Commonwealth of Pennsylvania
Public School Employees' Retirement System

DATE: May 3, 2007

SUBJECT: Recommended Changes to the Developmental Fund

TO: Members of the Board

FROM: Alan H. Van Noord, CFA
Chief Investment Officer

At the May Finance Committee meetings, Luke Jacobs will present his annual review of the Developmental Fund results for the past year. In addition, Luke will present proposed revisions to the existing Developmental Fund Policy. Included in the Finance Committee package are the following:

1. PSERS Developmental Fund Review – the power point annual review that Luke will present;
2. A clean copy of the proposed Public Market Emerging Investment Manager Program Policy;
3. A black-lined version of the transition from the Developmental Fund Policy to the Public Market Emerging Investment Manager Program Policy;
4. A clean copy of the current Developmental Fund Policy; and
5. A resolution for approval of the Public Market Emerging Investment Manager Program Policy.

Investment Office staff has undertaken a review of the Developmental Fund Program during the past six months. That review included comparing our program to that of other pension plan sponsors and revisiting the goals and objectives of the existing program. Our goal during that review was to design a program that would enhance the ability to generate excess returns. The current program has struggled to generate excess returns. We believe part of the reason for the poor performance is the narrow focus of the program on managers in Pennsylvania and minority or women-owned investment management firms. A term you hear a lot in the world of active management is breadth. Breadth provides a manager with more options to generate excess returns and lower risk and therefore providing the manager the opportunity to have a higher information ratio. Expanding the universe of potential managers expands the breadth of the program and enhances our ability to manage a successful program. While Investment Office staff believes promoting diversity in the program is important, we believe our primary goal is to retain managers who generate positive risk adjusted performance over time.

We are proposing a major re-write of the policy with the material changes as follows:

1. Revise the name of the program to the "Public Market Emerging Investment Manager Program" to recognize that PSERS is looking for the best available emerging investment managers.

2. Change the objectives and goals to a performance oriented program with continued preference to Pennsylvania-based, minority-, and women-owned firms as follows:
    a. Look and fund managers with successful histories of generating positive risk adjusted returns;
    b. Provide a source of potential managers for the main fund (a "bench" of potential managers); and,
    c. Assist managers grow through use of PSERS' name in the manager's marketing efforts.
3. Increase the allocation from 1.5% of the Fund (around $950 million) to a flat $1.0 billion;
4. Increase the maximum number of managers from 20 to 25 (however, we envision running with less than 25 the majority of the time).
5. Revise the criteria to participate in the Program into two sections:
    a. Required criteria, such has registration requirements, track record, and size; and,
    b. Preference criteria, including Pennsylvania-based, minority-owned and women-owned firms getting preference. This preference is similar to the Commonwealth's procurement practices that place preference at the end of the process - not at the beginning.
6. Expand the Administration section of the guidelines to provide the Board more insight into how this program will be run. One of the major additions to the process is the creation of an Internal Review Committee (IRC). The IRC will consist of the CIO, the Emerging Manager Portfolio Manager (EMPM), the five Investment Office Directors, and any other Investment Office Staff deemed necessary in the review. The IRC will meet with each prospective manager the EMPM has performed due diligence on and wishes to add to the Program. The IRC will provide the EMPM with feedback on that manager prior to making any final decision. The final decision on whether or not to hire a manager will rest with the EMPM, the EMPM's supervising Director, and the Chief Investment Officer.
7. Participation by any manager in the program is expected to be for three- to five-years after which a determination will be made whether to move them into the main fund, terminate them, or retain them until we have gathered more conclusive results.
8. Change the funding requirements from a fixed funding pattern ($15 million, $10 million, and $10 million for a total of $35 million) to a variable funding pattern of up to $75 million during the manager's participation in the Program. The reason for this change is two-fold. First, the size of the Fund has grown considerably since the program was initiated (from $26 billion in 1994 to over $60 billion today). Second, and most importantly, managers may run at significantly different risk levels. Managers that have lower active risk should have more capital allocated to them than managers with higher active risk if the EMPM desires to balance out the active risk in the Program. The manager with higher active risk will have more impact (positive or negative) than the manager with lower active risk and their account size should reflect that.

Ultimately, staff would like to see more managers graduate from the Program to the main fund. However, we can not stress enough that managers of this size entail a lot of potential business risk, including unsuccessful business plans, uncontrolled asset growth, strategies not proven through an entire market cycle, etc. If we can graduate 10% of the managers into the main fund, we would consider that a success. We will be looking for the diamonds in the rough and hope to be early investors with these managers.

If you have any questions or comments, please contact me at 717-720-4702.