COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES’ RETIREMENT SYSTEM

Liquidity Policy
I. SCOPE

This Policy addresses liquidity management within the asset allocation of the Pennsylvania Public School Employees’ Retirement System (“PSERS”) Defined Benefit Fund (“The Fund”).

II. PURPOSE

This Policy provides the broad strategic framework for managing the Fund’s liquidity involving investment assets, investment-related liabilities and short-term obligations including benefit payments.

III. ROLES AND RESPONSIBILITIES

Roles and Responsibilities related to this Policy are identified within PSERS’ Investment Policy Statement (“IPS”).

IV. PHILOSOPHY

In general, liquidity refers to the capacity to use and, if necessary, generate cash. Since most obligations are satisfied with cash, rather than other assets, this capacity is of paramount importance to PSERS.

For an asset or collection of assets, liquidity is a term used to characterize the capacity of the asset(s) to be efficiently converted into cash. “Efficiently” considers (1) the time involved in the conversion, (2) the price at which the conversion occurs and (3) the transaction costs. More liquid assets generally require less time to be converted into cash, can be converted into cash at or above “fair value”, and involve low transaction costs. Conversely, less liquid assets generally require more time to be converted into cash, may require discounting below “fair value” to be converted and may involve high transaction costs.

Liquidity is valued by the markets and, therefore, comes at a cost. Generally, the more liquid an asset is, the lower the expected return from it. For example, physical cash itself provides no future expected return.

In its asset allocation, PSERS seeks to balance the long-term usage of illiquid, or potentially illiquid assets, and leverage to help manage risk while generating targeted returns with the ability to raise and hold cash for short-term obligations, which is always the first priority of the System. During periods of market dislocations in which asset liquidity becomes impaired, maintaining the long-term asset allocation is a secondary priority relative to the immediate cash flow needs for benefit payments.

The term liquidity may also be used more broadly, referring to the capacity to satisfy short-term obligations in which both asset liquidity and liabilities are considered. In
this context, liquidity management refers to the process of balancing available assets relative to liabilities. It is a complex process that may be impacted by many variables, including conditions which affect asset liquidity as well as those conditions which affect liabilities. Investment-related liabilities include notional exceeding capital and unfunded commitments.

V. SOURCES OF LIQUIDITY RISK

Liquidity risk is the potential for loss resulting from the diminished capacity, or inability of the Fund to efficiently meet its benefit and investment-related payment obligations. Four broad areas of liquidity risk are considered below.

A. Employer Contribution Receipts

PSERS is funded by employee and employer contributions which represent a significant source of liquidity. Employee contributions have been received as projected over the history of PSERS. Employer contributions are actuarially determined and can be projected for a number of years in the future. However, employer contributions are subject to the Commonwealth of Pennsylvania’s (Commonwealth) budgetary constraints and may not be fully paid in any given year. This represents a significant risk to the projected liquidity of the Fund.

In the past, PSERS has gone through a protracted period where the actuarially-required employer contributions were not made by the Commonwealth. Act 120 of 2010 implemented a funding plan to slowly raise employer contributions to the actuarially required amount. During fiscal year 2017, a major funding milestone was reached as employers funded 100% of the actuarially required contributions to PSERS for the first time in fifteen years. Should the employer contributions be legislatively decreased in the future below the actuarially required contributions, the resulting decrease will increase liquidity risk for PSERS.

B. Benefit Payments

Many factors influence the liquidity risk associated with PSERS’ benefit obligations. These include the structural characteristics of the System, including benefits offerings, contribution rates, and member demographics. PSERS is currently considered to be a mature plan, i.e. a plan with a lower ratio of active members to retirees, in which cash outflows (benefit payments) exceed cash inflows (contributions).

This Policy relates only to the ultimate, short-term cash flow requirements associated with the cash payment of the benefits and not to PSERS’ structural benefit characteristics.
C. Assets

Asset liquidity is dependent upon several factors including:

- Market conditions (trading volumes, volatility, relative values of securities) at near normal levels;
- How quickly an asset can be bought and sold (this includes contractual provisions, such as gates, which may limit the ability to transact);
- Pricing efficiency; and
- Transaction costs.

Generally speaking, and with consideration of the variables above, the level of liquidity of the investments can be characterized, under normal market conditions, as follows:

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<tr>
<td>Non-Traditional Investments (e.g., Private: Equity, Real Estate, Credit, Infrastructure, etc.)</td>
<td>Absolute Return and Funds</td>
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<tr>
<td>Traditional Investments (e.g., Public: U.S. and Non-U.S. Equity, Fixed Income, Real Assets, etc.)</td>
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D. Investment-Related Liabilities and Cash Needs

Investment-related liabilities are those obligations resulting from investment activity and include:

- Derivatives related obligations including margin collateralization and other payment obligations;
- Transactional obligations; and
- Other contractual obligations.

Potential cash needs include the following:

- Asset allocation and Fund-level rebalancing activities;
- Internally managed portfolio fundings and transitions;
- Cash related to leveraged positions;
- Externally managed public and private markets portfolio capital commitments and transitions.

These liabilities and cash needs may also be impacted by market conditions and contractual provisions.
VI. RISK MANAGEMENT

In order to achieve its investment objectives, the Board has sought a balance of risk and return in its asset allocation. As part of that balance, the Board has elected to make allocations to Non-Traditional Investments and other illiquid asset classes and asset structures. This balance of risk and return is addressed by this policy which seeks to provide a roadmap of how PSERS considers both liquidity risk and returns, while recognizing that any allocation that seeks returns will appear sub-optimal in the midst of a crisis. Therefore, it is necessary to build the liquidity strategy in advance of the need for it.

A number of approaches are used to measure and manage the Fund's liquidity risks, including a combination of controls in policies, portfolio guidelines, account structures, procedures and operative legal and governing documents.

A. Assets

The asset allocation is the primary determinant of the Fund's liquidity. The liquidity characteristics of different asset classes are along a spectrum, as summarized in the table in Section V.C., with additional detail provided below. Limitations on less liquid asset classes are driven by the top-down allocation and ranges which are included in the Asset Allocation within the IPS.

PSERS maintains a dedicated allocation to Cash, including low risk/high quality liquid securities, within the Asset Allocation. This allocation is reviewed annually during the Asset Allocation analysis and is managed by IOP on a daily basis to provide for all near-term cash needs.

B. Investment-Related Liabilities

The primary investment-related liabilities include:

1. Unfunded capital commitments, contingent capital commitments, and funds with lock-up periods

Non-Traditional Investments (i.e., Private Equity, Private Credit, Private Real Estate and Private Infrastructure) require the commitment of a pool of capital which is then drawn, or funded, over time as needed (i.e., as investments are made). This unused (and unfunded) portion of capital, referred to as unfunded committed capital, represents a form of liability. At the time the manager calls for capital, investors must be prepared to provide cash to satisfy the call.

Similarly, contingent capital commitments, whereby a commitment is approved for a fund to be drawn at a later date, typically to be a liquidity provider during a crisis, represents a form of liability.
In addition, certain funds, typically Absolute Return funds, will provide favorable fee terms if a lock-up period, a period of time during which the investor is not permitted to withdraw funds, is accepted. IOP considers the overall liquidity position of the Fund prior to entering these agreements.

The contingent liquidity requirements of Non-Traditional Investment commitments are closely monitored and managed accordingly via the annual pacing plan as prepared for each Non-Traditional Investments asset class.

2. Derivatives

Usage of derivatives may result in additional liquidity needs, such as clearinghouse margining, collateralization with OTC derivative counterparties and derivative settlements.

3. Investment Expenses

These include items paid from PSERS' assets such as external management fees and related expenses; internal management expenses; and consultant, custody, legal and related fees and expenses.

C. Contingency Liquidity Plan

During a liquidity event, the CIO, working with the Board’s general Investment Consultant and with subsequent notification to the Board, may utilize contingency liquidity actions to satisfy the Fund’s liquidity needs.

In addition to assets held in transition and rebalancing portfolios, public fixed income assets are held, in part, for liquidity management purposes and may be utilized to satisfy liquidity needs. Specifically, Treasury securities are held in the following allocations and may be accessed as needed:

- US Long Treasury
- US Inflation Protected
- US Core Fixed

Access may require a modification to approved Targets, Ranges and Benchmarks included in the IPS. For example, the benchmark of the US Core Fixed allocation may be modified from the Bloomberg Barclays U.S. Aggregate to a customized Bloomberg Barclays U.S. Aggregate ex - U.S. Treasuries.

It may also become necessary to modify limitations in the Board’s Derivatives Policy (or Leverage Policy) as the liquidity environment deteriorates since derivatives are often a more liquid form of asset exposure than the underlying securities.
D. Contingency Funding

During a liquidity event, the CIO, working with the Executive Director, may utilize other contingency funding actions to satisfy the Fund’s short term liquidity needs. These may include use of a liquidity line of credit, repurchase agreements or cash collateral proceeds from securities lending to satisfy short term cash needs. The Board will receive notification of actions taken with regard to contingency funding not later than at the next Board meeting.

VII. MONITORING AND REPORTING

See Monitoring and Reporting section of the IPS.