

Commonwealth of Pennsylvania Public School Employees' Retirement System

DATE: November 19, 2010

SUBJECT: Capula Recommendation

TO: Members of the Board

FROM: James H. Grossman, Jr., CPA, CFA
Managing Director of External Public Markets, Risk & Compliance

At the Finance Committee meeting in December, staff and Aksia will recommend that PSERS invest \$200 million in the Capula Global Relative Value Fund Limited, Class F shares. This fund is a relative value fixed income absolute return fund. Capula's investment focus is in G3 (U.S., Europe, and Japan) interest rate trading in liquid government bonds, interest rate swaps, and futures. The portfolio is structured to ensure neutrality to directional interest rate moves in major markets.

Capula Investment Management was formed in 2005 by former members of JP Morgan's Proprietary Trading Group, led by Yan Huo, CIO. Capula is a UK registered global investment management firm with offices in London, Tokyo, and Connecticut. They manage in approximately \$8 billion as of October 2010 in three separate products. Capula has had very consistent performance since their inception in 2005, strong risk controls, and very good diversification characteristics to the existing managers in our absolute return program. We anticipate that Capula will generate low to mid double digit returns with single digit volatility.

Capula has multiple share classes with different terms. Staff has chosen to invest in the Class F shares. The advantages of investing in the Class F shares are that the management fees are 50 basis points lower than the other share classes and the performance fee is paid based on the 3-year performance of the Fund, not the annual performance. In exchange for these more attractive terms, we have committed to an 18-month hard lock and an additional 18-month soft lock (we can redeem during the soft lock period, but would have to pay a 5% redemption fee plus a top-off of the management fee).

Included for your review are a powerpoint presentation prepared by staff, Aksia's recommendation, and the resolution recommending an investment in Capula.

If you have any questions or comments prior to the meeting, please contact me at 717-720-4703.

Manager Recommendation Memo

November 19, 2010

Board of Trustees
Pennsylvania Public School Employees' Retirement System
5 North Fifth Street
Harrisburg, PA 17101

Re: Capula Global Relative Value Fund

Dear Trustees:

Aksia LLC, having been duly authorized by the Board of PSERS, has evaluated and herewith recommends a direct allocation to Capula Global Relative Value Fund ("Capula"). In the ongoing development of PSERS' portfolio of absolute return funds, Aksia recommends an initial allocation in line with Exhibit D of PSERS Investment Policy Statement, Objectives, and Guidelines.

Capula pursues a fixed income Relative Value strategy that is somewhat unique in that the macro views of the manager are purportedly a component in trade selection and sizing. The manager describes the strategy as discretionary fixed income using relative value trades rather than relying on model-driven theoretical boundary and convergence methodologies. The fund's investment universe is defined to developed European markets, US and Japan.

Aksia's recommendation is based upon the following analytical factors and is made within the context of PSERS' investment guidelines.

- Due diligence of Capula's investment strategy, including a review of their investment strategy, investment team and structure, and risk management process.
- Due diligence of Capula's operations, including an operations and infrastructure review, regulatory and compliance review, private placement memorandum review, Form ADV review, and financial statement review.
- Evaluation of the Capula's investment strategy within the context of the current investment environment.
- Appropriateness of the Capula fund for the Absolute Return component of PSERS' portfolio.

This recommendation is confidential, given solely for the benefit of PSERS and cannot be relied upon by other investors considering an investment in Capula, since their needs, objectives and circumstances may not be identical to those of PSERS. The scope of this recommendation is limited to the investment merits of the Capula fund. Aksia manager recommendation memos should be reviewed with other Aksia due diligence materials, including the full Investment Review and Operational Review. In addition, please consult your tax, legal and/or regulatory advisors before allocating to any private investment fund.

Please feel free to contact us should you have any questions about this recommendation.

Respectfully,

A handwritten signature in black ink, appearing to be 'NK' with a long horizontal stroke extending to the right.

Norman Kilarjian
Partner, Head of Relative Value and Tactical
Research

A handwritten signature in black ink, appearing to be 'JD' with several overlapping loops and a horizontal line below.

Jaeson Dubrovay
Partner, Co-Head of Americas
Advisory



Absolute Return Fund Allocation

Capula Global Relative Value Fund Limited

December 9, 2010

See Page 7 for Disclaimer

James H. Grossman, Jr., CPA, CFA
Managing Director of External Public
Markets, Risk & Compliance

Capula – Absolute Return Fund

Overview of Capula Investment Management

- UK registered global investment management firm
- Founded in 2005 by former members of JP Morgan's Proprietary Trading Group based in New York City and London
- Firm manages approximately \$8 billion in three separate products:
 - Capula Global Relative Value Fund: \$5.6 billion
 - Capula Tail Risk Fund: \$1 billion
 - Capula Global Government Bond Program: \$1.2 billion

Investment Team

- 72 employees with offices in 3 international offices (London, Tokyo, and Connecticut)
- Over 20 trading staff, approximately 50 non-trading staff, and 2 consultants
- Team, led by Yan Huo, CIO, consists of seven senior trading partners with 80 years collective experience

Capula – Absolute Return Fund

Fund Strategy

- The fund is a relative value fixed income arbitrage strategy
- The focus of the fund is on G3 (U.S., Euro, and Yen) interest rate trading in liquid government bonds, interest rate swaps, and futures
- The portfolio is structured to ensure neutrality to directional moves in major markets
- The fund targets absolute returns of 10-15% above cash with a target annualized volatility of 6-7%
- The fund has a tail risk hedging component that helps to manage risk through major market crises

Capula – Absolute Return Fund

Value Proposition

- Capula has shown consistent performance – no negative rolling 12-month period
- Capula has generated strong, statistically-significant risk-adjusted returns
 - Information ratio over past five years ended October 31, 2010 was 1.87
- Diversification
 - Capula has a very low correlation to U.S. equity markets (-0.04) and U.S. fixed income markets (0.15)
 - Capula has a low correlation with our other absolute return managers
 - Highest correlation is with BGI Capital Structure Fund (0.52)
 - Second highest correlation is with Brevan Howard (0.43)
 - All other correlations less than 0.30
- Strong risk management
 - Use scenario-based macro hedging designed to provide protection to the portfolio in stress and tail-risk scenarios
- Strong management team and operational platform
- Capula met all redemption requests during market turmoil
 - Liquid strategies

Capula – Absolute Return Fund

Performance, net of fees

	2005**	2006	2007	2008	2009	2010***
Class A*	4.16%	17.47%	18.00%	9.46%	12.01	8.49%

* - Performance is net of 2% management fee and 20% performance fee

** - Inception date: October 1, 2005

*** - through October 31, 2010

History with PSERS

- This would be PSERS first investment with Capula

Annualized Fund Returns and Volatility Since Inception (10/2005)

- Annualized Return: 13.70%
- Excess Annualized Return over 1-Month LIBOR: 10.51%
- Annualized Volatility: 5.58%
- Sharpe Ratio: 1.88

Capula – Absolute Return Fund

Fund Terms (Class F Shares)

- Management fee: 1.5%
- Performance Fee: 20% of the increase in NAV over the high water mark, crystallized after 3-year lock
- Hurdle rate: 0%
- High water mark: Yes
- Lock up period
 - 18 month hard lock
 - Second 18 months is soft locked
- Administrator: GlobeOp Financial Services (Cayman) Limited
- Auditor: Ernst & Young Ltd
- Redemption Fee
 - 5% plus top-off of management fee payable on redemptions made during 2nd 18 months after acquisition
 - After 3 years, no redemption fee
- Liquidity: Quarterly with 3 months notice
- Gate: 25% Investor Level Gate
- Transparency: Partial
- Side Pocket: No

Capula – Absolute Return Fund

Other

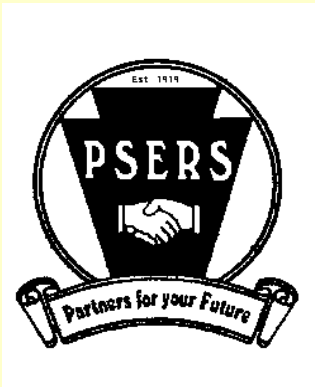
- Relationships with Aksia: None
- Placement Agents: None
- Political Contributions in PA: None

Capula – Absolute Return Fund

Recommendation

Staff, together with Aksia LLC, recommends that the Board invest in the Capula Global Relative Value Fund Limited, Class F Shares, in an amount within the target ranges established in Exhibit D of the Investment Policy Statement, Objectives and Guidelines.

DISCLAIMER: This document was presented to the Public School Employees' Retirement Board at the public meeting at which the Board acted on the resolution to which the information relates. The sole purpose for posting the presentation information on this website is to enable the public to have access to documents that were utilized at a public meeting of the Public School Employees' Retirement Board, and no other purpose or use is intended.



Absolute Return Fund Allocation

Capula Global Relative Value Fund Limited

December 9, 2010

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