Commonwealth of Pennsylvania
Public School Employees' Retirement System

DATE: January 9, 2009

SUBJECT: Proposed Revisions to the Investment Policy Statement, Objectives and Guidelines

TO: Members of the Finance Committee

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At the January Finance Committee meeting, staff will recommend that the Finance Committee adopt the proposed changes to the Investment Policy Statement, Objectives, and Guidelines (hereafter referred to as the Investment Policy Statement). The changes proposed are as follows:

Definitions (pages 1-7)

Given the addition of the Derivatives Policy discussed below, 20 new definitions were added to the Investment Policy Statement.

Derivatives Policy (pages 16-19)

We have added a System-wide Derivatives Policy to the Investment Policy Statement. The key components to this policy include:

Objective and Investment Standards

The overall objectives of using derivatives are to efficiently manage and/or reduce the risk of the overall investment portfolio. When used appropriately, derivatives represent a powerful tool in managing an investment portfolio.

Permitted Uses of Derivatives

The following are the proposed permitted uses of derivatives:

1. To implement investment strategies in a lower cost and more efficient manner;
2. To implement overlay strategies in search of alpha;
3. To replicate the return of a passive benchmark;
4. To efficiently manage the overall asset allocation of the Fund;

5. To construct portfolios with risk and return characteristics that could not be otherwise easily be created;
6. To hedge and control risks; or,
7. To facilitate transition management.

Prohibited Uses

Derivatives may not be used for any activity whose primary purpose is speculation while materially increasing the risk to the System.

Risks Associated with Derivatives

Major risks associated with the use of derivatives include:

1. Counterparty Risk – the risk that the entity that has the opposing position to the transaction will fail. For exchange-traded derivatives, this risk is minimal since the other entity involved is a clearinghouse which is guaranteeing the transaction. For over-the-counter (OTC) derivatives, that entity is generally an investment or commercial bank. To control this risk, we require that all counterparties used for OTC derivatives have a credit rating of A-/A3 or better. In addition, for swaps, we enter into ISDA Master Agreements that provide for the netting of positions as well as require the collateralization of the marked-to-market value of the swap transaction within certain thresholds.
2. Market Risk – this is the risk that is due to the variability of returns due to macroeconomic factors that affect all risky assets. We control this risk by only permitting the use of derivatives consistent with the objectives defined in this Policy.
3. Operational Risk – this is the risk of improperly monitoring positions, bad pricing, inadequate software, system failures, or human error. The System attempts to control this risk by hiring qualified staff, adequately staffing the investment operations, and procuring the appropriate technology.

Exhibit B (pages 30-31)

The two major changes to this exhibit include:

1. Adjusting the objectives to account for the increase in the allocation to private markets and private real estate due to total Fund net asset value declining (commonly referred to as the denominator effect). Quarterly, the private market and private real estate allocations are adjusted to within 50 basis points of their actual allocation. This adjustment is accomplished by increasing or decreasing the U.S. and non-U.S. equity allocations in equal amounts. The overall allocation to equity (which includes public and private equity and real estate) remains unchanged.
2. Widening the policy ranges due to the increased volatility of the market and the challenging liquidity environment.

Exhibit C (page 32)

Consistent with the recommendations in Exhibit B, adjust the Policy Index to reflect the asset allocation changes. In addition, we changed the names of the Lehman indexes to the Barclays Capital indexes as Barclays Capital acquired the Lehman index business and rebranded the index names.

Exhibit D (page 33)

Staff widened some of the target ranges for individual portfolios due to the relative outperformance of some of these portfolios vs. the performance of the total fund. In addition, staff added a target range for the public market emerging investment manager program portfolios. We do not consider any of these changes to be material.

The changes throughout the document have been black lined for your convenience in reviewing the changes.

If you have any questions or comments, please contact me.