Commonwealth of Pennsylvania
Public School Employees' Retirement System

DATE: December 12, 2007

SUBJECT: Investment Review / Investment Manager Recommendations

TO: Members of the Board

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

At the upcoming Finance Committee meeting in December, Bill Bensur from Wilshire Associates will review the investment results and make, in concurrence with staff, the following public market investment manager recommendations:

(1) BlackRock LIBOR Separate Account Portfolio

As we have gained exposure to the equity markets via swaps, the cash collateral backing those swaps has been invested in an internal LIBOR-Plus portfolio managed by Mark Heppenstall. He recently reached $2 billion in net assets in this portfolio and feels that he is at maximum capacity. In order to allow the internal portfolio managers to continue exploiting opportunities in the swap markets, we need to hire an additional manager to manage a cash account against a LIBOR benchmark. We recently interviewed a number of managers with Wilshire, and we recommend hiring BlackRock to manage a separate LIBOR-benchmarked account. BlackRock currently manages approximately $18 billion in LIBOR-benchmarked portfolios and has a good long-term track record.

(2) Boston Company U.S. Micro Capitalization Growth Absolute Return Equity Fund

In a continuing effort to identify unique sources of alpha generation, we recommend purchasing $200 million of this long/short micro capitalization equity fund. The fund is managed by Randy Watts, the portfolio manager who has been managing a long-only Russell 2000 growth portfolio for PSERS since 2000. We are familiar with Randy and his team and feel that this product is a good source of alpha generation due to the inefficiencies of the micro cap equity universe. The fund has a hard capacity of $300 million. Assets in excess of $300 million will be returned to the investors. PSERS will overlay the alpha generated by this fund with S&P 500 Index futures. The management fee will be 1% annually with a performance fee of 20% of the return in excess of the 3-month Treasury Bill Rate, subject to a high water mark.

(3) Opportunistic Debt Opportunities

We have been underweight fixed income over the past few years as the return prospects versus other assets classes were, in our opinion, poor. However, we now believe that there is an opportunity to deploy capital in fixed income securities with attractive return potential over the next five to seven years. As you may be aware, there have been significant dislocations in the residential and commercial mortgage backed securities, collateralized debt obligation, asset backed security, collateralized loan obligation, and bank loan markets over the past few months. Due to credit market illiquidity, risk aversion, and market wide de-leveraging of investment portfolios, there is an opportunity to purchase these assets at attractive valuations as securities have been sold indiscriminately to raise cash by distressed market participants. This situation is similar to the early part of this decade when the opportunity presented itself in distressed debt funds and the Board approved a 3% allocation to that asset class. This opportunity differs from distressed debt as distressed debt managers tend to acquire single name corporate securities, with the possibility of converting debt to equity in corporate restructurings. This opportunity lies in the ability of the investment manager to analyze the cash flows and collateral backing the underlying securities at the loan level. The Board recently approved a $350 million commitment to Oaktree in a bank loan fund. We recommend hiring the following investment managers to take advantage of the current dislocations in other segments of the fixed income markets:

- Hyperion Brookfield Asset Management, Inc. – allocation of $500 million (0.75% of PSERS' total net assets of the fund with a target range of 0% to 1.25% of the total net assets of the fund) in a separate account dedicated to the management of commercial mortgage backed securities (CMBS), residential mortgage backed securities (RMBS), and asset backed securities (ABS). Hyperion currently manages over $16 billion in CMBS, RMBS, and ABS assets across their firm.

- BlackRock Mortgage Investors Fund – allocation of $500 million in a limited partnership managed by BlackRock Financial Management, Inc. This fund is designed to invest in a portfolio of stressed and distressed RMBS, CMBS and related securities, including collateralized debt obligations. The maximum fund size will be $2 billion, of which they currently have $1 billion in commitments, excluding this recommendation.

- TCW Credit Opportunities Fund – allocation of $250 million in a limited partnership managed by TCW Asset Management Company. This fund is designed to invest across the spectrum of distressed opportunities in the market, including bank loans, collateralized debt obligations, RMBS, CMBS, ABS, etc. The maximum fund size will be $3 billion. TCW has just started marketing this product.

Each of these managers will present to the Finance Committee on December 12th.

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