COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES’ RETIREMENT SYSTEM

Non-Traditional Investments/Due Diligence Policy
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. SCOPE</td>
<td>3</td>
</tr>
<tr>
<td>II. PURPOSE</td>
<td>3</td>
</tr>
<tr>
<td>III. ROLES AND RESPONSIBILITIES</td>
<td>3</td>
</tr>
<tr>
<td>IV. RISK MANAGEMENT</td>
<td>3</td>
</tr>
<tr>
<td>V. DUE DILIGENCE (UNDERWRITING) PROCESS</td>
<td>4</td>
</tr>
<tr>
<td>External Managers</td>
<td>4</td>
</tr>
<tr>
<td>Co-Investment and Secondaries</td>
<td>6</td>
</tr>
</tbody>
</table>

## Revision History

<table>
<thead>
<tr>
<th>Description</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-Traditional Investments/Due Diligence Policy Established</td>
<td>March 6, 2020</td>
</tr>
<tr>
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</tr>
</tbody>
</table>
I. **SCOPE**

This Policy applies to investments in the Non-Traditional Investments Asset Classes (Private Equity, Private Credit, Private Real Estate, Private Infrastructure, Private Commodities and Absolute Return) and Non-Traditional Investment structures within other portfolios, including Co-Investments and Secondaries within an Asset Class, of the Commonwealth of Pennsylvania, Public School Employees' Retirement System (“PSERS”).

II. **PURPOSE**

This Policy provides a broad strategic investment framework for the due diligence process of investments in the Non-Traditional Investment Asset Classes and Non-Traditional Investment structures. The implementation of this policy is outlined in the procedure manuals for Non-Traditional Investments as maintained by the Non-Traditional Investment Office Professionals.

III. **ROLES AND RESPONSIBILITIES**

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

IV. **RISK MANAGEMENT**

Non-Traditional 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. PSERS seeks to identify and acknowledge the sources and types of risk inherent in each underlying investment strategy during the due diligence (underwriting) process. The key components of the process are identified below.

Furthermore, Non-Traditional Investments do not easily lend themselves to traditional methods of measuring investment return. Notably, several issues may arise when calculating the Internal Rate of Return (“IRR”) of a fund or single investment, which may make performance comparisons on an IRR basis misleading. These issues may arise at the fund level, for example, when a fund exhibits complex cash flow patterns, usage of subscription lines, and investment scale differences. To reduce the likelihood of these and similar issues negatively impacting IOP’s ability to conduct investment performance measurement and analysis, IOP does not rely solely on IRR but also utilizes Multiple of Invested Capital and Public Market Equivalents, such as Direct Alpha and Kaplan Schoar.

Certain PSERS practices serve to further mitigate risks across the Non-Traditional portfolios. PSERS will only consider investment structures that provide limited liability to the System, which limits the System’s losses to the amount invested.
Additionally, no single individual shall have the authority to allocate capital on behalf of the Fund and all decisions to invest require unanimous approval of the AIC, a positive recommendation from the Investment Consultant(s), and Board approval where applicable.

V. DUE DILIGENCE (UNDERWRITING) PROCESS

Thorough due diligence (underwriting) serves three primary objectives:

- **Develop an Understanding of the External Manager or Co-Investment, their Organization and Strategy**: Thorough due diligence allows the IOP to develop a credible thesis for an External Manager’s (or co-investment’s) future success. Documented underwriting helps the IOP to improve investment decisions over time by providing the basis for analysis of historical manager recommendations.
- **Performance Expectations**: IOP will utilize various metrics to evaluate manager performance including peer group analysis, benchmark analysis, and Public Market Equivalent (PME) where applicable.
- **Portfolio Fit**: IOP will evaluate how the prospective External Manager or Co-investment will impact the diversification attributes of the portfolio.

Implementation of this policy is comprised of the following elements for External Managers (i.e. funds):

- **Sourcing and Identification**
  - IOP identify potential External Managers through numerous sources, including internal efforts, Investment Consultants and peer institutions.
- **External Manager Interviews: Meetings, Calls and Negotiation of Terms**
  - Thoughtful structured interviews allow the IOP to project anticipated managers’ ex-ante performance by understanding the decision makers, their philosophies, organizational structures and motivations, and the resultant impact on performance.
  - Fees and other pertinent terms negotiated. Non-Traditional Investments may have substantial fees and costs; consequently, emphasis will be placed on negotiating, monitoring and controlling the direct and indirect costs of each investment.
- **Performance Analysis**
  - IOP analyze historical results to prove the merits of an External Manager’s investment strategy and the execution thereof. An External Manager’s relative performance is assessed against relevant metrics, including peer quartile rankings and public market equivalent returns (PME) when applicable.
- **Document Review**
  - Items to be reviewed fall into the following categories:
    - Current Due Diligence Questionnaires, Placement Agent Policy, and presentation materials
- Historical client letters and communications
- Audited financial statements
- Offering Materials (e.g. Private Placement Memorandum, Limited Partnership Agreement, Subscription Document)
- Investment Consultant(s) memoranda

- **Public Information Review**
  - IOP, in conjunction with the assigned Investment Consultant, gather and review information that is publicly available, including Form ADV, about the manager and key individuals at the firm.

- **Reference Calls**
  - IOP performs reference calls, e.g. former employers/colleagues, current investors, former investors, etc.

- **Operations Review and Due Diligence**
  - The assigned Investment Consultant conducts a full operational review and issues an Operational Due Diligence (ODD) memorandum.
  - IOP review the completed ODD memorandum.
  - PSERS’ Operational Due Diligence Manager will also conduct an internal ODD review

- **Investment Review and Due Diligence**
  - IOP prepare their memoranda of recommendation that address key aspects of the investment, generally including firm overview, market opportunity, portfolio fit, past performance, and identified risks.
  - The assigned Investment Consultant conducts a full investment review and issues an Investment Due Diligence (IDD) memorandum.
  - IOP review the completed IDD memorandum.

- **Allocation Implementation Committee (AIC) Review and Approval**
  - The AIC, an internal Investment Office committee, of which the CIO is a member, reviews the IOP and assigned Investment Consultant memoranda and supporting information. The AIC votes and if approved unanimously, the applicable portfolio manager can recommend the investment to the Board.

- **Preliminary Legal/Side Letter Negotiation**
  - IOP provides legal documents to PSERS’ Office of Chief Counsel (OCC) and Investment Operations groups.

- **Board Approval**
  - The IOP and assigned Investment Consultant recommendation memoranda are provided to the Board in advance of the Board meeting.

- **Contracting/Legal Negotiations**
  - Upon Board approval, the IOP coordinate final legal reviews with the OCC and Investment Operations groups. Identified matters will be addressed via a side letter when necessary. The side letter, unless otherwise approved by the Board, will detail PSERS-specific requirements, including but not limited to: compliance with PSERS’ Placement Agent Policy, information collection requirements (e.g. ILPA or comparable template), disclosure of Pennsylvania political contributions, and a Limited Partners Advisory Board seat where applicable.
Once the contracts have been approved and executed by the OCC, IOP, and PSERS’ Executive Office, the contracts are sent, if necessary, to the Office of Attorney General for review and execution.

Set forth below are the key elements for co-investments and secondaries. As of the date of this policy, co-investments and secondaries are only permitted to be entered into alongside existing funds in PSERS’ portfolio, except for co-investment opportunities located in Pennsylvania (PA Co-Investment Program). Co-Investment opportunities located in Pennsylvania from active relationships where PSERS and/or assigned Investment Consultant is a limited partner will first be vetted by the assigned Investment Consultant.

- **Sourcing and Identification**
  - IOP are offered potential co-investments and secondaries through existing fund investments

- **Allocation Implementation Committee (AIC) Due Diligence Approval**
  - Upon preliminary review of a co-investment or secondary opportunity, the relevant IOP alerts the AIC of the investment opportunity and requests approval to proceed with diligence.

- **Manager Discussions and Analysis**
  - Upon approval of the AIC to proceed with diligence, IOP will engage in detailed discussions with the External Manager offering the co-investment or secondary opportunity to better understand the merits and risks of the opportunity.

- **Document Review**
  - Examples include:
    - Investment Committee Memorandum
    - Financial Models
    - Bank / Lender presentation (if available)
    - 3rd Party Investment Consultant Reports (i.e. Quality of Earnings)
    - Audited Financial Statements
    - Offering Materials (e.g. Limited Partnership Agreement, Subscription Document)
    - Relevant investment and deal lead track records

- **Performance Analysis**
  - IOP analyze historical results to prove the merits of an External Manager’s investment strategy and the execution thereof.

- **Public Information Review**
  - IOP will gather and review information that is publicly available about the External Manager sponsoring the co-investment, the key individuals at the firm, and the co-investment entity

- **IOP Recommendation**
  - IOP prepares a presentation to the AIC that address key aspects of the investment, generally including company overview, market opportunity, portfolio fit, management track record, identified risks, External Manager concentration risk assessment and a cumulative asset class allocation
total for the internal co-investment and secondary investment programs; concluding with a formal recommendation.

- PA Co-investment Program opportunities will also be vetted and recommended by the assigned Investment Consultant and presented to the AIC.

  ▪ **AIC Review and Approval**
    - The AIC reviews the IOP recommendation and supporting information. The AIC then votes to approve or decline the co-investment.
    - The AIC must unanimously approve the co-investment.

  ▪ **Contracting/Legal Negotiations (when applicable)**
    - Upon AIC approval, the IOP begins legal reviews with OCC. Identified matters will be addressed via a side letter when necessary.
    - Upon Board approval:
      - The Office of Attorney General (OAG) has delegated to PSERS execution authority for fully negotiated contracts that meet the following criteria: 1) are with an existing manager, and 2) have immaterial changes from a previous contract.
      - Fully negotiated contracts that do not meet the above criteria must be sent to the OAG for review and approval.