Commonwealth of Pennsylvania
Public School Employees' Retirement System

DATE: March 2, 2015

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

TO: Members of the Board

FROM: James H. Grossman, Jr., CPA, CFA
Chief Investment Officer

At the March Finance Committee meeting, we will recommend that the Committee adopt the following changes to Addendums P and X5 and Exhibits C, D, and E of the Investment Policy Statement, Objectives and Guidelines (IPS).

Addendum P (Passive Currency Hedging Overlay Program)

Two changes are recommended to these guidelines:

1. Removed specific references to specific notional values and portfolio to be hedged. The Investment Office will provide to the investment manager the notional values and portfolio currency exposure. This change was made as we look to hedge not only the MSCI World ex. U.S. IMI Net Index currency exposure, but also the currency exposure in the high yield portfolio. The Board will be provided the hedging information via the Board's secure website as amendments are provided to the investment manager; and
2. Counterparty exposure guidelines were updated to limit exposure to any one counterparty to no more than 30% of the notional value at the time of entering the currency trade.

Addendum X5 (Private Markets and Real Estate Pennsylvania In-House Co-Investment Policy)

New guidelines recommended for the Pennsylvania In-House Co-Investment Program that Charlie Spiller will discuss in more detail at the March Finance Committee meeting.

Exhibit C – Current Target Allocation

Revise the current target allocation to reflect the expected allocation weights as of April 1, 2015, with the largest reduction to private markets equity based on the secondary sale with a commensurate increase in publicly-traded global equities.

Exhibit D – Policy Index

I will discuss this change in more detail at the Finance Committee meeting. One major and two minor revisions are recommended as follows:

1. Split the current MSCI ACWI IMI Special Tax with Developed Market Currencies hedged to USD Index (a global equity index) into two indexes:
   a. MSCI USA IMI Gross Index with a target of 8.6%; and,
   b. MSCI ACWI ex. USA IMI with Developed Market Currencies hedged to USD Net Index with a target of 12.9%;
2. Reduce the MSCI Emerging Markets Equity Index weight from 1.5% to 0.5%; and
3. Revise the Barclays Capital Global Aggregate GDP-weighted Developed Market ex.-U.S. (unhedged) Index to a hedged index.

Item #1 is the most significant of the recommended changes. The U.S. equity market has significantly outperformed the non-U.S. developed equity markets (i.e. Europe, Japan, etc.) over the past 5 years (16.13% for the S&P 500 vs. 9.61% for hedged world ex. U.S.). Staff believes we are at the beginning of a reversal of this trend. In addition, a GDP weighted index would only include 28% U.S. exposure (vs. 52.5% in a capitalization weighted index). This proposal has us moving our equity exposure from essentially 52% U.S./48% non-U.S. to a 40% U.S./60% non-U.S. and would represent what we believe is a more balanced and diversified equity exposure.

We have discussed these changes with AonHewitt, our general consultant, and they agree with the recommended change. In addition, other strategic partners as well as some economists we follow have been moving in this direction as well. With the U.S. Federal Reserve moving towards a tighter monetary policy and the European Central Bank and the Bank of Japan moving aggressively into easy money policies, we believe this represents an opportune time to make these changes.

Exhibit E – Public Market Investment Manager Target Ranges

The change recommended is to clarify that the permissible Foreign Currency Hedge Overlay applies to the total fund foreign currency exposure.

Blacklined and clean copies to each guideline have been included in the package for your review.

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