Commonwealth of Pennsylvania
Public School Employees' Retirement System

DATE: June 19, 2008

SUBJECT: Quarterly Investment Review/Investment Structure and Investment Manager Recommendations

TO: Members of the Board

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

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At the Finance Committee meeting in June, Gerry Smith, Managing Director of Equities, and Bill Bensur from Wilshire Associates will be reviewing performance for the quarter ending March 31, 2008. For the quarter, the Fund returned (5.16%), trailing the policy benchmark return of (4.40%) by 76 basis points. This return placed the Fund at the 58th percentile during the quarter in Wilshire's database. Our one year return was 3.28%, 74 basis points ahead of the policy index and at the 20th percentile in Wilshire's database. Active management continued to have a difficult time during the quarter generating much of the underperformance versus policy. As Gerry will discuss during his presentation, the Fund has a high correlation with the S&P 500 Index. Looking forward, staff will continue to seek out sources of return less correlated with equity indexes.

Wilshire and staff are also recommending changes to the investment structure as follows:

(1) Decrease the allocation to U.S. fixed income from 8.7% to 8.0%; and
(2) Increase the allocation to global fixed income from 3.3% to 4.0%.

These changes are recommended to accommodate the hiring of two emerging market debt managers. This represents a continuation of further sub-asset class diversification that staff and Wilshire embarked on a number of years ago. Emerging market debt provides access to economies that are growing faster than developed market economies and exposure to markets with improving credit fundamentals. The two emerging market debt managers staff and Wilshire recommend for the global fixed income allocation are as follows:

- Pacific Investment Management Company (PIMCO) – recommendation to invest $650 million in a newly created fund called the PIMCO World Bank/GEMLOC Fund. GEMLOC is an acronym for Global Emerging Markets Local Currency. The fund is part of the GEMLOC Program which is an exclusive relationship between the World Bank and PIMCO, designed to further the development of the emerging market local bond markets. The GEMLOC program has three separate but complimentary parts:
    - PIMCO to manage investments in local currency bonds;
    - The World Bank to provide advisory services to support policy reforms and strengthen local bond markets; and,

- IFC (International Finance Corporation) has entered into an agreement for the index provider, Markit, to develop a transparent, representative benchmark for local currency denominated debt.

The advantages of this fund will be that PIMCO will be able to gain access to certain markets, such as China and India, where other emerging market debt managers do not currently have access. The fund should also provide certain tax advantages not available to other EM debt managers. The fund is currently in the development phase and PIMCO is hopeful to have it open to investors before the end of the calendar third quarter.

- Stone Harbor Investment Partners LP – recommendation to invest $650 million in a local emerging market debt mandate. Stone Harbor is a traditional emerging market debt manager who has been investing in emerging markets as a team for the past 18 years. The original investment team started at Salomon Brothers Asset Management and ended up starting Stone Harbor in April 2006 as a spin out from Legg Mason. Stone Harbor currently manages over $14 billion in assets, all in fixed income and over half in emerging markets.

In addition, during our search for emerging market debt managers, we interviewed two managers that have LIBOR-based or absolute return type mandates that we believe will add diversification to our portable alpha program. The two managers that staff and Wilshire recommend for the portable alpha program are:

- Franklin Templeton Investments – recommendation to invest $350 million in their Emerging Market Debt Opportunities product. The distinguishing feature of the product is its absolute return approach where they will only invest in countries and securities that they find attractive, regardless of the country's weight in any emerging market debt benchmark. They are targeting 8 to 10% returns per year over a full market cycle.
- Lazard Emerging Income Plus, Ltd. Fund – recommendation to invest $350 million in this fund. This fund also has an absolute return orientation that invests in 55 lowly correlated emerging market countries. The fund itself is leveraged a maximum of 2.3 times (200% long and 30% short). This fund also has a duration profile of less than 12 months.

The other investment manager search completed was for non-U.S. small cap equity managers. We completed this search due to the change in the Fund's Policy Benchmark for non-U.S. equity from MSCI ACW ex. U.S. Index to the new MSCI ACW ex. U.S. Investable Market Index. The new benchmark includes approximately 15% exposure to non-U.S. small cap equity markets, and our current allocation to investment managers is only 8%. Given the capacity constraints in the non-U.S. small cap equity market, a number of our existing managers were closed to both new and existing relationships. As a result of the manager search, staff and Wilshire recommend hiring the following managers:

- Batterymarch Financial Management, Inc.
- Oberweis Asset Management Inc.
- Pyramis Global Advisors
- Victory Capital Management, Inc.
- Wasatch Advisors, Inc.

Wasatch is being hired as a dedicated emerging market small cap equity manager. The purpose for hiring Wasatch for this mandate is that PSERS will have three non-U.S. small cap equity managers (GlobeFlex, Munder, and recommended Victory Capital Management) that invest in EAFE plus Canada small cap equity mandates. This leaves a gap in the small cap emerging market beta exposure.

Finally, staff and Wilshire recommend an investment of $300 million in the BGI Capital Structure Investments Fund Ltd. (CSI). CSI seeks to capture relative value within and across issuer capital structures by going long and short U.S. issuers of large cap stocks and investment grade credit. The target excess return over 1-month LIBOR is 12 -15% with expected excess risk of 12 -15%. Staff and Wilshire believe CSI will be an excellent addition to the portable alpha pool as this fund is expected to have low correlations to equity markets. This is a new BGI fund which has an initial capacity of up to $1.0 billion barring an expansion of markets traded (currently, this fund will primarily trade in U.S. markets). BGI has been going to their larger client relationships to market this fund and staff believes that demand will far exceed capacity and expect that this fund will be closed in less than one year given its attractive risk and return characteristics. BGI will be presenting this strategy to the Finance Committee at the June meeting.

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