

**PENNSYLVANIA PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM  
INVESTMENT OBJECTIVES AND GUIDELINES  
MORTGAGE AND ASSET BACKED SECURITIES PORTFOLIO**

**ADDENDUM K1**

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**I. OBJECTIVES AND GOALS**

This actively managed mortgage and asset backed securities portfolio will consist primarily of MBS/ABS/CMBS securities and loans and cash equivalents.

**Measurement Process**

Performance will be measured on an absolute return basis. Returns are expected to be in excess of 10% per year.

**II. RISK**

The Board judges the question of risk to be categorized into groups of concerns including credit or bankruptcy, liquidity, diversification, and counterparties. These are applied to the market, sectors of the market, and individual issues. To a varying degree, each of these points is addressed implicitly or explicitly in different sections of these guidelines, but for clarity, they are summarized as follows:

A. Credit or Bankruptcy:

*Note:* Unless otherwise noted herein, all references to credit ratings throughout this document shall be read as applying to the ratings issued by Moody's, Standard & Poor's, Fitch Investor Service, and DBRS (hereafter referred to as the "Credit Rating Agencies"). If each of the Credit Rating Agencies assigns a credit rating, the credit rating will be the middle of the three ratings (for example, if Moody's rates a security Baa2, S&P rates a security BB+, and Fitch rates a security BBB-, the middle credit rating would be considered BBB- by Fitch). If four of the four Credit Rating Agencies assign a credit rating, the credit rating will be the third lowest. If only two of the four Credit Rating Agencies assign a credit rating, the credit rating will be the lower of the two. If only one of the Credit Rating Agencies assigns a credit rating, that credit rating will apply.

B. Liquidity - To insure the flexibility necessary to take defensive action when appropriate, positions should be in issues with sufficient float so as to facilitate, under most market conditions, prompt sale without severe market effect.

- C. Diversification - Concentration in any one issue, issuer, industry, issuer sector or geographic area is to be avoided. Adherence to the guidelines documented under III. Portfolio Definition and any amendments thereto will meet the Fund's diversification requirement.
- D. Counterparties - The commercial and investment banks used for approved OTC futures, approved OTC options, or forward/spot currency transactions must be rated A3 or better by Moody's Counterparty Ratings, (if not rated by Moody's, then rated A- or better by Standard and Poor's Counterparty Ratings or rated B or better by Fitch's Bank Individual Ratings). Net forward/spot contracts, futures contracts, and option exposures to any counterparty will not exceed 20% of the market value of the portfolio. Exposure is measured in net U.S. dollar equivalent terms (offsetting contracts will be netted for this purpose). Counterparty limits will not be applied to listed futures and options.
- E. Capital Loss - Preservation of capital is of major concern. It is the manager's responsibility to avoid, or minimize, capital losses.

### **III. PORTFOLIO DEFINITION**

It is required that the account be continuously managed. This does not imply continuous activity. It requires staying current at all times with the objectives of the manager's investment policy for discretionary mortgage and asset backed securities portfolios and the requirements of these Guidelines.

Within that framework, the fact that this portfolio is to be fixed income in nature, and within the following limitations, the manager has the discretion to make portfolio changes to accomplish the stated objectives.

#### **General**

- A. All subsequent references in these guidelines do not apply to issues or issuers fully guaranteed by the United States Government and its agencies rated Aaa/AAA.
- B. At no time may the manager's portfolio:
  - i. have more than 40% of the portfolio at market value to any single RMBS/ABS Servicer in the portfolio (there is no concentration limit for CMBS servicers), or
  - ii. have more than 2% of the portfolio at market value invested in RMBS/ABS securities of any one issuing trust; or
  - iii. have more than 7% of the portfolio at market value invested in the CMBS securities of any one issuing trust; or
  - iv. have any exposure to non-U.S. currencies or securities; or

- v. have more than 25% of the portfolio at market value in collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs).

*Note: These restrictions are to be taken in conjunction with the maturity and credit limits discussed above under "Risk" and below under "Fixed Income Securities."*

## **Cash and Cash Equivalents**

With respect to cash equivalents (securities with maturities of 15-months or under, securities puttable within 12 months at face amount or higher, and variable rate securities that reset at least quarterly), overall quality and risk guidelines apply. Approved for use are: STIF, securities issued by the United States Government and its agencies, certificates of deposit with federally insured banks, bankers acceptances with major money center banks who are members of the Federal Reserve System and insured by the FDIC, repurchase agreements with counterparties meeting the rating guidelines under Counterparties, commercial paper rated P-1, securities rated A3/A- or better puttable at face amount or higher within 12 months, and variable rate securities that reset at least quarterly and are rated A3/A- or better. No single issue used in this section may exceed 7% of the portfolio at market value at any time, (excluding STIF and U.S. Government securities).

## **Fixed Income Securities**

### **Maturity Limits**

All securities must have a final legal maturity of 50 years or less.

### **Duration Limits**

The effective or option-adjusted duration of the portfolio must range from plus to minus 35% of the effective or option-adjusted duration of the Lehman Brothers U.S. Universal Index.

### **Credit Ratings and Limits**

A maximum of 50% of the portfolio at market value may be invested in high yield securities with ratings below Baa3/BBB- (including unrated securities).

## **Derivatives**

### **Mortgage Loan Related Tranches**

Real estate mortgage investment conduit (REMIC) and collateralized mortgage obligations (CMOs) are permissible investments in the portfolio.

### **Options**

The portfolio shall be permitted to establish and maintain long and short positions in listed options on fixed income futures. Options on fixed income futures may only be used for interest rate risk management. In addition, the use of any form of derivative security or investment strategy that effectively leverages the portfolio is prohibited.

### **Forward Contracts**

The portfolio shall be permitted to establish and maintain long and short fixed income forward commitment positions, including mortgage dollar rolls. Fixed income forward commitment positions may only be used for interest rate risk management. In addition, the use of any form of derivative security or investment strategy that effectively leverages the portfolio is prohibited.

### **Futures**

The portfolio shall be permitted to establish and maintain long and short positions in listed fixed income futures contracts. Fixed-income futures may only be used for interest rate risk management. In addition, the use of any form of derivative security or investment strategy that effectively leverages the portfolio is prohibited. All futures trades must be cleared through clearing brokers who have contracts with the Fund.

### **Absolute Restrictions**

Unless otherwise covered in these investment guidelines, all other investments are strictly prohibited without the written permission of the Chief Investment Officer. The following are examples of some of the prohibited types of transactions and is not meant to be an all-inclusive list: leverage of any sort, letter stock, private placements (excluding 144A securities), commodities, etc.