I. OBJECTIVES

This actively managed mortgage and asset backed securities portfolio will consist exclusively of non-agency RMBS securities and cash equivalents. The objectives of this portfolio are:

1. to generate positive absolute net of fee performance of one-month LIBOR plus 2.00% or more annually; and,
2. to generate those excess returns with an Information Ratio of 0.30 or greater over a rolling 3-year period (hurdle rate for this calculation will be one-month LIBOR).

II. PORTFOLIO RISK MANAGEMENT

The Board’s expectations are that this portfolio be actively managed within the spirit of a short duration non-agency Residential Mortgage Backed Securities mandate. Within this framework, the following are the portfolio risk constraints under which the manager is required to operate:

A. Interest Rate Risk

1. The effective or option-adjusted duration of the portfolio must range from zero to no more than 1.0 years.
2. No more than 40% of the portfolio at market value may be invested in securities with a fixed rate coupon.

B. Spread Risk

The effective or option-adjusted spread duration of the portfolio must be less than 3.5 years.

C. Credit Risk

1. The weighted-average credit rating of the portfolio must be Baa1/BBB+ or better.
2. No more than 33% of the portfolio at market value may be invested in securities with ratings below Baa3/BBB- (including non-rated securities).
3. No more than 20% of the portfolio at market value may be invested in non-rated debt securities.

4. No more than 25% of the portfolio is permitted to be invested in non-agency RMBS that is below the senior or super-senior portion of the capital structure.

Note: Credit ratings shall include ratings issued by Moody’s, Standard & Poor’s, and Fitch Investor Service (hereafter referred to as the “Credit Rating Agencies”). If each of the Credit Rating Agencies assigns a credit rating, the credit rating will be the middle of the three ratings (for example, if Moody’s rates a security Baa2, S&P rates a security BB+, and Fitch rates a security BBB-, the middle credit rating would be considered BBB- by Fitch). If only two of the three Credit Rating Agencies assign a credit rating, the credit rating will be the lower of the two. If only one of the Credit Rating Agencies assigns a credit rating, that credit rating will apply.

The rating for the internally-managed PSERS Short-Term Investment Pool is considered Aaa/AAA for credit rating purposes.

D. Currency Risk

1. At no time may the manager’s portfolio invest in securities denominated in foreign currencies.

E. Sovereign Risk

1. None of the portfolio may be invested in non-U.S. securities.

F. Concentration Risk

1. No more than 40% of the portfolio at market value to any single RMBS Servicer in the portfolio.

2. No more than 10% of the portfolio at market value invested in RMBS securities of any one issuing trust.

G. Derivative Counterparty Risk

1. The commercial and investment banks used for approved OTC futures and approved OTC options must be rated A3 or better by Moody’s Counterparty Ratings, (if not rated by Moody’s, then rated A- or better by Standard and Poor’s Counterparty Ratings or rated B or better by Fitch’s Bank Individual Ratings).

2. Futures contracts and option exposures to any counterparty will not exceed 20% of the market value of the portfolio. Exposure is
measured in net U.S. dollar equivalent terms (offsetting contracts will be netted for this purpose).

3. Counterparty limits will not be applied to listed futures and options.

H. Liquidity Risk

Positions in letter stock, private placements (excluding 144A securities, B-Notes, and Mezzanine Loans), physical real estate, physical commodities, and any other positions unable to be liquidated promptly without severe market impact are prohibited.

III. DERIVATIVES

The portfolio is permitted to establish and maintain long and short positions in:

1. Listed options on fixed income futures;
2. Fixed income forward commitments, including mortgage dollar rolls; and
3. Listed fixed income futures contracts.

Fixed income derivatives may only be used to manage interest rate risk.

IV. AMENDMENTS

A written request to the Chief Investment Officer (CIO) and Deputy Chief Investment Officer (DCIO) should be made if the manager believes that these portfolio risk constraints significantly limit the ability of the manager to achieve the objectives of the portfolio. A written amendment will be issued from the CIO, or the DCIO in the CIO’s absence, if the request is approved.