Commonwealth of Pennsylvania
Public School Employees' Retirement System

DATE: September 27, 2007

SUBJECT: Investment Review / Investment Structure Recommendations

TO: Members of the Board

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

At the upcoming Finance Committee meeting in September, Bill Bensur from Wilshire Associates will be reviewing the investment results and making, in concurrence with staff, some investment structure changes. The investment structure changes being recommended are as follows:

(1) Investment Manager Mandate Change

We propose changing the currency hedge mandate managed by Pareto. Currently, Pareto has a 100% hedged benchmark for management of the currency hedge. This allows Pareto to add value in weak dollar environments. However, in strong dollar environments, the best they can do is perform at the benchmark gross of fees (below, net of fees). To allow Pareto to add value in strong dollar environments, we propose increasing the notional value of the currency hedge from 30% to 40% while decreasing the hedge ratio from 100% to 75%. Overall, the currency hedge will remain targeted at 30% of the non-U.S. equity exposure (40% x 75%). However, Pareto will then have the ability to add value in strong dollar environments by hedging up to 40% of the non-U.S. equity exposure back to U.S. dollars.

(2) Investment Manager Transition

On July 9, 2007, an agreement was reached between Logan Circle Partners and Delaware Investments to transition 31 Delaware fixed income professionals to Logan Circle effective October 31, 2007. Logan Circle was founded by Jude Driscoll, former CEO and President of Delaware. Included in this transition is the senior management team currently managing our U.S. core plus fixed income portfolio. This team was originally at Conseco before moving to Delaware and has had an excellent track record. PSERS hired Delaware in March 2005, and their performance since inception is up 4.76% vs. a 4.19% return for the Lehman U.S. Universal Index.

(3) Investment Manager Terminations

On July 18th and 19th, staff from PSERS met with Wilshire and conducted a thorough strategy review of the public market investments. Based on this review, we recommend the following:

i. In U.S. equities, terminate Mellon Equity's active DJ Wilshire 4500 portfolio and Wellington Management Company's active Russell 2000 portfolio (the latter otherwise known and the Small Cap 2000 portfolio) due to performance;
ii. In non-U.S. equities, terminate The Boston Company's active MSCI ACWI ex. U.S. portfolio due to performance and in order to reduce active management in this composite. In conjunction with this termination, we will be increasing the internally-managed passive non-U.S. equity target from 30% to 50%; and
iii. In U.S. TIPS, terminate Brown Brothers Harriman due to performance and move the assets to the internally-managed TIPS portfolio.

(4) Loan Fund Recommendation

The recent turmoil in the fixed income markets has created some opportunities for long-term investors such as PSERS. While the turmoil began in the sub-prime mortgage sector, it has spread to other areas of the market, including bank loans. Bank loans are generally secured bank debt representing the highest priority over claims in a company's capital structure. Bank loans are also floating rate debt; therefore, there is very little duration risk since the floating rate resets quarterly. According to a recent estimate by Goldman, Sachs & Co., the backlog in the bank loan market currently stands at about $165 billion. When the high yield bond market is included, the backlog of debt waiting to be placed grows to over $300 billion. Several large underwriters are carrying funded bridge loans on their balance sheets. As underwriters have become concerned about the liabilities associated with these deals, they have approached large money managers, such as Oaktree Capital Management, to reduce their exposure. The opportunity for PSERS is to invest in a loan fund managed by Oaktree to take advantage of buying bank loans and other senior debt instruments at significant discounts to their underlying value. As you may recall, PSERS recently approved an investment into Oaktree's distressed debt fund. This fund is structured to take advantage of this opportunity which is different from opportunities afforded to it in their distressed debt and high yield funds.

PSERS staff and Wilshire recommend the following:

i. Commit $350 million to the Oaktree Loan Fund 2x, L.P. This fund will have the ability to leverage its investments in bank loans and other senior debt instruments up to 2 times. However, there is no guarantee that they will be able to obtain this type of leverage. The return estimates, net of fees, for this fund will range from LIBOR plus 280 bps assuming no leverage to LIBOR plus 700 bps assuming full use of the leverage allowed. The opportunity in this segment of the market is over the short term. As such, the investment term for this fund is 1 year. Initial closing of this fund was September 13, 2007; however, they will be having a second closing in October for funds such as PSERS.
ii. Actively manage the duration of the investment in this fund with derivative instruments. This allocation will be included in the U.S. fixed income composite. As noted above, this portfolio has essentially no duration. The duration mismatch to the Lehman U.S. Universal index will be corrected by using derivative instruments to increase the duration of this investment to the duration of the Lehman U.S. Universal index. This correction will be done by PSERS Managing Director of Fixed Income. Therefore, the expected return, net of fees, is estimated to be the Lehman U.S. Universal index plus between 280 bps and 700 bps.

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