Commonwealth of Pennsylvania
Public School Employees' Retirement System

DATE: August 3, 2007

SUBJECT: PIMCO Conversion

TO: Members of the Board

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

At the Finance Committee meeting on August 3, 2007, we will be recommending the following:

- Conversion of PIMCO's $1.1 billion Enhanced S&P 500 Index portfolio to PIMCO's portable alpha strategies of PARS and GCOF (both discussed below). Since the combination of these strategies has higher returns and higher risk, we will be recommending an allocation of $300 million to this portfolio. The remaining $800 million from the Enhanced S&P 500 Index portfolio would be transferred to the internally managed S&P 500 Index portfolio. In addition, we will handle the beta overlay for this portfolio (S&P 500 Index Futures).

The rationale for this recommendation is to better utilize PIMCO's global research strengths and aims to improve the risk/return profile of this assignment. A brief discussion of PIMCO's Enhanced S&P 500 Index, PARS, and GCOF strategies follows.

PIMCO's Enhanced S&P 500 Index combines equity futures (to replicate the S&P 500 index beta) with active management of money market instruments to produce incremental returns over the S&P 500 Index. Excess returns in the Enhanced Index are generated primarily by:

- Capturing a term premium (duration management);
- Capturing a credit premium (holding lower credit quality instruments);
- Owning securities that are less liquid to capture a transactional illiquidity premium; and,
- Employing strategies designed to benefit from implied volatility premiums.

PARS is an acronym for PIMCO Absolute Return Strategy. PARS was created to address the needs of investors seeking absolute returns, portable alpha, or returns with low correlations to traditional asset classes. PARS potential returns derive from:

- Magnifying the risk allocations of PIMCO model portfolios relative to their benchmark;
- Transporting these potential sources of alpha to LIBOR space; and,
- Using flexible guidelines to enhance PIMCO alpha.

PARS risks are limited by:

- An appropriate set of guidelines and a portfolio mandate that prevents any one strategy from dominating the portfolio; and,
- Factor exposures determined by the PIMCO Investment Committee, including but not limited to, the level of interest rates, the slope of the yield curve, foreign exchange, and sector spreads.

The overall return objective for the PARS V Fund is 1-month LIBOR plus 12 to 18% with a 12 to 18% tracking error (targeting an information ratio of 1.0).

GCOF is an acronym for the PIMCO Global Credit Opportunity Fund. GCOF seeks to deliver absolute returns by taking advantage of opportunities in the broader global credit markets, including ABS, Investment Grade Credit, High Yield, and Emerging Markets. GCOF takes advantage of PIMCO's substantial experience, expertise, and global resources in these areas. This broad opportunity set provides a target-rich environment independent of market conditions for each asset class. Relative value strategies are expected to provide most of the potential returns under normal conditions. Such strategies include, but are not limited to, relative value trades across:

- Sovereign and corporate issuers;
- Parts of an issuer's capital structure;
- Tranches within ABS, CDO, and other structured products; and,
- Maturities within an issuer's credit curve.

The overall return objective for GCOF is to outperform 3-month LIBOR by 6 to 9% with a 6 to 9% tracking error (targeting an information ratio of 1.0).

We believe that PARS and GCOF offer much more breadth than the Enhanced Index, meaning that individually these products have more alpha generating opportunities than the Enhanced Index product and many more when combined.

The proposal is to combine PARS and GCOF in equal weights into one portfolio. This portfolio will have an expected gross excess return of 9.00% with a tracking error of between 7.22% and 8.16% (tracking error varies based on forward expectations of correlations of between 0.2 and 0.6). This results in an expected Information Ratio of 1.1, versus a historical Information Ratio of 0.36 for the Enhanced Index product. PSERS would invest in offshore funds that have administration fees of 20 bps. The management fee for the account would be 1.00% with a 25% performance fee on returns in excess of LIBOR. The performance fee would be subject to a highwater mark. The advantage of having the two portfolios combined into one separate account is that if either strategy underperforms, it reduced the overall performance fee. The weightings to PARS and GCOF would be rebalanced once the allocation reaches 60%/40% due to market movements.

Staff and Wilshire (see attached recommendation) believe that the combination of these two products encompasses the best top down ideas (PARS) and bottom up ideas (GCOF) that PIMCO has to offer. We believe that the conversion of PIMCO's Enhanced S&P 500 Index to this proposal will provide PSERS an optimal portable alpha return solution with a better risk/return profile.

As a point of reference, PIMCO's Enhanced S&P 500 Index portfolio returned 6.51%, net of fees, for the past five years ending March 31, 2007 versus an index return of 6.27%, generating 24 basis points of alpha. Net of fees, this combined solution is projected to generate 600 basis points of alpha.

If you have any questions or comments, please contact me at 717-720-4703.