Commonwealth of Pennsylvania
Public School Employees' Retirement System

DATE: January 9, 2015

SUBJECT: Proposed Revisions to Investment Risk Guidelines

TO: Members of the Board

FROM: Joseph W. Sheva, CPA
Portfolio Manager

At the January Finance Committee meeting, we recommend that the Committee adopt the following changes to Addendum X2 and Exhibits E and F of the Investment Policy Statement, Objectives and Guidelines (IPS).

Addendum X2 (Absolute Return Policy)

Add language to permit the Absolute Return Portfolio to have one Absolute Return Investment Fund / Absolute Return Investment Manager that exceeds the maximum allocation guidelines noted in the Absolute Return Policy. The maximum allocation in either case may not exceed 25%.

Exhibit E – Public Market Investment Manager Target Ranges

Add a 4.0% limitation for the maximimum allocation amount to the internally-managed U.S. Master Limited Partnership Index portfolio. The percentage limitation was set to the Current Target Allocation per IPS Exhibit C, which allows fort the entire Master Limitied Partnership allocation to be indexed internally.

Eliminate the limitation for Public Markets Emerging Investment Manager Program portfolios. Limitations on manager portfolios will be based on investment strategy, as defined in Exhibit E, and in absolute dollar terms of the total program, which is currently limited to $1.0 billion.

Exhibit F - Public Markets Emerging Investment Manager Program Policy

Reduce the maximum number of investment managers allowable in the Program from 25 to 10. The allowable amount of 10 is consistent with PSERS' resources to manage and administer external relationships.

Align the individual investment manager funding constraint with existing constraints in Exhibit E by replacing the absolute limitation of $100 million per investment manager with the limitations set forth in Exhibit E. Also, aligned managers with capital allocations exceeding $100 million with existing Policy that requires Board approval for hiring new managers.

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

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

	Target Ranges as a percentage of the Total Fund
Real Asset Portfolios:	
Master Limited Partnership Portfolios	
Externally Managed Enhanced and Full Discretion	0.0% - 2.0%
Internally Managed U.S. Master Limited Partnership Index	0.0% - 4.0%
Commodities Portfolios	
Externally Managed Full Discretion and Enhanced Index Commodity	0.0% - 2.0%
Internally Managed Enhanced Commodities Index Portfolio	0.0% - 4.0%
Internally Managed Gold Index Portfolio	0.0% - 4.0%
Internally Managed Synthetic Beta Replication[2]	0.0% - 2.0%
PTRES Portfolios	
U.S, Non-U.S., and Global PTRES	0.0% - 1.0%
Internally Managed Synthetic Beta Replication[2]	0.0% - 2.0%
Risk Parity Portfolios:	
Externally Managed Risk Parity Portfolios	0.0% - 4.0%
Internally Managed Optimal Liquid Beta Portfolio	0.0% - 5.0%
Absolute Return Portfolios:	0.0% - 2.0%
Short Duration Fixed Income Portfolios:	
Internally Managed LIBOR-Plus Short-Term Investment Pool	0.0% - 8.0%
Externally Managed LIBOR-Plus Short-Term Investment Pool	0.0% - 5.0%
Externally Managed Short Duration Non-Agency RMBS Portfolios	0.0% - 1.0%
Internally Managed Short-Term Investment Pool	No limit
~~**PMEIM Program Portfolios**~~	~~0.0% - 0.3%~~

Internally Managed Synthetic Beta Replication represents market exposures in the various asset classes achieved through Derivative exposures such as futures, options, swaps, etc. IOS will synthetically achieve beta exposures to either assist in a transition from one actively managed portfolio to another or to generate alpha. It excludes synthetic beta replication within the actively managed and indexed Separate Account portfolios.

[2] The maximum amount of internally managed synthetic beta replication will be 11% of the total fund (excludes beta synthetically replicated within the actively managed and indexed Separate Account portfolio).

Exhibit F – Public Markets Emerging Investment Manager Program Policy

PUBLIC SCHOOL EMPLOYEES' RETIREMENT BOARD
PUBLIC MARKETS EMERGING INVESTMENT MANAGER PROGRAM POLICY

I. OBJECTIVES AND GOALS

Consistent with the Board's fiduciary responsibilities, the Pennsylvania Public School Employees' Retirement System (PSERS, System, or Fund) has established the Public Markets Emerging Investment Manager Program (PMEIM Program) to:

1. Locate and fund managers with successful histories of generating positive alpha with Risk commensurate with the alpha generated (positive Risk adjusted returns);
2. Provide a source of potential managers for the main fund; and,
3. Assist public market emerging investment management firms with positive Risk adjusted returns grow through use of the System's name in the manager's marketing efforts.

The Board has allocated up to $1.0 billion to the PMEIM Program. Funding for each investment manager will come from assets allocated within the main fund similar to or most closely related to the investment manager's mandate. The maximum number of investment managers in the program at any one time shall not exceed ~~25~~10. The program may run with less than ~~25~~ 10 investment managers.

II. PUBLIC MARKETS EMERGING INVESTMENT MANAGER PROGRAM CRITERIA

Investment Manager desiring to participate in the program must meet the following required criteria:

- Firms must be registered under the Investment Advisors Act of 1940 or be exempt therefrom (and will maintain such registration or exemption);
- Firms must provide transparency of positions and transactions;
- Firms must provide at least quarterly liquidity;
- Firms, the portfolio manager, or any combination thereof must have a three-year historical, performance record verified by at least one consultant or accounting firm in accordance with Global Investment Performance Standards (GIPS);
- Firms considered to provide Equity, Commodity or Absolute Return exposure must have no more than $1.5 billion of total assets under management when hired (existing investment managers will be terminated within a reasonable period of time from the PMEIM Program when the total assets under management exceeds $3.0 billion);
- Firms considered to provide Fixed Income exposure must have no more than $3.0 billion of total assets under management when hired (existing investment managers will be terminated within a reasonable period of time from the PMEIM Program when the total assets under management exceeds $6.0 billion);
- For performance-based fee accounts, the managers must exceed both a hurdle rate and a high water mark before they can earn the performance-based fee.

Preference will be given to investment managers deemed by Investment Office Staff (IOS) as able to meet the objectives, goals, and required criteria noted above plus having one or more of the following characteristics:

- Pennsylvania investment management firms headquartered or incorporated within the Commonwealth; and/or,
- Minority- or women-owned investment management firms approved by the Office of Minority and Women Business Enterprise in accordance with the criteria established by Executive Order No. 1987-18 and 4 Pennsylvania Code, Section 68.204.

Please note: *Firms applying for participation under the status of a Women and/or Minority Owned Business must contact the Office of Minority & Women Business Enterprise at (717) 783-3119 to obtain the proper certification material.*

III. ADMINISTRATION OF THE PUBLIC MARKETS EMERGING INVESTMENT MANAGER PROGRAM

IOS has the authority to hire and fund any investment manager meeting the objectives, goals, and criteria set forth above as long as capacity exists within the PMEIM Program. IOS has authority to invest in any type of business organization or investment fund (including, without limitation, Separate Accounts and limited partnerships) that meets the liquidity and transparency guidelines set forth in this Policy. The PMEIM Program is prohibited from investing in investment vehicles that primarily include private equity, private debt, venture capital or private real estate instruments. Investments in Absolute Return strategies are subject to manager selection requirements within the Absolute Return Policy (Addendum X2).

The Emerging Manager Portfolio Manager (EMPM) is responsible for administering the PMEIM Program. The EMPM will meet with managers that appear to meet the objectives, goals, and criteria of the PMEIM Program. Any investment manager considered for hiring into the PMEIM Program will meet with the Internal Review Committee (IRC). The IRC will review each manager considered for inclusion in the PMEIM Program and provide feedback to the EMPM. IOS approval required to hire any manager into the PMEIM Program include the EMPM, the EMPM's supervisor, and the CIO.

IOS is required to obtain Board approval in instances when the CIO, EMPM's supervisor, and EMPM locate (or have retained) an exceptional investment manager that does not meet one or more of the above required criteria. In these cases, IOS shall present to the Board the specific reasons for hiring the investment manager. Upon approval of the Board, IOS shall have the authority to fund the investment manager subject to VI. Fundings, which is described later.

The EMPM's responsibilities also include either recommending the investment manager for inclusion in the main fund or terminating the investment manager. Investment managers hired into the PMEIM Program will continue in the program for generally three- to five-years. If the investment manager generates strong Risk adjusted returns, IOS will use best efforts, in conjunction with the General Investment Consultant and the Board, to make a place in the main fund for that investment manager. IOS and the General Investment Consultant will consider things such as the investment manager's assets under management and projected ability to continue generating strong Risk adjusted returns in the future. An investment manager may be terminated by the EMPM, with approval from the EMPM's supervisor and the CIO, if that investment manager is underperforming, not generating strong Risk adjusted returns, not meeting the criteria to move into the main fund, changes their investment process, has personnel turnover, or any other reason which is deemed by IOS to be in the best interests of the System.

IV. INVESTMENT GUIDELINES

Each investment manager shall manage its portfolio within the constraints of the contract entered into between the investment manager and the Board, the Investment Policy Statement, Objectives and Guidelines, any applicable addendum, and any applicable amendments thereto. IOS shall have authority to negotiate the investment contract with the investment manager, including the investment guidelines.

V. INSURANCE

All of the standard insurance provisions set forth in the Investment Policy Statement, Objectives and Guidelines, except for the maximum deductibles, will apply to the investment manager until the investment manager is either managing over $100 million for the Emerging Manager Program or is moved out of the Emerging Manager Program into the main fund. The maximum deductible for both the Error and Omissions Insurance and the Fidelity Bond is the greater of 10% of audited retained earnings or:

Asset Size	Maximum Deductible
$0 - $50 million	$50,000
$50 - $75 million	$100,000
$75 – 100 million	$200,000

VI. FUNDINGS

Board approval is required for total capital allocations exceeding $100 million. Investment strategy limitations are consistent with IPS constraints. ~~Total capital allocated to any individual investment manager may not exceed $100 million during their participation in the PMEIM Program.~~ The EMPM, the EMPM's supervisor, and the CIO will determine the amount of the initial allocation and each subsequent allocation to each investment manager.