

Commonwealth of Pennsylvania Public School Employees' Retirement System

DATE: October 11, 2018

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

TO: Members of the Board

FROM: Joseph W. Sheva, CPA, FRM
Senior Risk Manager



At the October 11, 2018 Investment Committee meeting, the Committee determined that the following revisions, originally proposed as part of a memo dated September 24th, 2018, be included in a revised resolution. In the revised resolution, the Investment Office recommends that the Board adopt the Investment Policy Statement, Objectives and Guidelines (IPS) revisions to section VI. Risk Management and Controls as noted below.

VI. Risk Management and Controls:

The Investment Office is making the following recommendations within this section of the IPS.

Private Market and Real Estate Discretionary Structure Capital Limits:

The Investment Office is recommending the following changes to this section:

- A. Rename "Internally-Managed Co-Investment and Secondary Investment Capital Limits";
- B. Update the introductory paragraph;
- C. Move the Public Markets co-investment limits to this section (currently this limit resides in the Investment Manager Target Ranges section).

Adoption of the above recommendations would place all the co-investment and secondary investment capital limits into one section of the IPS.

D. Increasing the total capital limits to the following co-investment strategies as follows:

	Current	Recommended
Private Markets	\$750 million	\$1 billion
Private Debt	\$100 million	\$250 million
Real Estate	\$300 million	\$500 million
Infrastructure	\$500 million	\$1 billion
Public Markets	\$100 million	\$250 million

The concept of a co-investment program is to have the opportunity to participate in unique deals, typically at a lower fee than would be offered within an investment in a Fund structure. Therefore, significantly constraining co-investment capacity could potentially be counterproductive to a goal of investing in investments with a good risk/return profile at the lowest possible fee. Adoption of the recommended capital limits will place an aggregate capital limit on all of these investments at \$3.25 billion (inclusive of PA co-invest), an amount that is reasonable based on the risk controls noted below and within each of the specific co-investment guidelines. Also note that capital limits are not target allocations, therefore it is unlikely that the aggregate will be \$3.25 billion.

The primary Board-level risk controls for the various co-investment and secondary investment programs (e.g. Public Markets, Private Markets, Real Estate, etc.) are to limit the size of each program (e.g. the recommendations above) and to place limits on individual investments within the program (e.g. \$25 million limit for each initial investment and \$10 million for follow-on investments). As stated above, significantly constraining the size of each program could potentially be counterproductive to other Board objectives and thus these limits should be reviewed through a risk/return paradigm, particularly in light of the length and success of the current programs. Regarding limits on individual investments, I believe these limits are reasonable and necessary to the risk management of the program, as they limit individual investment concentration risk (e.g. promote diversification) and therefore remain appropriate.

The Investment Office implements each investment strategy within these limits, while considering all aspects of the investment portfolio risks at a fundamental-level. For example, concentration risk, such as those noted above, are considered investment-by-investment and on an on-going basis in conjunction with other risks such as the liquidity profile of the System, investment operational risks, the impact to the overall risk profile of the System, etc.

Note that the Investment Office is currently in the process of creating a co-investment guideline that encompasses each of the strategies for proposed adoption at a future Investment Committee meeting. Currently each co-investment strategy has a stand-alone guideline.

The blacklined excerpt and a clean copy of the above recommendations have been included in the package for your review.

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

Internally-Managed Co-Investment and Secondary Investment Capital Limits

The aggregate allocation to Co-Investments and Secondary Investments shall be subject to the capital limits established by the Board through the Current Target Allocation in the Strategic Asset Allocation section. The Investment Office is permitted to manage the allocation of capital to each program up to the limits below. The CIO shall have discretion on the timing of reducing amounts exceeding the limits. However, the CIO is not permitted to allocate additional capital to those strategies currently above the limits.

Private Market and Real Estate Discretionary Structure Capital Limits

All allocations to individual Private Market and Real Estate Discretionary Structure (i.e. Co-Investment and Secondary Investment) strategies shall be subject to the limits established by the Board through the Current Target Allocation in the Strategic Asset Allocation section. IOS is permitted to manage the allocation of capital to each Private Market and Real Estate strategy up to the capital limits noted below. The CIO shall have discretion on the timing of reducing any strategy exceeding the limits approved below. However, the CIO is not permitted to allocate additional capital to those strategies currently above the limits.

Capital Limits

Private Markets:

Private Markets ~~In-House Co-Investment and Secondary Investments~~ _____
_____ ~~\$750 million~~ 1 billion

- \$25 million limit for each initial investment
- \$25 million limit for each secondary investment
- \$10 million limit for follow-on investments

Private ~~Debt Debt In-House Co-Investment and Secondary Investments~~ _____
_____ ~~\$100-250~~ million

- \$25 million limit for each initial investment
- \$25 million limit for each secondary investment
- \$10 million limit for follow-on investments

Real Estate:

~~Farmland Investments~~ _____ \$100 million
Real Estate ~~In-House Co-Investment and Secondary Investments~~ _____
_____ ~~\$300-500~~ million

- \$25 million limit for each initial investment
- \$25 million limit for each secondary investment
- \$10 million limit for follow-on investments

Infrastructure:

Infrastructure ~~In-House Co-Investment and Secondary Investments~~ _____
_____ ~~\$500 million~~ 1 billion

- \$100 million limit for each investment

Other:

Private Markets and Real Estate Pennsylvania ~~In-House Co-Investments~~ _____
_____ \$250 million

- \$25 million limit for each initial investment

- \$10 million limit for follow-on investments

Public Markets ~~In-House Co-Investment Program~~

\$100-250 million

- \$25 million limit for each initial investment
- \$10 million limit for follow-on investments

Internally-Managed Co-Investment and Secondary Investment Capital Limits

The aggregate allocation to Co-Investments and Secondary Investments shall be subject to the capital limits established by the Board through the Current Target Allocation in the **Strategic Asset Allocation** section. The Investment Office is permitted to manage the allocation of capital to each program up to the limits below. The CIO shall have discretion on the timing of reducing amounts exceeding the limits. However, the CIO is not permitted to allocate additional capital to those strategies currently above the limits.

	<u>Capital Limits</u>
<u>Private Markets:</u>	
Private Markets	\$1 billion
<ul style="list-style-type: none">• \$25 million limit for each initial investment• \$25 million limit for each secondary investment• \$10 million limit for follow-on investments	
Private Debt	\$250 million
<ul style="list-style-type: none">• \$25 million limit for each initial investment• \$25 million limit for each secondary investment• \$10 million limit for follow-on investments	
<u>Real Estate:</u>	
Real Estate	\$500 million
<ul style="list-style-type: none">• \$25 million limit for each initial investment• \$25 million limit for each secondary investment• \$10 million limit for follow-on investments	
<u>Infrastructure:</u>	
Infrastructure	\$1 billion
<ul style="list-style-type: none">• \$100 million limit for each investment	
<u>Other:</u>	
Private Markets and Real Estate Pennsylvania	\$250 million
<ul style="list-style-type: none">• \$25 million limit for each initial investment• \$10 million limit for follow-on investments	
<u>Public Markets</u>	\$250 million
<ul style="list-style-type: none">• \$25 million limit for each initial investment• \$10 million limit for follow-on investments	