STATEMENT OF PURPOSE

The purpose of the Pennsylvania Public School Employees' Retirement System (PSERS) Direct Real Estate Program (the "Program") Policy Statement is to provide the framework and specific requirements which will allow the Finance Committee (the "Committee"), Board of Trustees (the "Board"), Staff and external real estate professionals to fully understand and implement the real estate program in a manner to achieve the Board's objectives for the asset class of real estate.

In addition to this "Statement of Purpose" and the following "Definitions" sections, this Policy Statement is separated into five sections which describe "Objectives," "Investment Criteria," "Transaction Review and Closing Process," "Schedule of Fees for External Real Estate Professionals", "Asset Management Policies and Procedures" and "Reporting".

This Policy Statement is designed to enable the PSERS' real estate program to create the highest possible risk-adjusted returns in a controlled, coordinated and comprehensive manner. Recognizing that real estate market conditions and PSERS' objectives for real estate may change over time, this document will be periodically revised and updated, as needed, so that the PSERS' real estate program will be grown on a proactive basis.

DEFINITIONS

The term "Advisor" shall be deemed to mean any company or individual who, by contractual agreement, provides property asset management services to PSERS on a non-discretionary basis. Unless otherwise stipulated, PSERS will retain the authority to approve major asset management practices and disposition of property investments generated and/or managed by such company or individuals.

The term "Manager" shall be deemed to mean any company or entity that, by contractual agreement, assumes discretion over a specified amount of PSERS' real estate capital, provides asset management services and periodically reports to PSERS. By virtue of the contractual agreement, PSERS shall not retain ultimate authority as to the buying, holding or selling the individual property investments administered by such manager.

The term "Asset Manager" shall be deemed to mean any company or individual which may be retained by PSERS to recommend, implement or supervise PSERS' asset management policies and procedures for either all or a specified number of PSERS' individual real estate property investments.

The term "Consultant" shall be deemed to mean any company or individual which provides any of the following services to PSERS: (1) definition, modification and monitoring of real estate investment policy and program; (2) individual property due diligence solely for the
benefit of PSERS; (3) recommendations which relate to establishment or termination of relationships with Advisors, Managers, Joint Venture Partners or Asset Managers; (4) monitoring of and reporting on real estate investment performance and portfolio composition characteristics; and (5) unless otherwise stipulated, PSERS will retain the authority to approve the acquisition, major asset management practices and disposition of property investments generated and/or managed by such company or individuals.

Preference shall be shown by PSERS for the hiring and retention of advisors, managers, asset managers and consultants who function in a fiduciary capacity.

The term “Submitter” shall be deemed to mean any company or individual that proposes property investment opportunities to PSERS.

OBJECTIVES

The Program was closed to new acquisitions several years ago and is currently going through an orderly liquidation process.

LEGAL INVESTMENTS

PSERS has determined that it is appropriate to make legal investments in real estate as a separate asset class. Legal investments are those that are permissible under existing state and federal statutes, regulations and rulings. All such investments must be exclusively controlled by the Board. Control by the Board does not preclude its delegation of investment responsibilities to the Committee, or to PSERS' staff, or to PSERS' Advisors and Managers if such delegation is determined by the Board to be prudent.

PERFORMANCE

The real estate portfolio will be expected to achieve a minimum, long-term six percent (6%) real (inflation adjusted) rate of return. It is intended that this real rate of return objective be achieved at the portfolio level and thus, the projected real rate of return over the holding period of any individual investment need not achieve six percent if the investment assists the real estate portfolio in meeting overall objectives and complies with other content of this Policy Statement.

Acceptable return for any individual investment will be determined within the context of:

a) The role of that investment in enabling PSERS' overall real estate portfolio to meet its objectives.

b) The anticipated components of overall return (income and appreciation), as related to the type of property, location, investment structure, property life cycle stage, tenant mix and quality of the income stream.

c) The degree of risk associated with the investment in terms of the foregoing composition categories.
It is PSERS' intent to terminate (sell) any investment at the point in time when its value has been maximized to PSERS' portfolio. Therefore, while PSERS considers real estate a long-term asset class, each investment position will be continually monitored and disposition strategies will be in place so that transactions are able to occur to maximize individual investment profitability and value.

**DIVERSIFICATION**

The PSERS' real estate program will be prudently diversified by investment structure, investment method, property type, property value, investment value, property life cycle stage, and economic region in order to minimize the impact of secular or cyclical changes in the economy, financial markets and/or real estate markets. Consequently, this Policy Statement will address diversification among all foregoing portfolio composition characteristics.

**RISK MANAGEMENT**

For the purpose of focusing on maximized risk-adjusted returns, preservation of investment capital and implementation of appropriate asset management procedures, a basis of the real estate program is the management of risk.

Categories of risk which will be analyzed and understood prior to the funding of any investment or the establishment (or re-establishment) of any asset management plan include real estate market risk, financial risk, business risk and environmental hazard risk. Therefore, no investment will be consummated without full assessment of lease structures and tenant mixes as related to the quality of income streams, the reasonableness of economic property operating forecasts and a complete analysis of all physical property and market area characteristics.

A major factor of risk management is the monitoring of portfolio performance and composition so that active strategies may be implemented from time to time to improve overall risk adjusted performance at the portfolio level.

Another critical factor to effective risk management is market awareness, specifically as it applies to real estate market conditions and trends. Therefore, PSERS' real estate program will take into consideration such factors as relative capital intensity in the marketplace; availability of quality products, opportunities and investment vehicles; and achievable yields and internal rates of return.

The primary emphasis for creation and expansion of the real estate program will be on that component of the portfolio that will consist of operating, income producing properties. This component will primarily consist of completed and substantially leased properties with a trackable performance history and leasing cycles. An asset will be classified in this category based upon the relative predictability of future cash flows. The property types in this category will generally consist of high quality, well-located office, retail, industrial and multi-family residential properties. Locations of these assets will be generally limited to major metropolitan areas throughout the United States that have demonstrated a resilience to major economic or real estate market recessionary conditions, and markets which are characterized by new supply constraints. The targeted net real internal rate of return for these investments is a
minimum of 6.0%. A minimum of seventy-five percent (75%) (weighted by investment value) of the real estate portfolio shall be allocated to operating, income producing investments.

PSERS may also invest in other assets as a supplement to the operating, income producing investment program. The other assets may include non-traditional property types and/or properties that involve development, re-development or leasing risks and may require specialized acquisition or management expertise to enhance the value of the investment. An asset may be classified as other based upon the relative unpredictability and/or instability of future cash flows. Given the higher risk profile of these assets, the return requirements are a minimum of 200 to 300 basis points above the operating, income producing portfolio return requirements. In addition, the holding period for the other investments will generally be less than that of the operating, income producing portfolio and each other investment must include a thorough and well-defined exit strategy. A maximum of fifteen percent (15%) (weighted by investment value) of the Board's real estate allocation shall be available for other investments.

In addition to operating, income producing and other assets, PSERS may also invest in specialized investments such as agriculture and timber in accordance with the Policy Statement. A maximum of ten percent (10%) (weighted by investment value) of the real estate portfolio shall be allocated to such specialized investments.

DISCRETION

Real estate investment decisions and recommendations will be guided by the "prudent expert" standard, embracing the prudent decision-making process typically employed by experts in the areas of real estate acquisition, operation, management and disposition.

PSERS will retain discretion over the decision to invest after detailed analysis, due diligence and underwriting of the investment proposal and will retain discretion over the adoption, implementation and maintenance of management and operating policies and procedures, as outlined in this Policy Statement.

PSERS approval will be required for the funding of capital and for major operational, management and disposition activities.

The Board may, through delegations of authority, permit PSERS' real estate staff to implement the real estate program by having discretion over specified investment program decisions (as outlined in this Policy Statement).
INVESTMENT CRITERIA

INTRODUCTION

The following criteria are applied only to PSERS' "hard asset" real estate and not securitized real estate or real estate financial instruments such as options and credit enhancements. Emphasis will be placed on the degree of equity orientation, level of security, potential risk-adjusted returns and compliance with all content of this Policy Statement for each investment opportunity.

While the investment criteria specified herein will apply most directly to specified individual property investments, they also will be used by PSERS and its Consultant to review and evaluate the underlying characteristics and strategies of the commingled funds to which PSERS may allocate real estate capital.

Each section of these investment criteria will be used in conjunction with all other sections so that any potential investment must meet a wide range of underwriting requirements in order to qualify for consideration by PSERS.

INVESTMENT STRUCTURES

PSERS will give first priority to investing in specified properties where PSERS will be the sole investor or in which it can obtain a controlling interest. Exceptions may be made in the case of extremely large transactions or transactions which may involve portfolios of properties.

INVESTMENT METHODS

PSERS may utilize the following structures in implementing the real estate investment program:

UNLEVERAGED ACQUISITIONS: Since emphasis is placed on the degree of equity orientation and minimization of financial risk, PSERS has a preference for acquiring properties not encumbered by debt.

LEVERAGED ACQUISITIONS: PSERS will typically not acquire any property on a leveraged basis unless the property is encumbered by "well-margined," traditional debt providing "positive leverage."

EQUITY-ORIENTED DEBT: Properly structured participating or participating/convertible debt investments may be considered. Any such mortgage financing will normally be senior to all other debt and ground leases (except in the event of a PSERS' combined position as a ground lessor/leasehold lender). Loan structuring features shall typically include a pay rate equal to the contract interest rate, acceptable debt service coverage by actual cash flow from the property, satisfactory participation levels in annual and residual income and value, a proper conversion option and creditworthy borrowers. In order to be classified as equity real estate, equity-oriented debt investments should be structured to provide more than a 25% participation in net cash flow or sales proceeds.
TRADITIONAL DEBT: PSERS may, as a part of its real estate program, make traditional mortgage loans (straight debt without significant equity participation features) with the intention to enhance current portfolio cash yields. Such investments should be secured by first mortgages on real estate bearing either fixed or floating interest rates. The underwriting of such mortgage loans shall include the same structuring features enumerated above for equity-oriented debt and consideration for a cash yield premium to reflect the lack of significant or any participation features. Debt that is structured to provide 25% or less participation in net cash flow or sales proceeds will be classified as traditional debt.

EQUITY/DEBT COMBINATIONS: Equity/debt combination investment opportunities will be underwritten according to PSERS' requirements for both ownership and mortgage loan investments. Such investments may include investment positions as both an owner and lender in the same asset, separated equity and debt positions in a portfolio of assets or land ownership and leasehold lending for one or more specified assets.

JOINT VENTURE: Properly structured joint ventures, defined as any asset of which less than 100% is owned by PSERS, may also be considered. The underwriting of such an investment will include an analysis of the joint venture partner(s) in addition to the normal underwriting of a proposed transaction.

PROPERTY STATUS

PSERS may invest in the following stages of a property's investment life cycle:

OPERATING: PSERS has a preference for investing in operating properties. Operating properties refer to those properties that have a physical and financial record and are substantially (80% or greater) leased. Such properties have typically experienced at least one full tenant leasing cycle and have a relatively mature tenant mix.

LEASING: PSERS may consider properties that are in the leasing stage of the investment life cycle. Properties in the leasing stage are defined as being fully completed and ready for occupancy but not fully occupied (less than 80% leased). Acceptance of a relative degree of risk of properties in the leasing cycle should be offset by overall yield potential and fulfillment of other portfolio objectives. Typically, guarantees or other financial instruments will be a PSERS' requirement to reduce leasing risk.

DEVELOPMENTAL: PSERS may consider developmental properties, defined as those under construction or in a pre-construction phase. Typically, appropriate financial guarantees will be required to avoid or minimize developmental and leasing risk.

RE-DEVELOPMENTAL: PSERS may consider rehabilitative or redevelopment properties, defined as those typically having functional and/or economic obsolescence to the extent that correction of these conditions can create a meaningful economic improvement for the property.
OPPORTUNISTIC: Appropriate for inclusion in PSERS' investment criteria are opportunistic or "value-added" properties that may not fall into the foregoing property status categories. Such properties are defined as those whose current financial condition and value may be substantially enhanced by innovative asset management and/or financial structuring techniques.

For developmental re-developmental and opportunistic properties, PSERS may consider the issuance of forward purchase or funding letters. Such commitment letters should contain stringent completion, occupancy and cash flow achievement and require funding within a specific time period from the date of the issuance of the commitment letter. PSERS shall attempt to receive a satisfactory, non-refundable commitment fee for such forward commitments.

TENANT MIX

A reasonable mix of national credit tenants, regional or local credit tenants and other local tenants is typically necessary for all property types except residential, land, timber and agriculture. It is mandatory to create and maintain an appropriate balance of tenant types.

Investment in single-tenant properties is included in PSERS' investment criteria, but such properties must typically generate highly competitive immediate cash yields. Emphasis will be placed on properties (excluding timber and agriculture) with a design and location conducive to conversion to multiple tenant use at the time of lease expiration.

PROPERTY LOCATIONS

PSERS' real estate investments will be diversified across economic regions to allow for competitive portfolio performance in the event of a temporary weakness in any one region and to allow for differing urban and suburban market trends within any metropolitan area.

Economic region diversification will include consideration of New England, MidAtlantic, South, Industrial Midwest, Central Plains, Energy States, Pacific Southwest and Pacific Northwest locations.

Typically, PSERS will limit its investments in any one Primary Metropolitan Statistical Area (PMSA) to ten percent (10%) of the total investment value of its real estate portfolio. However, exceptions may be made for the metropolitan areas of Philadelphia and Pittsburgh, Pennsylvania.

After the establishment of a broad economic regional mix within the portfolio, preference may be given to investments throughout Pennsylvania consistent within the content of this Policy Statement.

PSERS may consider investing in real estate located in countries other than the United States. However, criteria and other requirements for foreign real estate are not included herein. No foreign investment may be consummated until the adoption by PSERS of an expanded Policy Statement specific to foreign real estate investment and management issues.
PROPERTY TYPES

The property types that PSERS may consider are:

OFFICE: Acceptable subcategories within the office property type include low-rise business/technological parks, mid-rise properties, and high-rise buildings. PSERS shall pursue office properties located in central business districts, suburbs of major urban areas and infill sites.

RETAIL: Shopping centers acceptable for investment include regional malls, mini-regional malls, community centers, and (on a very selective basis) neighborhood centers.

Provided appropriately strong asset management is available, PSERS shall give priority to investing in shopping centers which have strong occupancy but may be in need of revised tenant mixing, cosmetic improvements and more innovative management, and which have the potential for expansion.

Full-line shopping centers, rather than specialty, off-price or discount only centers, shall receive investment priority.

INDUSTRIAL: Industrial properties acceptable for investment include industrial parks and buildings located within industrial parks, rather than free-standing buildings. Uses may include light manufacturing, warehouse, research, incubator space, self-storage and combinations of the foregoing with office space.

RESIDENTIAL: The preferred type of residential real estate is multi-family housing. Rental projects under consideration shall have appropriate tenant restrictions in place without being discriminatory as to race, religion, color, national origin, physical handicap, medical condition, marital status, sex or age.

Such properties shall typically have histories of producing relatively stable income streams, evidencing an ability to increase income over time at rates greater than the then-current inflation rate. In addition, primary consideration will be given to those properties located where there is no threat of rent control and which have obtained preliminary governmental approval for future conversion to ownership housing.

A subcategory of residential real estate that may be considered is retirement housing.

MIXED-USE: Such properties are defined as those with more than one use and which are of greater overall economic value than the sum of the values of their individual uses. They shall be underwritten based on PSERS’ requirements for all separate uses contained therein.

LAND: Two categories of land are included in PSERS’ investment criteria: land under existing income producing improvements and undeveloped land.

First priority will typically be given to land under existing, income producing improvements or improvements under construction. Preferably a land lease shall not be subordinated to debt on the improvements (with the exception of PSERS’ own debt), thus allowing a priority cash distribution.
The second category of acceptable land is land in the predevelopment stage, but only under a strict set of conditions. Such land transactions shall be structured so that PSERS has the alternatives of retaining the land under a ground lease, selling the land to a development or other holding entity, participating in the future development process or subdividing and selling all or a part of the property.

AGRICULTURE: Acceptable agriculture properties include farmlands of good quality located in primary farming regions contiguous to well-established agricultural infrastructures. Emphasis will be given to properties with traditional row crops and common permanent crops.

Acceptable investment properties should have the ability to efficiently and consistently provide above average crop yields. Properties should be of sufficient size to allow an efficient operation and should be of similar size to properties within the local market area.

TIMBER: Acceptable investment properties should include good quality, professionally managed timber that is in close proximity to well-established timberland infrastructure and is of a sufficient size to allow efficient harvesting techniques and operation. Timberland investments may include properties in various timber production life cycle stages.

ENVIRONMENTAL HAZARDS

PSERS will only invest in properties that fully comply with all local, state and federal governmental environmental-related regulations. PSERS may consider properties that are affected by environmental hazards, but only after a satisfactory, systematic evaluation of each prospective investment so affected. Major pre-investment considerations include the potential risks, liabilities, corrective work and costs associated with the presence and management of environmental hazards. The potential risks should be viewed as being self-insured, since the amount of insurance available to cover same is virtually non-existent. Therefore, quantification of potential liability must be made prior to investment.

TRANSACTION SIZES

Individually specified properties shall not generally be less than $10 million of investment size. In the event portfolios are acquired, individual property sizes shall generally be a minimum size of $5 million; however, they may be smaller if all the properties are located at the same site or the property(ies) is(are) within the Commonwealth of Pennsylvania. No individual investment shall typically exceed one percent (1.0%) of the total PSERS' investment portfolio.
TRANSACTION REVIEW AND CLOSING PROCESS

SPECIFIED PROPERTY INVESTMENTS

PSERS’ staff, in conjunction with the Consultant, shall be responsible for the presentation of investment proposals to the Committee/Board.

Origination and Review Process

All proposals by Submitters (or other transaction originators) shall be entered into the PSERS’ Activity Log that shall be maintained by PSERS' Managing Director of Private Markets and Real Estate (MDPMRE). All proposals by the Submitters shall be made in writing. Once said entry has been made, the Submitters shall be protected as the transaction originator. The investment brief shall contain the following major categories of information:

1. Cover Letter
   a) Preliminary summary of the merits of the proposed transaction
   b) Preliminary summary of downside risks

2. Property Profile
   a) Location
   b) Physical description
   c) Age
   d) Summary of major tenants

3. Market Description
   a) A brief assessment of the marketplace including competition

4. Preliminary investment structure
   a) Acquisition price (or loan amount)
   b) Basic transaction terms
   c) Projected closing date
   d) Legal and operational aspects of the investment entity
   e) Preliminary pro forma cash flow for a minimum of ten (10) years from the date of closing, showing all source and types of income and expenses, including all assumptions.
   f) Preliminary projections of initial cash yield and internal rate of return to PSERS on both a gross and net basis.
When the MDPMRE determines that the proposal warrants further consideration, the Submitter shall prepare and deliver to the MDPMRE and Consultant a formal investment package within 45 days of notification. The formal investment package shall contain the following information:

1. An executed letter of intent with the proposed seller or borrower, and/or other correspondence indicating Submitter control over the deal.

2. A statement confirming that the investment is still available on the terms specified in the investment brief.

3. Changes, if any, in the content of the previously submitted investment brief.

4. Risk and return evaluation
   a) Narrative analysis of risk and yield potential from the property's existing and potential economics, leasing structure, physical attributes and location within its marketplace.
   b) Statement of historical income and expenses of the property for a minimum of three (3) years, or since its completion (if less than three years old), preferably audited or certified by an auditor.
   c) Pro forma cash flow for a minimum of ten (10) years from the date of closing, showing all sources and types of income and expenses.
   d) Annual projections of gross and net cash flow to PSERS showing all advisor fees.
   e) Projection of gross and net internal rates of return to PSERS.
   f) Specification of all assumptions utilized in the cash flow projections.
   g) Sensitivity analysis assuming both downside and upside variables in market rents, vacancy factors and terminal capitalization rates.

5. Complete rent roll.

6. A reputable third party Real Estate Consulting firm's review of the property's market area and immediate neighborhood and the Submitter's analysis of the subject property's competitiveness within its market area.

7. Comprehensive description of all physical characteristics, especially as they relate to physical or functional obsolescence.

8. Statement of valuation based on market sales analysis, replacement cost analysis, income analysis, including a valuation conclusion.

9. An analysis of the on-site management and leasing, including fees and capabilities.

10. A preliminary long-term asset management plan, including disposition strategies.

11. Such additional information as may be relevant or necessary, as the Consultant or the MDPMRE may determine.
Approval and Closing Process

After review of an investment package, the Consultant shall inform the MDPMRE of its conclusions and recommendations regarding the investment opportunity.

Upon concurrence by the MDPMRE and Consultant of the validity of an investment opportunity, the investment will be scheduled as an agenda item at the next possible Committee meeting. The MDPMRE may inform the Submitter of preliminary staff level approval of a transaction, but shall indicate to the Submitter that formal approval requires Committee and Board concurrence.

Immediately following Committee approval the MDPMRE shall schedule the investment as an agenda item at the next possible Board meeting. The MDPMRE may inform the Submitter of Committee approval, but shall inform the Submitter that formal approval requires Board action.

Immediately following Board approval, the MDPMRE and Consultant will prepare a formal notice of approval to be sent to the Submitter/Seller, including specification of all conditions of closing. Within ten (10) working days of Submitter's/Seller's receipt of said notification of approval, the Submitter/Seller shall provide in writing to the MDPMRE and Consultant evidence that the Seller of the subject transaction has formally agreed to all PSERS' conditions of closing and shall specify a closing date acceptable to PSERS.

Within 30 days of Advisor receipt of formal notice of approval, Submitter/Seller will prepare or cause to be prepared and delivered to the MDPMRE and Consultant the following:

1. Complete market analysis demonstrating the subject property's competitiveness within its market area.

2. A complete environmental hazard analysis including a preliminary risk management plan.

3. Any other information that PSERS may require as a condition to closing. (PSERS may require, on a case-by-case basis, an independent appraisal.)

At the next Committee and Board meetings following a staff level investment approval, the MDPMRE will submit an executive summary of the transaction. Documents relating to any such investment will be executed in accordance with PSERS' standard policy, i.e., by any 2 of the individuals holding the following positions: Executive Director, Chief Investment Officer or Assistant Executive Director.

The MDPMRE will request that the Deputy Chief Counsel - Investments request that the Pennsylvania Office of General Counsel designate outside legal counsel experienced in real estate to assist in the closing. This process will be under the direct supervision of PSERS' Chief Counsel who will be required to sign off as to his or her satisfaction of all legal issues related to the property, the investment structure and the documentation prior to the closing date in order for a closing to occur.

Approved March 13, 2009
Upon completion of the generation, review and approval of all closing checklist items, a letter must be sent by the Seller to the MDPMRE and Consultant stating the following:

1. All conditions to closing have been met (or list all outstanding items and their status); and

2. To the best of the Seller’s knowledge, there have been no changes since the time of approval of any physical property, market area or economic factors which could cause the investment to be of any lower quality than that which was approved or identify any such changes and evaluate its effect upon the proposed investment.

No closing will occur without formal sign-off of the closing letter by the Consultant, MDPMRE and the Chief Investment Officer.

As soon as practical after closing, PSERS’ Legal Division will provide, or cause to be provided, to the MDPMRE a closing binder (or binders) containing all pertinent documentation, approved asset management plans and various exhibits demonstrating performance and operational monitoring and reporting systems. The closing documents will be maintained in the PSERS home office files or at the Pennsylvania Treasury, as appropriate.
SCHEDULE OF FEES FOR EXTERNAL REAL ESTATE PROFESSIONALS

INTRODUCTION

The schedule of fees which PSERS pays to its Advisors, Managers and Consultants is based primarily on the consideration of achieving satisfactory net (after fee) returns and receipt of professional, competent services as required by this Policy Statement. Fees shall be structured with emphasis on:

1. Fair compensation related to the quality of services;
2. Relationship to original cost or fair market value of assets, as objectively determined and/or upon income as PSERS may deem appropriate;
3. Emphasis on asset management, rather than brokerage-type services;
4. Provision of high quality property level as well as portfolio level services;
5. Implementation of long-term asset management plans designed to maximize value over entire anticipated asset holding periods;
6. Potential for unbundling services, as appropriate, property by property;
7. Ability to terminate services without penalty fees.

ADVISOR AND MANAGER FEES

It is PSERS' intent to retain flexibility to negotiate fee schedules that make distinction among services provided by differing Advisors or Managers, differing investment strategies and differing investment structures.

Although PSERS' fee schedules may require breakpoints based on transaction sizes, amounts of capital invested or the size of any Advisor's/Manager's PSERS portfolio, emphasis will be placed on the need to manage each asset on a property-by-property basis.

Advisor compensation shall be determined on an individual contract basis, and Manager fees shall be governed by the terms of commingled fund documentation approved by PSERS in advance of funding. Advisor and Manager fees may be "flat" or "performance based." For the latter fee structure, it is PSERS' intent to structure performance-based fees to achieve the following:

1. Minimize or eliminate front-end "load";
2. Minimize ongoing annual fees until a negotiated "threshold" return has been received by PSERS;
3. Advisor/Manager participation in profitability only after the threshold return has been received;
4. Definition of the threshold return expressed in real (inflation adjusted) terms;

5. Definition of achievement of the threshold return at a portfolio, rather than individual deal level.

**CONSULTANT FEES**

Consultants shall be paid on a retainer fee basis as determined by the terms of a negotiated consultant contract. The Consultant shall not typically be paid on any basis related to the following:

1. Closing of individual transactions;

2. Asset management services;

3. Performance of the PSERS’ real estate portfolio or individual assets therein;

4. In any other manner that would conflict with advisory or managerial services and fees paid to Advisors and Managers.
ASSET MANAGEMENT AND POLICY PROCEDURES STATEMENT

INTRODUCTION

The term "asset management" as it pertains to PSERS’ real estate investment program encompasses all activities relating to the operations of acquired or financed specified property real estate investments.

RESPONSIBILITIES

Asset Managers may be authorized by the MDPMRE to:

1. Recommend annual operating and capital budgets for property assets.
2. Execute property level contracts with service providers.
3. Recommend or select special project professionals such as engineers, appraisers and property managers.
4. Negotiate proper insurance coverage.
5. Ensure that all property level taxes and assessments are paid on a timely basis.
6. Approve and execute contracts for capital improvements on any property that are in accordance with a budget previously approved by PSERS.
7. Approve and execute leases that are consistent with the leasing guidelines contained in the annual business plan.
8. Recommend property disposition strategies and opportunities for properties under their management.
9. Provide property level operational and economic information as required by the MDPMRE to facilitate appraisal, audit and reporting practices.
10. Protect and defend PSERS’ interests in any property as may be warranted by any event of an emergency or extenuating nature.

The MDPMRE shall:

1. Review and authorize annual operating budgets for all property assets.
2. Review and authorize capital budgets for all normal capital budget items for each property. Normal capital budget items include lease-related tenant improvements, leasing commissions, and other capital expenditures related to the ongoing and routine maintenance of the property.

Approved March 13, 2009

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3. Together with the Chief Investment Officer, approve budgets for extraordinary operating and capital items as recommended by Asset Managers for amounts not to exceed PSERS’ annual expenditures of $5 million per property. The MDPMRE shall be responsible for giving written notice of such approvals to the Executive Director.

4. Approve for execution all property management and leasing agreements, modifications and amendments.

5. As circumstances warrant, select, or approve external Asset Manager selection of, special project professionals such as engineers, appraisers and property managers.

6. On recommendation by the Consultant and with concurrence of the Chief Investment Officer, take such action as may be necessary to enhance, protect or preserve the Fund's real estate assets when a decision cannot be postponed in order to seek Board approval.

7. On recommendation by an Advisor and concurrence by the legal office or appointed counsel, take such action as may be necessary to enforce the rights and remedies of the Board to the fullest extent of the law and/or otherwise available under the Board's mortgage and other real estate documentation.

8. Report to the Committee and Board on actions taken under these and other delegations of authority that may have significant effect on the value of any real estate asset or the real estate portfolio.

9. Make certain that the appropriate types and levels of insurance are in force at all properties to include multi-peril, general liability and rental income recovery; that Asset Managers have in force appropriate levels of errors and omissions insurance; and that Property Managers have in force reasonable levels of liability insurance -- all of which should be evidenced by appropriate certificates of coverage on file in PSERS' offices.

10. Supervise external Advisor, Manager and Consultant compliance with all requirements of this Policy Statement.

Board approval shall be required for the sale, refinancing, retirement or other substantive changes of all or any fractional ownership or other interest in any property asset or investment position.

PRELIMINARY POLICIES AND PROCEDURES

The MDPMRE and Consultant shall prepare or caused to have prepared preliminary asset management policy statements during the transaction review and closing process prior to funding or non-conditional commitment to fund any property investment.

A preliminary asset management policy and procedures statement will include:

1. Identification of potential property managers and leasing agents.

2. Structures of leases.
3. Environmental risk management plan.
4. Market positioning related to competitive properties and other market influences.
5. Reporting timing procedures and methodology.
6. Preliminary disposition strategies.

**ASSET MANAGEMENT POLICIES AND PROCEDURES**

Within forty-five (45) days from the date an asset is transferred, the Advisor or Manager shall provide the MDPMRE and the Consultant with an asset management policies and procedures plan.

The plan must be updated by the Advisor and submitted for the review by the MDPMRE within 45 days of each calendar year-end. Annual asset management review meetings will be scheduled with the MDPMRE (or his staff) and the Advisors. At the direction of the MDPMRE, the Consultant may be required to assist in reviewing the plan.

The plan will contain the following sections:

- Property Summary
- Investment Objectives
- Market Summary
- Property Management and Leasing
- Physical Property Review
- Asset Evaluation
- Operating and Capital Budgets and Financial Comparisons
- Hold/Sell Recommendation and Disposition Plan

The contents of each section are described below:

**Property Summary:**

The property summary is a one page summary that includes: a brief description of the site and the improvements including parking and rentable area; most recent property valuation and occupancy information; and identification of any critical issues or events that may significantly impact the value of PSERS' investment.

**Investment Objectives:**

Investment objectives identify the major long-term (more than five years) intermediate-term (two to five years) and short-term (one year) goals for the property. An estimated time frame for achievement of each goal must be specified.
Market Summary:

The market summary discusses overall leasing, occupancy and purchase/sales activity within the market area. It also identifies major competitive projects and their physical and financial characteristics. These characteristics may include: location, condition, ingress/egress, amenities, physical appearance, occupancy lease rates and value.

Property Management and Leasing:

This section establishes guidelines for new leases considering market conditions and the competitive position of the property. Guidelines must be established for rent levels, building and tenant improvements, leasing commissions and rental concessions. Parameters may be segmented for different sections of the property (e.g. storage space, high-rise office and ground floor retail). The marketing and tenant retention strategies must be discussed including specific leasing and occupancy goals and the methods that will be used to achieve them. The tenant Retention Strategy must specifically identify leases expiring over the intermediate-term (five year period) and the Advisors planned activities tenant retention strategies must be discussed including specific leasing and occupancy goals and the methods which will be used to achieve them. The tenant Retention Strategy must specifically identify for renewal of those tenants. Tenants that have decided not to renew must be specifically identified and a brief explanation provided.

Physical Property Review:

Based on the Advisor's site inspections, this section describes the physical condition of the property and its major systems (e.g., HVAC, elevators, landscaping, etc.). Necessary and planned improvements are discussed including the status of construction in progress. Planned testing for environmental hazards must be mentioned, with any existing or potential environmental hazards specifically identified. The actions taken or planned to abate the hazard must be explained including an estimated time frame for completion of the abatement.

Asset Evaluation:

This section evaluates the strengths, weaknesses, opportunities and threats for the property. It also identifies the property's relative position compared to its major competition.

Operating and Capital Budgets and Financial Comparisons:

Operating and capital budgets will be based on calendar years and shall be prepared for each property in substantial compliance with Exhibit II. The presentation will include a comparison with the prior year's budget and actual activity of the prior year. All line items shall be reported on an accrual basis meaning that income is recorded as it is earned and expenses as they are incurred. As necessary, explanatory notes shall be incorporated into the budget presentation.

Hold/Sell Recommendation and Disposition Plan:

The Advisor will explicitly recommend that PSERS either hold or sell the asset. The recommendation may be different for portions of an investment (for example it may be
recommended that one building be sold from an industrial park owned by PSERS). The reasons for the recommendation must be discussed with sufficient analysis to support the hold/sell recommendation. The analysis should include a discounted cash flow of the investment over its anticipated holding period.

In addition to the hold/sell recommendation, the asset management plan will include an investment disposition plan with the following elements at a minimum:

- Projected timing of sale that would maximize PSERS' holding period return
- Anticipated structure of disposition (outright sale, partial sale, etc.)
- Identification of potential buyers - by type, or identity, if possible
- Process for implementation of disposition decisions including the use of brokers, engineers and other professionals
- Estimated sales proceeds, costs of sale and net disposition proceeds
- PSERS' projected internal rate of return over the projected holding period

REPORTING

External Reporting:

Property Managers and Leasing Agents:

- Advisors will establish monthly reporting guidelines for Property Managers and Leasing Agents.

Advisors:

Within 45 days of each calendar quarter, the Advisors will provide the MDPMRE with a report on each investment containing the following:

- Property summary including property name, address, occupancy, and a brief description of its improvements and the investment structure
- Current value accrual basis financial statements including a statement of Assets and Liabilities, and a Statement of Operations comparing the current period and year-to-date activity to budget
- Litigation report summarizing the status of any current of potential litigation
- Update on the progress of each property in relation to its asset management plan goals and objectives specifically commenting on:
  - Marketing conditions (occupancy levels and trends, leasing and sales activity, etc.)
  - Property occupancy and leasing activity
  - Status of planned capital expenditures including environmental hazard abatement projects

Approved March 13, 2009
• Critical factors or events that have significantly influenced or may potentially influence the investments performance
• Recommended changes to the asset management plan

• Explanation of material variances comparing the current quarter actual activity to budget for the following line items:
  • Effective gross income
  • Total operating expenses
  • Tenant improvements
  • Leasing commissions
  • Building improvements
  • Debt service

A material variance is defined as actual activity that varies by more than 10% of budget in either direction.

• Calculated gross (before Advisor fees) and net (after Advisor fees) returns to PSERS

• Notes to all financial statements, including summary of encumbrances and co-venturer interests

• In addition, such other reports as PSERS may require.

The Consultant:

Each calendar quarter the Consultant will prepare on an accrual basis an operating and status report on the entire PSERS' real estate portfolio. The report will be submitted to the MDPMRE.

The report will contain the following information:

1. Executive summary
2. Current investment value of individual investments and the portfolio
3. Economic performance of individual investments, commingled funds and the portfolio, in terms of yields and returns:

   a) Time weighted
      1) Current quarter
      2) Last four quarters

   b) Dollar weighted
      1) Schedule of capital in/cash out
      2) Internal rate of return

   c) Components of yields
      1) Cash flow
      2) Appreciation

4. Portfolio composition characteristics summary by:

   a) Property types
   b) Property locations
   c) Investment structures
   d) Investment values
   e) Property values
   f) Property life cycle stages

The Consultant's quarterly reports will be delivered to PSERS within 90 days of the end of each calendar quarter. However, the reports will not be due to PSERS prior to thirty days from the Consultant's receipt of all information from the Advisors necessary to accurately prepare the report.

When requested by the Chief Investment Officer and/or PSERS compliance staff, a complete listing of all holdings, pending trades, transaction history and any additional related information should be provided.
AMENDMENTS AND REVIEW

It is the Board’s intention through the Consultant and investment staff to review portfolio manager compliance with this document quarterly, and if the guidelines are changed in any way, the foregoing will be so amended.

In the application and implementation of the Investment Objectives and Guidelines, the Chief Investment Officer has the authority to narrow or broaden the guidelines to meet individual portfolio needs and to determine the appropriateness of any investment. All changes will be reported to the Finance Committee at the next regularly scheduled meeting.

If at any time the portfolio manager feels that the objectives cannot be met, or the guidelines constrict performance, the Chief Investment Officer should be notified in writing. The manager is encouraged to suggest changes in these guidelines at any time. By signature the portfolio manager agrees to these Investment Policy Statement, Objectives, and Guidelines and shall perform in accordance herewith.

_______________________________________________________________
Company Name

Pennsylvania Public School Employees’ Retirement System

_______________________________________________________________
Portfolio Manager Signature

Chief Investment Officer

_______________________________________________________________
Portfolio Manager Name

_______________________________________________________________
Date Accepted     Date Proposed

Approved March 13, 2009

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EXHIBIT I

CONFLICT OF INTEREST CLEARANCE FORM

(INVESTMENT ADVISOR)

This Conflict of Interest Certificate ("Certificate") is given by ________________________________ ("Advisor") in favor of the Pennsylvania Public School Employees’ Retirement System ("PSERS"), pursuant to the Advisory Agreement ("Agreement") dated as of ________________, by and between Advisor and PSERS in connection with Advisor acting as investment advisor to PSERS for PSERS purchase of certain real property located at ________________________________ (the "Property").

Adviser hereby represents and warrants to PSERS as follows:

1. No Interest In Property Or Benefit From Acquisition. Neither Advisor, its affiliates and other related entities nor any of its agents, officers or employees has received or will receive, directly or indirectly, any benefit from the Property, or from the purchase of the Property by PSERS, other than the acquisition, asset management and property liquidation fees set forth in the Agreement.

2. No Relationship With Seller. Except as otherwise disclosed in writing by Advisor to PSERS, Advisor, its affiliates and other related entities have no agreement or arrangement respecting the Property with the seller of the Property or with any broker or any other person or entity, and Advisor, its affiliates and other related entities have no direct or indirect ownership interest in said seller.

3. No Knowledge Of Conflicts Of Other Parties. Advisor has no knowledge of any of the matters described in this Certificate with respect to any member of the Committees of PSERS, or employee or internal investment contractor of PSERS.

IN WITNESS WHEREOF, Advisor has executed this Certificate, and hereby certifies the foregoing to be true and correct under penalty of perjury, as of the ______ day of _____________, 19____.

___________________________________________________
By: _______________________________________________
### ANNUAL OPERATING BUDGET

Property Name: 

**Budgeted Period:**

**Income:**

- **Base Rent (by property type):** 
- **Escalations (by property type):** 
- **Percentage Rents (by property type):** 
- **Expense Recovery:** 
- **Parking Income:** 
- **Interest:** 
- **Participation Income (participating mortgage loans):** 
- **Miscellaneous Income:** 

**Total Income:** $________

**Operating Expenses:**

- **Taxes and Insurance:** 
- **Utilities:** 
- **Salaries & Payroll:** 
- **Maintenance & Repairs:** 
- **Supplies:** 
- **Contract Services:** 
- **Marketing:** 
- **Administrative:** 
- **Legal/Professional (includes audit and appraisal):** 
- **Property Management:** 
- **Owner Costs:** 
- **Ground Rent:** 
- **Reimbursable:** 
- **Miscellaneous:** 

**Total Operating Expenses:** $________

**Income Less Operating Expenses (before Advisor fees):** $________

**Advisor Fees:** $________

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*Approved March 13, 2009*
ANNUAL OPERATING BUDGET

Income Less Operating Expenses (after Advisor fees) $_____

Debt Service:
  Interest expense $_____
  Principal repayment

Total Debt Service $_____

Capital Expenditures:
  Tenant Improvements $_____
  Building Improvements
  Leasing Commissions $_____

Total Capital Expenditures $_____

Net Cash Flow: $_____

Approved March 13, 2009