritten, and identify mispriced securities. The model can be adjusted to reflect past experience with issuer, loan servicer, and data vendor. The process emphasizes individual security selection rather than top down themes which should allow OWS to generate performance in all market environments.</p>
<p>Investment Team</p> <p>While the investment team is broken down by asset backed security market, the process is inclusive and collaborative. All trades are approved by David Sherr. Senior portfolio managers have the ability to add risk to the portfolio up to certain predefined limits. The senior portfolio managers have extensive experience analyzing very complex credit structures.</p>
<p>Bedrock Capital Associates, LLC (Bedrock)</p> <p>The acquisition of Bedrock allows OWS to originate their own commercial lending deals. Bedrock is a nine person unit dedicated to commercial real estate financing. The senior management has deep, long standing relationships dating back over 20 years. In a competitive market, these relationships are critical in transaction origination. Bedrock will provide customized financing solutions for middle market, transitional properties to facilitate the move from stressed status to stable status. This deal also improves OWS' nationwide market intelligence and diversifies the existing pipeline of commercial investments.</p>



Investment Risks

Liquidity, Basis, Market, and Fundamental Risk
<p>While the Fund does attempt to hedge away a portion of the portfolio market risk through various index hedges, it typically runs a net long position so returns will be correlated to market prices. OWS attempts to mitigate this risk by allocating to securities with some form of event driven or idiosyncratic catalyst that offers additional upside pricing outside of general credit performance.</p> <p>In addition, the fund will invest in less liquid assets as they believe there is a return premium for investing in less liquid assets. OWS attempts to mitigate the Fund's liquidity risk through the asset/liability structure and redemption terms of the Fund.</p>
Competition
<p>While competition does exist in the structured credit space, OWS' technology platform and investment experience has differentiated the team. In addition, the increasing complexity of capital structures and the granularity of collateral risk attributes create barriers of entry to investors which will result in market inefficiencies and alpha opportunities.</p>
Leverage
<p>In some cases, the use of leverage can introduce an asset/liability mismatch as the Fund could be financing long duration assets that pay down over time with 1-3 month liabilities. OWS attempts to actively manage the maturity structure through a combination of longer term and evergreen financing structures.</p>

Portfolio Fit

The investment in the Fund will be included in the Absolute Return portfolio. Aksia is supportive of the allocation based on its due diligence on the investment strategy and its belief that the strategy will complement PSERS' current portfolio.

Since inception in January 2011, the strategy has outperformed the equity and credit markets with lower volatility. The Fund has low correlation to the overall Absolute Return program since inception.

The source of funds to make this investment will be unallocated cash.

Finance Committee Disclosures

Relationship with Aksia	None disclosed
Use of Placement Agents	None used for this investment
Political Contributions in PA	None disclosed
Conflicts	None disclosed
Introductory Source	Aksia LLC
History with PSERS	No prior history
Internal Alpha Team Approval Date	September 22, 2015



Oversight Responsibility

Investment Office	Bob Little
External Consultant	Aksia LLC

Recommendation

Staff, together with Aksia LLC, recommends (i) that the Board invest \$200 million in the OWS Credit Opportunity investment strategy, within which OWS will create the OWS Credit Opportunity Offshore Fund III, Ltd. (Fund), and (ii) that the Investment Office shall have the discretion to invest additional sums within the target ranges approved by the Board in Exhibit E of the Investment Policy Statement, Objectives and Guidelines, as amended from time to time, provided that any investment of an additional sum by the Investment Office shall be reported to the Board in a timely manner.