



pennsylvania
State Employees' Retirement System

**Commonwealth of Pennsylvania
State Employees' Retirement Board**

Alternative Investments Statement of Investment Policy

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Commonwealth of Pennsylvania
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Alternative Investments Statement of Investment Policy

Pursuant to Title 71, Section 5931, the Board of the Pennsylvania State Employees' Retirement System ("SERS") establishes this Alternative Investments Statement of Investment Policy (the "Policy Statement") that sets forth the long-term objectives and policies for managing Alternative Investments. The Policy Statement ensures that managers, advisors, and other participants selected by the Board adhere to the investment principles and guidelines of SERS. Additionally, the use of the Policy Statement assures sufficient flexibility in managing investment risks and returns associated with Alternative Investments. The Board may provide for exceptions, or amend this Policy Statement, in whole or in part.

I. Introduction

Alternative Investments are largely comprised of non-traditional investments made in limited partnerships organized to make domestic and international private market investments such as venture capital, leveraged buyouts, distressed debt, and special situations acquired in primary or secondary markets. Venture capital investments generally involve the financing of young, non-public growth companies. These investments are made in: (i) seed stage companies in their conceptual phase, (ii) early stage companies after a product has been developed but before revenues are realized, and (iii) late stage companies with demonstrable revenue and attraction for strategic sale or initial public offering of stock. The term "private equity" is employed to describe private market investments in the equity and subordinated debt of established companies.

The members of the Board, employees of the State Employees' Retirement Fund ("Fund"), and its agents shall stand in a fiduciary relationship to the members of the System within the constraints of the "prudent investor" standard.

II. Investment Objectives

Alternative Investments are expected to provide return premiums over publicly traded securities, improve the Fund's diversification, and enhance the Fund's asset base over long periods of time. SERS' long-term performance objective for Alternative Investments is to achieve a risk-adjusted return, net of fees, in excess of the 10-year average annualized return of the Russell 3000 Index plus a 300 basis point risk premium.

III. Asset Allocation

Asset allocation is a critical driver of the long-term success of Alternative Investments. Since it is not possible to rebalance quickly in Alternative Investments, pacing and manager selection have heightened

importance as tools to influence allocation. Long-term asset allocation targets are established in the Strategic Investment Plan.

Fund investments should be planned and executed in a manner that adheres to the asset allocation targets (transitional and long-term) specified for Alternative Investments in SERS' Strategic Investment Plan. These targets are combined with the targets for global public equity and expressed as a desired asset allocation range, for all of SERS' equity-like investments titled "Total Equity", rather than using discrete percentages. By allowing acceptable allocation ranges, the Fund is not forced to constantly rebalance its assets thus improving the Fund's operational efficiency. Likewise, commitments to the alternative investments asset class may exceed carrying values since committed capital is typically drawn down over a long time period. During this period, some investments will be realized, resulting in distributions of capital back to SERS.

IV. Pacing

SERS' Strategic Investment Plan may recommend annual commitment ranges to be made by the Fund within each strategy as well as a total target commitment for the Fund (the "Pacing Analysis") in order to achieve both the target strategic allocation and the overall allocation to the Alternative Investments asset class. The Pacing Analysis shall take into account the Fund's overall allocation to and investments in the Alternative Investments asset class, within each strategy, across industries and geography, and by vintage year as well as the market environment and such other considerations as are appropriate. The Fund shall strive to avoid concentrations in strategies, industries, geographic areas, funds, managers, or vintage years.

V. Investment Guidelines

In an attempt to control the risks inherent in Alternative Investments, SERS strives to invest with alternative investment managers capable of attaining SERS' long-term investment objectives. Selection shall be predicated upon a comprehensive review of each prospective investment manager's ("Manager" or "Firm") current abilities and investment track record to determine if the investment return objectives, as articulated in SERS' Strategic Investment Plan, can be achieved. Collectively, these Fund investments will be broadly diversified in terms of vintage year, industry focus, geographic focus, venture capital stage (e.g., seed, early, growth, or later stage), and private equity focus (e.g., buyouts, distressed, secondaries or other). Exposure to Pennsylvania-based managers may be a component of SERS' Alternative Investments program if achieved within the fiduciary constraints of the "prudent investor" standard. SERS may invest in "fund-of-funds", separately managed accounts, or other vehicle, if by doing so, SERS achieves access to opportunities and/or investment information that might not otherwise be directly attainable in a more efficient or effective manner.

Alternative Investments shall satisfy the following minimum criteria:

1. Investment Strategy

The investment strategy must target investments that satisfy SERS' definition of Alternative Investments. There must be a sufficient universe of potential investments to accommodate institutional investing. The investment strategy must be set forth in sufficient detail to permit substantive and meaningful review of the opportunity, verification of investment concept, and comprehensive analysis of risk factors. The investment strategy shall also outline the Firm's corporate governance policies and procedures with respect to management of the Firm and its underlying investments. Finally, there must be sound evidence that the investment will provide reasonable probability of achieving the return and risk objectives of SERS.

2. Investment Process

The Firm shall demonstrate a sound process for sourcing, performing due diligence, selecting, monitoring, and exiting investments. The investment process shall describe the Firm's internal investment and management controls. The process should also provide for regular monitoring and valuing of existing investments, as well as a strategy and procedure for exiting investments. The Fund has carefully documented its investment processes, including those related to hiring advisors to manage the Fund's investments. Those processes and due diligence tools are available for review on the Fund's intranet at <http://employee.sers.pa.gov/investments.aspx#policies> and are incorporated by reference into this policy.

3. Management

The Manager must have expertise and experience in sourcing, pricing, selection, structuring and negotiating alternative investments. It is preferable that key investment personnel have direct experience investing for institutional investors, a history of working together, a successful track record of implementing the strategy proposed for this investment, and managing portfolios of capital similar in size to the amount currently sought. Depending on the strategy, operational experience in target industries is desirable.

4. Terms and Conditions

Each partnership agreement shall be negotiated such that SERS receives competitive terms and conditions. SERS' leverage to negotiate terms may be reduced when it commits relatively modest capital or if the Firm's offering is heavily oversubscribed.

IV. Risk Management

SERS will seek to minimize risk through investment due diligence and portfolio diversification. Before

any investment is recommended to the Board and an investment is made by SERS, the Investment Staff and/or its Alternative Investments consultant will diligently review the investment opportunity. A due diligence review by the staff and/or Alternative Investments consultant shall include meetings with the investment principals, reviews of pertinent offering documents and supporting materials, the Manager's completion of a due diligence questionnaire, and reference checks. Such reviews will attempt to evaluate the soundness of the investment opportunity and its adherence to SERS' investment guidelines (listed above) as to investment strategy, process, management, and terms and conditions.

SERS will also seek to minimize risk within its Alternative Investment portfolio by diversifying its investments. Diversification will be achieved by investing with managers in funds with differing vintage years, industry focuses, geographic focuses, venture capital stages, and private equity focuses. In addition, individual funds will be diversified by limiting the amount of capital that can be invested in any one company.

V. Manager Monitoring and Evaluation

Each Manager will provide SERS' Investment Office with quarterly unaudited reports (or semi-annual reports if customarily produced by the Manager) and annual audited reports in sufficient detail to allow SERS' Investment Staff to assess performance of each Alternative Investment. Each Manager is expected to report on a timely basis all material developments including, but not limited to, personnel changes, contractual problems or amendments, distribution issues and other items required for appropriate monitoring by the SERS Alternative Investment staff. Each Manager, as part of its investment report to SERS, is expected to provide information concerning Pennsylvania portfolio activity, including employment statistics.

Semiannually, the Alternative Investment consultant will submit to the Board an Alternative Investment performance report. Performance measurement will utilize an Internal Rate of Return metric ("IRR"). The IRR is based on inflows and outflows of partnership capital, giving consideration to the residual value of investment holdings, and calculated net of management fees, expenses, and the Manager's share of carried interest. The IRR calculation is an annualized since inception measure, updated quarterly, and along with cash-on-cash return multiples, shall serve as the primary objective measurement of a Manager's performance. The performance of each investment will be compared against Burgiss' relevant Vintage Year Median Returns (or other relevant relative return data made available by SERS' Alternative Investment consultant).

The Board understands that Alternative Investments are long term in nature, illiquid, and generally involve a duration of 8 to 15 years. Therefore, investment performance must be viewed over a longer time horizon than the assessment period used for publicly traded securities. Although the final performance of an Alternative Investment cannot be known until its termination, it is recognized that performance of a more mature investment (7–10 years) provides a useful indication of its progress.

For SERS' Investment Staff to more actively monitor a Manager's investments for compliance with the terms and provisions of the limited partnership agreement and SERS' expectations, SERS often seeks an advisory board or valuation committee seat. In such capacity, SERS' Investment Staff will generally participate in the review and/or approval of: (i) a Firm's valuation policy, (ii) investments remaining in the portfolio, (iii) the Manager's valuation of such investments, and (iv) whether potential conflicts of interest exist. As the size of SERS' commitments shrinks, it is likely SERS will have fewer opportunities to serve on advisory boards and valuation committees.

VI. Separate Documents Incorporated by Reference into this Policy Statement

- 1. Hiring Investment Advisors**
- 2. Venture Capital/Private Equity Fund Assessment Due Diligence Questionnaire**