

# Commonwealth of Pennsylvania Public School Employees' Retirement System

DATE: November 20, 2015

SUBJECT: Proposed Revisions to Investment Policy Statement, Objectives, and Guidelines

TO: Members of the Board

FROM: Joseph W. Sheva, CPA  
Risk Manager

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At the December Finance Committee meeting, we will recommend that the Committee adopt the following changes to Addendums X2, X3-PM, X3-RE, and X3-PD and Exhibit H of the Investment Policy Statement, Objectives and Guidelines (IPS).

## **Addendum X-2 (Absolute Return Policy)**

- Within the Risk Management guidelines, under concentration risk, Investment Office Staff (IOS) recommends increasing the maximum allocation threshold to any one Absolute Return Investment Manager (ARIM) from 15% to 20%. The reason for the request at this time is due to one manager exceeding the threshold due to positive performance. During the review of this threshold as it relates to this manager, it was determined that increasing the maximum allocation for all managers within the Absolute Return Program would add only a trivial amount of risk to the Program as a whole. Diversification of risks, the primary goal of concentration threshold guidelines, is expressed within the Program in far more significant ways than this particular guideline represents.

## **Addendums X3-PM, X3-RE, and X3-PD (Co-investment Programs: Private Markets, Real Estate and Private Debt)**

- Within the Objectives section of each Addendum, IOS recommends allowing an additional amount for follow-on investments, with each investment limited to \$25 million in total. The purpose of allowing follow-on investments, that increase the total invested amount, is to provide the ability to take advantage of opportunities or to protect positions from dilution in follow-on rounds.
- Within the Risk Management section of each Addendum, IOS recommends removal of the Standard Deviation sub-section. Management of private market investments using standard deviation as a risk control, particularly with the small number of investments expected within these programs, is not pertinent and thus should not be in the guidelines. Note that there are other, more applicable, risk controls throughout the Addendum.

- Within the Performance Objective section of Addendums X3-RE and X3-PD, IOS recommends changing the relative outperformance objective amount, currently set at 300 basis points each. It is recommended to change the outperformance objective for the Real Estate Co-investment program to 200 basis points and the Private Debt Co-investment program to 150 basis points. Each change is recommended as these amounts are believed to reflect a more representative expectation of outperformance in these programs. It is noted that setting unrealistic alpha expectations for mandates typically implies the taking of more risk, thus setting alpha expectations to a more reasonable, yet challenging, level allows for better risk/return decisions by the portfolio manager.

### **Investment Policy Statement (IPS):**

- IOS recommends adding a section titled “Implementation” to the IPS.

During our on-going review of the IPS we’ve noted many areas that are procedural in nature, i.e. parts explaining how IOS implements the strategic vision set forth by the Board. In addition, IOS has identified several subjects that are worthy of proper controls and documentation, as well as communication to the Board. The vast majority of these subjects are appropriately addressed, and can be categorized, as IOS “implementation policies”. Communicating these subjects in the form of policies and procedures to the Board via the IPS would require the Board to approve all staff procedures that are operational in nature, which is clearly not best governance practices, and would be an extremely inefficient use of staff and Board time. One example of an important subject that we plan to address in this manner is with regards to investment performance calculation methodology. We have attached for your information an implementation policy that establishes in detail the work that IOS will implement pursuant to the discretion granted to IOS by the Board. We will provide access to the Board this and each additional IOS Implementation Policy and materially change thereto via the Board’s Diligence directory.

### **Exhibit H – Counterparty and Broker/Dealer Policy**

- IOS recommends removing this Policy from the IPS and make available to the Board in accordance with the newly inserted “Implementation” section within the IPS.

Blacklined and clean copies to each guideline have been included in the package for your review.

If you have any questions or comments, please contact me at 717-720-4632.