


Commonwealth of Pennsylvania Public School Employees' Retirement System

DATE: March 6, 2008

SUBJECT: Investment Policy Statement, Objectives, and Guidelines

TO: Members of the Board

FROM: James H. Grossman, Jr., CPA, CFA 
Director of External Public Markets, Risk & Compliance

At the Finance Committee meeting on March 6, 2008, we will present for your approval modifications to the Investment Policy Statement (IPS). We revised three definitions and added a definition for the Credit Suisse High Yield Index. We also changed references for the Developmental Fund to the Public Market Emerging Investment Manager Program. In addition to these minor changes, the more significant changes that are recommended for approval are as follows:

1. Exhibit B – page 27 and 28. Updated Asset Allocation to account for the recommended changes to the strategic allocation. The following are the major changes:
 - a. Decreased the Public Market U.S. equity exposure from 27.0% to 22.5%
 - b. Increased the Public Market Non-U.S. equity exposure from 27.0% to 27.5%
 - i. Within Non-U.S. equities, increased the allocation to non-U.S. small cap from 10% of the total to approximately 15% of the total since the new benchmark in Exhibit C for non-U.S. equities contains approximately 15% small capitalization stocks.

Note: The changes in a. and b. above were done to maintain our public market equity exposure close to the global market capitalization weights, although the U.S. will remain slightly overweighted from a strategic asset allocation point. As of December 31, 2007, the split between U.S. and non-U.S. equities, as represented by the MSCI All Country World Index, was roughly 40% U.S. and 60% non-U.S.

- c. Increased the private markets exposure from 11.0% to 13.0%
- d. Increased the total real estate exposure from 8.0% to 10.0%
 - i. Maintained the current 25% public market real estate securities/75% private market real estate split.
- e. Within fixed income, decreased the U.S. fixed income allocation from 12.6% to 8.7% and increased the high yield and opportunistic fixed income allocation from 1.1% to 5.0%. This change was made to allow the Fund to opportunistically take advantage of the current opportunities in various areas of the fixed income market, such as bank loans, residential mortgage backed securities, and commercial mortgage backed securities.

- f. All policy ranges were updated. The major asset class ranges were established using the standard deviations of the asset classes. For the sub-asset classes, a range of +/- 2% was used with the exception of large cap U.S. and non-U.S. equities (+/- 5%) and U.S. micro cap equities (+/- 0.5%).
2. Exhibit C – page 29 – Updated policy benchmark to reflect the following:
 - a. Changed in the Public Market Non-U.S. Equity index from the MSCI ACW Index ex. U.S. (gross dividends) to the MSCI ACW Index ex. U.S. Investable Market Indices (net dividends) effective July 1, 2008. This change addresses a recommendation made by IFS (recommendation IIE-1) during their fiduciary audit that the Fund adopt a benchmark with non-U.S. small cap stocks. Staff is requesting an implementation date of July 1, 2008 to allow for the change in benchmarks at the individual manager level (non-U.S. small cap manager benchmarks will be changed from the S&P/Citigroup indices to the MSCI indices);
 - b. Added a new policy benchmark for High Yield and Opportunistic Fixed Income. We are recommending the Credit Suisse High Yield Index to measure the performance of this segment of the asset allocation
 - c. Adjusted the percentages based on the changes to Exhibit B.

Note: The policy benchmarks will be adjusted as private real estate, private markets, and commodities are funded. Amounts will be adjusted quarterly in 0.5% increments. Amounts will come equally from U.S. and non-U.S. equities until the policy target for non-U.S. equities is reached. Once reached, the entire amount will come from U.S. equity until the policy target for U.S. equities is reached. Once commodities reaches the target of 5%, then the policy index for commodities will no longer be adjusted. The policy index will continue to be adjusted for private real estate and private markets on a quarterly basis, equally from U.S. and non-U.S. equity until each have reached target.

3. Exhibit D – pages 30 and 31. Added the ability for Investment Office Staff to internally manage a portion of the allocation synthetically through derivatives as opportunities arise. There have been times when, due to market dynamics, the Fund can enter into swaps or other structured instruments on favorable terms. During the swap discussion in December, we discussed some of those that we have already exploited in the index funds. An example of a situation we may explore would be an emerging market equity swap priced at LIBOR minus 50 to 100 basis points. In this example, assuming we can earn LIBOR on the cash backing the swap, we can achieve a return of the MSCI Emerging Market Index plus 50 to 100 basis points without any tracking error that we get from our active emerging market managers. Again, we would only enter into these instruments opportunistically and, more importantly, only with credit worthy counterparties on a collateralized basis. Capital for these trades would come from the active public market manager portfolios and would be done on an unleveraged basis. In addition, limits on the amount of these trades permitted by asset class and in total have been included in Exhibit D.

Please contact Alan Van Noord or me with any questions or comments.