


**Commonwealth of Pennsylvania  
Public School Employees' Retirement System**

**DATE:** May 1, 2008  
**SUBJECT:** Investment Office Incentive Compensation Plan  
**TO:** Members of the Board  
**FROM:** Jeffrey B. Clay   
Executive Director

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Attached for your consideration and approval at the May 1, 2008 Personnel Committee Meeting is the Investment Office Incentive Compensation Plan Policy for the Fiscal Year Ending June 30, 2009. We have made numerous changes to the document from the previous year. New sections have been underlined while superseded portions have been ~~crossed-out~~. While many housekeeping changes were made, there were no changes to the target incentive levels by position level that are shown on page 3 of the Plan. However, if an individual was promoted from one level to another, that individual would be eligible to receive the incentive for that level. For example, if a Senior Level Staff member was promoted to Portfolio Manager, then the potential incentive for this staff member would increase from 35% to 40%.

Attached to this memo is a brief summary of the proposed changes being made to the plan. The following is a more detailed explanation of some of the significant proposed revisions to existing position incentives:

**A. Managing Director of Equities**

The portfolio level incentive for managing the S&P 500 Index portfolio has been eliminated and the portfolio level incentive for the Internally Managed Alpha Generation Program has been increased from 10.0% to 20.0%. This recognizes that responsibility for the management of the S&P 500 Index portfolio is being transferred from Gerry Smith to Chris Baker. Gerry took on the responsibility for the management of this portfolio when Mary Jo Bashore retired. Gerry will maintain supervisory responsibilities over this and the other equity index portfolios. However, Gerry's primary responsibilities will be for the Internally Managed Alpha Generation Program and with assisting Alan and the Managing Directors with macro level alpha idea research.

**B. Managing Director of Fixed Income**

We reweighted the portfolio level incentives by decreasing the incentive for the Lehman Aggregate Bond Portfolio from 17.0% to 15.0% and increasing the incentive for the LIBOR-Plus Short-Term Investment Pool from 1.5% to 3.5% to

recognize the increased size and importance of the LIBOR-Plus allocation. In addition, the incentive targets were revised from + or – 10 basis points of the 3-month LIBOR Total Return Index to earn the full incentive to a scaled incentive from LIBOR flat to LIBOR + 10 basis points to earn the full incentive due to the increased opportunities available to generate excess returns in this asset class.

C. Portfolio Manager: S&P 500 Enhanced Index and Portable Alpha Overlay

We reweighted the portfolio level incentives by decreasing the incentive for management of the Enhanced S&P 500 Index portfolio from 24.0% to 15.0% and creating a portfolio level incentive of 9.0% for managing the S&P 500 Index futures exposure for the Portable Alpha Program as well as the S&P 500 Index Account. This was done to recognize the importance of managing the S&P 500 index futures overlaying over \$3 billion of portable alpha and LIBOR-Plus strategies.

D. Portfolio Manager: S&P 500 Index and Equity and Derivatives Trader

This represents a modification of the current Senior Trader position to include portfolio management responsibilities for the S&P 500 Index portfolio as discussed more fully under the Managing Director of Equity section above.

E. Managing Director of Private Markets

Changed portfolio level incentives to include the total real estate partnership portfolio as well as the private equity, private debt, and venture capital portfolio (previous version only included the latter). The split of the incentives is 13.0% for the private equity, private debt, and venture capital portfolio (reduced from 20% last year) and 7.0% for the real estate portfolio.

F. Portfolio Manager: Core and Value Added Real Estate Portfolio Management  
Senior Investment Analyst: Opportunistic Real Estate Partnership Portfolio

The overall incentive structure for the real estate portfolio has been split between Mike Grubic (core and value added) and Bill Stalter (opportunistic) to reflect their individual responsibilities. The incentive structure for each of these portfolios is different. The index used to measure performance in real estate is the NCREIF Index which reports returns gross of asset management fees. Wilshire reports PSERS' real estate returns net of asset management fees. The overall real estate incentive is calculated at NCREIF to NCREIF plus 100 basis points. When you factor that we have to make up the asset management fees (approximately 125 basis points on average), this is a real net of asset management fee spread of approximately NCREIF plus 125 bps to NCREIF plus 225 bps. We have separated the real estate portfolio into three portfolios based on the strategic allocation of 20% core, 30% value added, and 50% opportunistic. On a weighted basis, the combined incentive target remains NCREIF plus 100 bps to earn the full incentive. The individual portfolio level incentives recognized different performance objectives by

strategic allocation recognizing the lower return target for core to the more aggressive return target for opportunistic with value added in between.

- G. Portfolio Manager: U.S. Private Equity (1)
  - Senior Investment Analyst: Non-U.S. Private Equity/Global Private Debt
  - Senior Investment Analyst: Public Market Emerging Investment Manager Program and Venture Capital
  - Intermediate Investment Analyst: U.S. Private Equity (2)/Secondary Funds

As in real estate, the overall incentive structure for private equity, private debt, and venture capital has been split between the four investment staff managing these portfolios. The portfolio level incentives will be based strictly on the portfolios over which each of the individuals has direct responsibility. Previously, their incentives were based on the whole program.

If you have any questions, please contact me.

**PSERS  
Proposed Changes to the Investment Office Incentive Compensation Plan for 2008-2009**

<b><u>General Changes to Plan</u></b>	
None.	

<b><u>Position</u></b>	<b><u>Specific Changes</u></b>
Chief Investment Officer	No changes were made.
Managing Director of External Public Markets, Risk, and Compliance	No changes were made.
Senior Investment Analyst: External Public Markets, Risk, and Compliance	No changes were made.
Operations Manager	New position.
Compliance Office	New position for promotion from a junior level to an intermediate level compliance officer.
Junior Compliance Officer	No changes were made.
Managing Director of Equities	<ol style="list-style-type: none"> <li>1. Eliminated incentive for managing the S&amp;P 500 Index as this responsibility will be transferred to Chris Baker.</li> <li>2. With the change in 1., increased the incentive for the Internally Managed Alpha Generation Program from 10.0% to 20.0%.</li> </ol>
Portfolio Manager: S&P 400 Index, 600 Index, & Internally Managed Alpha Generation Program	No changes were made.
Portfolio Manager: MSCI ACW ex. U.S. Index & Internally Managed Alpha Generation Program	<ol style="list-style-type: none"> <li>1. Widened the band that the MSCI ACWI ex. U.S. Index is expected to track from +60 basis points and – 10 basis points to +70 basis points and –20 basis points.</li> </ol>
Managing Director of Fixed Income	<ol style="list-style-type: none"> <li>1. Changed objective of the LIBOR-Plus Short-Term Investment Pool from an index like band of + or - 10 basis points to an active objective of 10 basis points or more.</li> </ol>
Portfolio Manager: S&P 500 Enhanced Index and Portable Alpha Overlay	<ol style="list-style-type: none"> <li>1. Added incentive to recognize value added from managing the S&amp;P 500 Index overlay of the portable alpha program</li> </ol>

	(global macro, currency, and other portable alpha funds). No changes were made.
Portfolio Manager: TIPS Account	No changes were made.
Managing Director of Trading and Derivative Strategies	No changes were made.
Portfolio Manager: S&P 500 Index and Equity and Derivatives Trader	New position for promotion from a senior level trader to a portfolio manager.
Senior Equity and Derivatives Trader	No changes were made.
Intermediate Equity Trader	No changes were made.
Junior Equity Trader	No changes were made.
Managing Director of Private Markets	<ol style="list-style-type: none"> <li>1. Changed portfolio level incentive to include an incentive for private equity, private debt, and venture capital (13.0%) and real estate (7.0%). Previously, incentive was only for private equity, private debt, and venture capital.</li> <li>2. Revised supervisory incentive percentage to recognize additional individuals under the Managing Director's supervision.</li> </ol>
Portfolio Manager: Core and Value Added Real Estate Portfolio Management	<p>(Note: Changes below are due to promotion from senior investment analyst to portfolio manager).</p> <ol style="list-style-type: none"> <li>1. Increased total fund incentive from 12.0% to 16.0%</li> <li>2. Changed portfolio level incentives to recognize oversight of two separate portfolios as follows: <ol style="list-style-type: none"> <li>a. Core real estate which will compose 9.5% of the incentive; and</li> <li>b. Value added real estate which will compose 14.5% of the incentive.</li> </ol> </li> <li>3. Increased the total maximum incentive from 35.0% to 40.0%.</li> </ol>
Senior Investment Analyst: Opportunistic Real Estate Partnership Portfolio	<ol style="list-style-type: none"> <li>1. Changed portfolio level incentive to recognize that the incentive is to be based on the performance of the opportunistic real estate portfolio.</li> </ol>
Junior Investment Analyst: Real Estate Portfolio	New junior level position.

<p>Portfolio Manager: U.S. Private Equity</p>	<p>(Note: Changes below are due to promotion from senior investment analyst to portfolio manager).</p> <ol style="list-style-type: none"> <li>1. Increased total fund incentive from 12.0% to 16.0%</li> <li>2. Changed portfolio level incentives to recognize oversight of only the U.S. private equity portfolio and increased percentage from 23.0% to 24.0%.</li> <li>3. Increased the total maximum incentive from 35.0% to 40.0%.</li> </ol>
<p>Senior Investment Analyst: Non-U.S. Private Equity/ Global Private Debt</p>	<ol style="list-style-type: none"> <li>1. Changed portfolio level incentive to recognize that the incentive is to be based on the performance of the non-U.S. private equity and global private debt portfolio.</li> </ol>
<p>Senior Investment Analyst: Public Market Emerging Investment Manager Program and Venture Capital</p>	<ol style="list-style-type: none"> <li>1. Changed the second portfolio level incentive to recognize that the incentive is to be based on the performance of the venture capital portfolio</li> </ol>
<p>Intermediate Investment Analyst: U.S. Private Equity (2) / Secondary Funds</p>	<p>New intermediate level position.</p>
<p>Junior Investment Analyst: Private Equity/ Venture Capital/Private Debt</p>	<ol style="list-style-type: none"> <li>1. Eliminated real estate portion of portfolio level incentive as responsibilities transferred to the Junior Investment Analyst: Real Estate Portfolio.</li> <li>2. Increased portfolio level incentive for private equity, private debt, and venture capital from 10.0% to 19.0%.</li> </ol>