


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

DATE: July 20, 2012
SUBJECT: Proposed Revisions to Addendum E
TO: Members of the Board
FROM: Joseph W. Sheva, CPA 
Portfolio Manager

At the August Finance Committee meeting, we will ask the Committee to adopt the changes to Addendum E. The changes made were to add language to the guidelines, using our MSCI ACWI Ex. U.S. internally-managed account as a point of reference, to allow for internal management of an emerging market index account.

Blacklined copies of the changes to this guideline have been included in the package for your review.


If you have any questions or comments, please contact me at 717-720-4632.


Commonwealth of Pennsylvania Public School Employees' Retirement System

DATE: July 24, 2012

SUBJECT: PSERS Emerging Markets Equity Index portfolio

TO: Members of the Board

FROM: Gerard C. Smith, CFA 
Managing Director of Equities

Susan E. Oh, CFA 
Senior Portfolio Manager

We are recommending initiation of an internally managed Emerging Market Equity Index portfolio. This is a natural evolution for PSERS internal equity program. PSERS has benefited extensively from the internal management of assets and we believe this mandate will allow PSERS to expand its Global investment capability, improve investment flexibility and liquidity, and enhance staff knowledge. Additionally, this internally managed fund will have significant cost advantages over external mandates, as do all our internally managed funds.

PSERS Emerging Market Equity Index portfolio would not pose implementation hurdles because of the investment capability and operational infrastructure that has been in place at PSERS for many years. This international portfolio would utilize the same processes and procedures that have been used to efficiently and successfully manage our PSERS All Country World X US portfolio for over 15 years.

Under the direction of the Senior Portfolio Manager, the PSERS Emerging Markets Equity index portfolio will be managed by Jane Jeong, a Portfolio Manager, in accordance with PSERS Investment Objectives and Guidelines Addendum E and E1 (revised guideline is proposed in Joe Sheva's memo in this tab).

Jane Jeong's Bio

Prior to joining PSERS on July 30, 2012, Jane had 10 years of experience at California Public Employees' Retirement System (CalPERS) where she proposed, implemented and managed their first internally managed Emerging Markets Equity portfolio. She transitioned from Global Equity group to Asset Allocation group in 2008 where she spent much of her time building return forecast models for various asset classes and researched/recommended new asset classes and asset allocation mixes. Before joining CalPERS, Jane was a derivate analyst for Transamerica Occidental Life Insurance Company and a consultant/auditor for KPMG, LLP.

She earned a Master of Business Administration in Financial Engineering from University of Illinois and a Bachelor of Arts in Economics from Seoul National University.

We are excited to have Jane join our PSERS Investment team!

If you have any questions or comments, please contact Gerry Smith at 717-720-4913 or Susan Oh at 717-720-4621.

**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%
Returns outside of range
Acceptable
Unacceptable
 - B. S&P 400 Index Fund
S&P 400 Index +/- 0.25%
Returns outside of range
Acceptable
Unacceptable
 - C. S&P 600 Index Fund
S&P 600 Index +/- 0.35%
Returns outside of range
Acceptable
Unacceptable
 - D. MSCI All Country World (ACW) Index ex. U.S. Fund
MSCI ACW Index ex. U.S. (net) -0.20% to +0.70%
Returns outside of range
Acceptable
Unacceptable
 - E. MSCI World ex. U.S. Small Cap Index Fund
MSCI World ex. U.S. Small Cap Index (net) +/- 0.50%
Returns outside of range
Acceptable
Unacceptable
 - F. MSCI Emerging Markets Index Fund
MSCI Emerging Markets Index (net) +/- 1.00%
Returns outside of range
Acceptable
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

- 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% (5.0 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.

e. 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.

f. MSCI Emerging Markets:

A. All stocks with an index weight greater than 0.020% (2.0 basis points) must be held within a variance of 0.020% (2.0 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 0.020% (2.0 basis points) but not exceeding 0.05% (5.0 basis points).

C. Country weight variances will be no greater than 0.20% (20 basis points) from the underlying index.

~~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~~

iii. 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.

iv. 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 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. non-U.S. equity~~ 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. non-U.S. equity~~ 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~~ Deputy Chief Investment Officer (DEPMDCIO) 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, or the ~~DEPMDCIO~~ DCIO in the CIO's absence, if the request is approved.

Proposed 8/8/12