Commonwealth of Pennsylvania
Public School Employees' Retirement System

DATE: January 4, 2011

SUBJECT: Proposed Revisions to the Investment Objectives and Guidelines Addenda

TO: Members of the Finance Committee

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

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At the January Finance Committee meeting, we will ask the Committee to adopt the proposed changes to the portfolio specific guidelines for the Addendums noted below (hereafter referred to as addenda).

The more substantive changes to the Addenda have been black lined for your convenience in reviewing the changes. Substantive changes to the Addenda are based on suggestions made by Investment Offie Staff. If you have any questions or comments regarding these changes, please contact me at 717-720-4703.

At this meeting, we will be seeking approval for the following addenda:

<u>Addendum E – Internally Managed Indexed Equity Portfolios</u>

- Added MSCI World ex. US Small Cap Index and MSCI Emerging Markets Index as allowable investments.

PENNSYLVANIA PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM
INVESTMENT OBJECTIVES AND GUIDELINES
INTERNALLY MANAGED INDEXED EQUITY PORTFOLIOS

ADDENDUM E

I. OBJECTIVES

This internally managed passive U.S. or non-U.S. equity index portfolios will consist of stock, U.S. cash equivalents, and non-U.S. cash in non-U.S. accounts. The guidelines do not cover the assets identified as being used in the Internally Managed Alpha Generation Program (Addendum E1), or performance derived from these assets. The objectives of each portfolio are:

1. Each internal equity index manager will be measured on a total return basis (yield plus appreciation) each month. On a rolling return basis performance versus the benchmark will be judged as follows, net of all manager fees and transaction costs:

A. S&P 500 Index Fund

S&P 500 Index +/- 0.10%	Acceptable
Returns outside of range	Unacceptable

B. S&P 400 Index Fund

S&P 400 Index +/- 0.25%	Acceptable
Returns outside of range	Unacceptable

C. S&P 600 Index Fund

S&P 600 Index +/- 0.35%	Acceptable
Returns outside of range	Unacceptable

D. MSCI All Country World (ACW) Index ex. U.S. Fund

MSCI ACW Index ex. U.S. (net) -0.20% to +0.70%	Acceptable
Returns outside of range	Unacceptable

E. MSCI World ex. U.S. Small Cap Index Fund

MSCI World ex. U.S. Small Cap Index (net) +/- 0.50%	Acceptable
Returns outside of range	Unacceptable

F. MSCI Emerging Markets Index Fund

MSCI Emerging Markets Index (net) +/- 1.00%	Acceptable
Returns outside of range	Unacceptable

II. PORTFOLIO RISK MANAGEMENT

The Board's expectations are that each portfolio be managed within the spirit of a passive U.S. or non-U.S. equity index mandate. Within that framework the manager has discretion to make portfolio changes to accomplish the stated objectives with the following limitations:

A. Index Mismatch Risk

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i. The index manager has discretion regarding the timing of trading for all announced index changes and miscellaneous corporate actions within the following parameters:

a. Index additions may be purchased any time following the announcement date, but no later than 10 business days after the effective date of the addition.
b. Index deletions may be sold any time following the announcement date, but no later than 10 business days after the effective date of the deletion.
c. Index stock dividends, spin-offs, rights, warrants, etc., may be sold or exercised at any time, but no later than three months after receipt. On occasion, especially in non-U.S. markets, if these securities are temporarily unmarketable or have insignificant market value, less than .005% (1/2 basis point), they may be held for up to one year unless written permission to hold the securities longer is granted by the Chief Investment Officer.
d. The manager may purchase or sell a non-included index stock involved in a merger or acquisition with an index stock (or a stock that is being added to or deleted from an index) to take advantage of liquidity or arbitrage opportunities.

ii. The following index specific parameters also apply:

a. S&P 500 Index:
   A. All stocks with an index weight greater than 0.01% (1 basis point) must be held within a variance of 0.005% (1/2 basis point).
   B. Up to 5 stocks can have a variance from the index weight greater than 0.005% (1/2 basis point) but not exceeding 0.05% (5 basis points)

b. S&P 400 Index:
   A. All stocks with an index weight greater than 0.05% (5 basis points) must be held within a variance of 0.01% (1 basis point).
   B. Up to 5 stocks can have a variance from the index weight greater than 0.01% (1 basis point) but not exceeding 0.05% (5 basis points).

c. S&P 600 Index:
   A. All stocks with an index weight greater than 0.02% (2 basis points) must be held within a variance of 0.01% (1 basis point).
   B. Up to 5 stocks can have a variance from the index weight greater than 0.01% (1 basis point) but not exceeding 0.05% (5 basis points).

d. MSCI ACW Index ex. U.S.:
   A. All stocks, with the exception of Emerging Markets stocks, with an index weight greater than 0.015% (1.5 basis points) must be held within a variance of 0.015% (1.5 basis points). Different classes of a stock may be combined to meet this variance parameter.
   B. Up to 20 stocks can have a variance from the index weight greater than 0.015% (1.5 basis points) but not exceeding 0.05% (5 basis points).
   C. Country weight variances, with the exception of Emerging Markets exposure, will be no greater than 0.10% (10 basis points) from the underlying index.
   D. Emerging Markets exposure in the MSCI ACW Index ex. U.S. will be gained through either an exchange traded fund, commingled fund, swaps, or a combination thereof. The Emerging Market weight variance will be no greater than 0.20% (20 basis points) from the underlying index.

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a. MSCI World ex. U.S. Small Cap:

A. Exposure in the MSCI ex. U.S. Small Cap Fund will be gained through either an exchange traded fund, commingled fund, swaps, or a combination thereof. None of these positions will be considered as assets being used in the Internally Managed Alpha Generation Program.

b. MSCI Emerging Markets:

A. Exposure in the MSCI Emerging Markets Fund will be gained through either an exchange traded fund, commingled fund, swaps, or a combination thereof. None of these positions will be considered as assets being used in the Internally Managed Alpha Generation Program

ii. Cash and Cash Equivalents

a. Except for a reasonable temporary period at the inception of the account, upon cash inflows, or as part of an anticipated redemption/withdrawal, cash and cash equivalents will not exceed 7% of the total market value of the account. To exceed 7%, written permission must be obtained from the Chief Investment Officer.

b. Cash in the portfolio shall be invested in the Fund's STIF account for U.S. dollars and the custodian's or sub-custodian's commingled fund accounts for non-U.S. currencies. Cash to back swap positions may be invested in the Fund's STIF account or the internally-managed LIBOR plus short-term investment pool.

c. Non-U.S. cash balances will be exchanged for U.S. dollar cash equivalents within 10 days when any individual non-U.S. cash balance exceeds, on average, 0.005% (1/2 basis point) of the total market value of the account except for non-U.S. cash required for security settlements (trades, rights and warrants exercised, etc.).

d. Unequitized cash equivalents will not exceed 2% of the total market value of the account for more than 3 consecutive days at any point in time.

iii. Common, Convertible, and Preferred Securities

a. Any stock that is a component of its related index may be held. Any stock dividends, spin-offs, rights, warrants, bonds, etc. received from a stock that is an index component may be held for sale at the manager's discretion within the parameters listed above.

B. Liquidity Risk

i. 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 investments and is not meant to be an all-inclusive list: leverage of any sort (i.e. long positions can be no greater than 100% of the net asset value of the portfolio), letter stock, private placements, physical real estate, physical commodities, fixed income securities (excluding STIF), etc.

C. Derivative Counterparty Risk

i. 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

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and Poor's Counterparty Ratings or rated B or better by Fitch's Bank Individual Ratings).

ii. 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).

iii. Counterparty limits will not be applied to listed futures and options.

III. COMMISSIONS

Excluding MSCI ACW Index ex. U.S. trades, best efforts must be made to execute all trades through the Fund's trading desk unless approval is given to execute trades elsewhere by the Chief Investment Officer. Commissions on U.S. trades executed outside the Fund's trading desk for agency transactions may not exceed three cents per share. Approval for any commissions in excess of the three cents per share policy must be received in writing from the Chief Investment Officer.

All MSCI ACW Index ex. U.S. trades may not exceed five basis points of the principal value. Approval for any commissions in excess of the five basis point policy must be received in writing from the Chief Investment Officer.

IV. DERIVATIVES

- Futures, SPDRs, and other listed index replicating securities may be purchased to equitize cash not to exceed 7% of the total portfolio market value. The futures contract, SPDR, etc. purchased to equitize cash must directly correspond to the related index. For example, the S&P 500 Index portfolio can only purchase S&P 500 Index-related products. All futures trades must be cleared through clearing brokers who have contracts with the Fund.

- Swaps are permitted subject to the prior written approval of the Chief Investment Officer.

V. AMENDMENTS

A written request to the Chief Investment Officer (CIO) and Managing Director of External Public Markets, Risk & Compliance should be made if the manager believes that these portfolio risk constraints significantly limit the ability of the manager to achieve the objectives of the portfolio. A written amendment will be issued from the CIO if the request is approved.

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Proposed
PSERB Resolution 2011-_____
Re: Investment Objectives and Guidelines
January 21, 2011

RESOLVED, that the Finance Committee of the Public School Employees' Retirement Board (the "Board") hereby recommends that the Board adopt the proposed Investment Objectives and Guidelines Addenda listed below for the Public School Employees' Retirement System pursuant to the recommendation of James H. Grossman, Jr., Managing Director of External Public Markets, Risk & Compliance, dated January 4, 2011.

Addendum	**Addendum Title**
E	Internally Managed Indexed Equity Portfolios