COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

Absolute Return Policy

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Revision History

Absolute Return Policy Established	**March 6, 2020**
Policy Revised	**March 5, 2021**
Policy Revised	**March 15, 2022**

I. SCOPE

The Absolute Return Policy ("Policy") applies to investments in the Absolute Return asset class (the "Portfolio") within the Pennsylvania Public School Employees' Retirement System ("PSERS") Defined Benefit Fund the "Fund").

II. PURPOSE

This Policy provides a broad strategic investment framework for managing investments in the Portfolio. The Non-Traditional Investments Due Diligence Policy provides the key components of the underwriting (due diligence) process.

III. ROLES AND RESPONSIBILITIES

Roles and Responsibilities related to this Policy are identified within PSERS' Investment Policy Statement ("IPS").

IV. INVESTMENT PHILOSOPHY

Through investment in Absolute Return strategies, PSERS seeks to reduce the risk and/or enhance the returns of PSERS' overall investment program through investment in a diversified basket of portfolios.

The Portfolio targets managers which provide idiosyncratic returns and portfolios that exhibit low correlation to equities, fixed income, commodities, and other sources of low-cost beta over a full market cycle.

This Portfolio targets risk-adjusted returns in excess of its benchmark, net of fees, over a full market cycle. The benchmark for Absolute Return is identified within the IPS.

To maintain diversification within the Portfolio, PSERS pursues a global investment strategy that incorporates various investment strategies, asset types, and investment vehicles across the risk spectrum pursuant to the strategic asset allocation set forth in the IPS.

Investments shall be diversified across fund size, sector, strategy, geography, and vintage year (if applicable). This will be implemented through primary and secondary investments in closed-end funds, open-end funds, and co-investments.

V. ALLOCATION

Allocation is a critical driver of the long-term success of PSERS. As it is difficult to rebalance quickly, manager selection has heightened importance as a tool to manage the allocation.

As of the revision date, the Portfolio is considered an inactive area within PSERS' investment program and new commitments are not being considered as the long-term target is zero.

The Portfolio can be segmented by sector as outlined below.

Sector	Description
Event Driven	Event-Driven strategies focus on identifying catalyst-oriented investments across the capital structure (both equity and credit instruments). Event-driven strategies include event & merger, event credit, performing credit, and some other asset-based strategies such as aviation. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event driven exposure includes a combination of sensitivities to equity markets, credit markets, and idiosyncratic, company specific developments. Investment insights are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.
Relative Value	Relative-Value strategies attempt to take advantage of price differentials by buying and selling different, yet related securities. Relative-value strategies include fixed income arbitrage, insurance linked, long/short credit, quantitative strategies, structured credit, volatility, and risk premia. Managers employ a variety of fundamental and quantitative techniques to establish investment insights, and security types range broadly across equity, fixed income, derivative, or other security types. Fixed income strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager.
Multi-Strategy	Multi-strategy strategies invest across multiple asset classes, typically (but not always) with multiple decision-makers or risk-takers. Most multi-strategy funds diversify across three or more underlying strategies. Within the multi-strategy strategy there are several sub-strategies. Asia Multi-Strategy managers focus on investing across a wide range of strategies and may include both directional and RV manager types. Directional Multi-Strategy managers invest across a wide range of strategies, typically with a longer-term horizon and with an event orientation and would have varying net exposure and market betas. Relative Value Multi-Strategy managers invest across a wide range of strategies, typically with low net (or neutral) exposure and an RV approach to trade construction. Liquid Alternatives managers implement a multi-strategy approach with increased liquidity and lower fees than traditional hedge funds.
Tactical Trading	Tactical-Trading strategies focus on short- and medium-trades predicated on movements in underlying economic variables and the impact these have across a range of asset classes. Tactical-trading strategies include CTA, global macro, discretionary commodities, and risk mitigation. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom-up disciplines, and quantitative and fundamental approaches.
Long/Short Equity	Long/Short-Equity strategies invest long or short in the equity of publicly traded companies based on estimates of a company's future prospects and stock valuations. Long/short equity strategies usually employ a bottom-up fundamental approach focused on buying equities expected to increase in value and shorting equities expected to decrease in value. Most long/short equity managers maintain a net long equity exposure.

VI. PERMISSIBLE INSTRUMENTS

A. Investment Types

All sectors are eligible for inclusion in the Portfolio including event driven, relative value, multi-strategy, tactical trading, and long/short equity. Investments are diversified by strategy in order to reduce the impact from any one strategy. Sector diversification will be monitored by IOP. IOP are permitted to manage the allocation within the target ranges noted below.

Sector	Range
Event Driven	0-50%
Relative Value	0-65%
Multi-Strategy	0-40%
Tactical Trading	0-65%
Long/Short Equity	0-20%

The Policy authorizes commitments to investment vehicles, including, but not limited to, funds, partnerships, co-investments, secondaries, separate accounts, joint ventures, and limited liability companies (collectively "Investments").

Investments may be considered throughout the entire capital structure. PSERS will only consider investment structures that seek to provide limited liability to PSERS, limiting PSERS' potential losses to the amount committed, plus reasonable, normal investment expenses.

All investment structures must be reviewed by PSERS' legal counsel and provide the necessary legal protections acceptable to the Investment Office, PSERS' Office of Chief Counsel, and the Office of Executive Director. Structures should be commensurate with a given investment's objectives and risks.

B. Co-Investments and Secondary Investments

<u>Co-Investments</u>: As of the date of this Policy, co-investments are only permitted to be entered into alongside existing External Managers in the Fund.

<u>Secondary Investments</u>: In a secondary transaction, an existing limited partner sells its limited partnership interest to a third-party buyer. PSERS is permitted to acquire additional/and or new limited partnership interests ("Secondary Investments") in funds managed by an existing External Manager. A co-investment may still be held in the PSERS' portfolio if the fund that offered the co-investment was sold as a part of a secondary sale

The maximum cumulative allocation for co-investments and secondary investments is $250 million. The total investment in any single co-investment or secondary investment is limited to $75 million plus accrued interest and ordinary and necessary expenses.

VII. PERFORMANCE OBJECTIVES

The long-term objective for the Portfolio is to outperform its policy benchmark as set forth in the IPS, on a net-of-fees basis, over long-term time horizons through prudent investment commitment pacing, diversification, and External Manager selection while providing a return stream that has low correlation to low-cost beta, including traditional equity, credit, interest rates, and commodity asset classes.

VIII. RISK MANAGEMENT

Absolute Return investments do not easily lend themselves to traditional quantitative measures of risk, such as standard deviation and benchmark Tracking Error. Rather, risk is managed through a combination of quantitative and qualitative techniques. The following sections identify certain significant risks of Absolute Return Investments and their methods of control.

A. Liquidity Risk

Liquidity risk includes both the underlying holdings in a fund and the provisions for making redemptions from the fund itself. Redemption terms will be evaluated for consistency with underlying holdings in order to reduce the risk of forced selling of holdings at inopportune times caused by other investors in the fund. IOP will monitor liquidity provisions of each Absolute Return investment including notification periods, lock-ups, gates, and withdrawal restrictions. All Absolute Return investments will be considered less liquid investments and viewed in the context of a longer time horizon. PSERS' overall liquidity risk is managed by the Board during the Strategic Asset Allocation process.

B. Blind Pool Risk

Some capital commitments are made into closed-end funds. Most, and in some instances all, of the investments to be made by the Investment Manager within a closed-end limited partnership structure are unknown at the time PSERS commits to invest in the partnership. When PSERS invests into blind pools, due diligence is focused on evaluating numerous aspects of the investment opportunity including, but not limited to: 1) Investment Manager track record, 2) firm capabilities, and 3) market opportunities.

C. Geographic and Sector Concentration

Over-concentration to any particular geography or sector can expose the portfolio to unintended macro-level risks. As such, IOP strives to diversify the investments across geographies and sectors. Geographic and sector concentration risk are considered during the due diligence process (see Non-Traditional Investments Due Diligence Policy).

D. Currency Risk

Investments may be denominated in foreign currencies. Significant movements in foreign currency values, relative to the U.S. Dollar ("USD"), may impact a portfolio's reported returns which are denominated in USD. Currency risk is often impractical to hedge at the investment level; however, it can be managed by IOP in accordance with the Currency Hedging Policy.

E. Manager Risk

External Manager exposure risk typically manifests within Private assets in the following ways: (a) the size of PSERS' commitment to a specific partnership or fund investment; (b) open-ended, or evergreen structures where IOP have discretion to increase or decrease allocation, and (c) PSERS' exposure to any one External Manager or firm. These risks are controlled as follows:

a. Partnership or fund investment exposure is controlled by limiting the allocation to a specific partnership or open-ended fund investment. The maximum allocation to any one partnership or open-ended fund is limited to 15% of the Portfolio. In addition, the maximum allocation to any one separate account is limited to 15% of the Portfolio.
b. Within the Portfolio, PSERS' maximum total allocation (defined as net asset value plus unfunded commitments) to all partnerships and other investment vehicles sponsored by a particular External Manager or firm, within the Absolute Return asset class, is limited to 20% of the Portfolio.
c. The Portfolio is permitted to have one External Manager/fund that exceeds the maximum allocation guidelines noted above. In no case may the maximum allocation to any one External Manager/fund exceed 25% of the Portfolio.
d. The CIO shall have discretion on the timing of reducing any External Manager portfolio exceeding the limit. However, the CIO is not permitted to allocate additional exposure to that External Manager currently above the limit.

F. Leverage Risk

External Managers may finance a portion of their asset purchases with debt. Leverage constraints are typically identified in the governing documents at the underlying investment and fund levels. The use of debt to finance asset purchases has the potential to enhance the asset's return on equity but also has the potential to magnify losses. PSERS seeks to invest with External Managers that have demonstrated the prudent use of leverage. Monitoring leverage risk includes scrutiny over External Managers' usage of subscription facilities.

G. Valuation Risk

In some cases, Private assets are illiquid and not traded frequently. As a result of a lack of observable inputs of trading activity, a reliable market price of such investments may not be available, and consequently a fair value of these assets cannot be determined by readily observable inputs. In such cases, assets may be valued by the External Manager, third-party appraisers, or some combination thereof. PSERS' strives for External Managers that have a formal valuation policy.

H. Market Risk

The Portfolio is designed to have a low overall level of sensitivity to broad market risk factors such as equity markets, interest rates, and commodity prices. IOP, in conjunction with the specialty Consultant, will monitor risk factors at the individual investment and overall portfolio levels.

I. Counterparty Risk

The use of prime brokers, leverage providers, servicers, custodians, derivatives, and other third-party service providers introduces counterparty risk in the Portfolio. If counterparties are not able to meet their obligations, losses may occur. IOP, in conjunction with the Investment Consultant, will review this risk through operational due diligence reviews of the Private Investment Managers.

J. Legal Risk

Private investments have unique characteristics which require legal expertise. All investment structures must be reviewed by PSERS' legal counsel and provide the necessary legal protections acceptable to the Investment Office, PSERS' Office of the Chief Counsel, and the Office of the Executive Director. Structures should be commensurate with a given investment's objectives and risks.

IX. MONITORING AND REPORTING

See Monitoring and Reporting section of the IPS.