



COMMONWEALTH OF PENNSYLVANIA  
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

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Non-Traditional Investments/Due Diligence Policy

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### Revision History

Non-Traditional  
Investments/Due Diligence  
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## **I. SCOPE**

This Policy applies to investments in the Non-Traditional Investments Asset Classes (Private Equity, Private Credit, Private Real Estate, Private Infrastructure, Private Commodities and Absolute Return) and Non-Traditional Investment structures within other portfolios, including Co-Investments and Secondaries within an Asset Class, of the Commonwealth of Pennsylvania, Public School Employees' Retirement System ("PSERS").

## **II. PURPOSE**

This Policy provides a broad strategic investment framework for the due diligence process of investments in the Non-Traditional Investment Asset Classes and Non-Traditional Investment structures. The implementation of this policy is outlined in the procedure manuals for Non-Traditional Investments as maintained by the Non-Traditional Investment Office Professionals.

## **III. ROLES AND RESPONSIBILITIES**

Roles and Responsibilities related to this Policy are identified within PSERS' Investment Policy Statement ("IPS").

## **IV. RISK MANAGEMENT**

Non-Traditional Investments do not easily lend themselves to traditional quantitative measures of risk, such as standard deviation and benchmark Tracking Error. Rather, risk is managed through a combination of quantitative and qualitative techniques. PSERS seeks to identify and acknowledge the sources and types of risk inherent in each underlying investment strategy during the due diligence (underwriting) process, and the potential risk each underlying investment may have on the respective portfolio within each Non-Traditional Investment Asset Class. The key components of the due diligence process are identified below in Section V.

Furthermore, Non-Traditional Investments do not easily lend themselves to traditional methods of measuring investment return. Notably, several issues may arise when calculating the Internal Rate of Return ("IRR") of a fund or single investment, which may make performance comparisons on an IRR basis misleading. These issues may arise at the fund level, for example, when a fund exhibits complex cash flow patterns, usage of subscription lines, and investment scale differences. To reduce the likelihood of these and similar issues negatively impacting IOP's ability to conduct investment performance measurement and analysis, IOP does not rely solely on IRR but also reviews and analyzes Investment Multiples, including Total Value Multiple and Distribution to Paid-In Ratio, and Public Market Equivalents, such as Direct Alpha and Kaplan Schoar evaluates both net and gross performance over time to gain a comprehensive view



of a prospective External Manager, their investment performance, and ability to generate consistent and replicable returns for limited partners.

Certain PSERS practices serve to further mitigate risks across the Non-Traditional portfolios. PSERS will only consider investment structures that provide limited liability to the System, which limits the System's losses to the amount invested. Additionally, no single individual shall have the authority to allocate capital on behalf of the Fund, and all decisions to invest require unanimous approval of the AIC. With the exception of co-investments and secondary investments alongside existing External Managers, investment decisions also require a positive recommendation from the Investment Consultant(s), and Board approval.

## V. **DUE DILIGENCE (UNDERWRITING) PROCESS**

Thorough due diligence (underwriting) serves three primary objectives:

- Develop an Understanding of the External Manager or Co-Investment, their Processes and Strategy: Thorough due diligence allows the IOP to develop a credible thesis for an External Manager's (or co-investment's) future success. Documented underwriting helps the IOP to improve investment decisions over time by providing the basis for analysis of historical manager recommendations.
- Performance Expectations: IOP will evaluate manager performance on a) an absolute basis and b) a relative basis compared to its peer group, the Fund's Asset Class Policy benchmark, the Fund's Asset Class Risk Benchmark, or a Public Market Equivalents
- Portfolio Fit: IOP will evaluate how the prospective External Manager or Co-investment will impact the diversification and risk-return attributes of the portfolio.

### A. External Managers (i.e. funds):

- **Sourcing and Identification**
  - IOP identify potential External Managers through numerous sources, including internal efforts, Investment Consultants and peer institutions.
- **External Manager Interviews: Meetings, Calls and Negotiation of Terms**
  - Thoughtful and structured interviews allow the IOP to estimate a prospective External Manager's' performance by understanding the decision makers, their philosophies, organizational structures and motivations, and the resultant impact on performance.



- Fees and other pertinent terms are negotiated. Non-Traditional Investments may have substantial fees and costs; consequently, emphasis will be placed on negotiating, monitoring and controlling the direct and indirect costs of each investment.
- **Performance Analysis**
  - IOP and the Investment Consultants analyze historical results to to build conviction in the merits of an External Manager's investment strategy and the execution thereof. An External Manager's relative performance is assessed against relevant metrics, including peer quartile rankings and public market equivalent returns when applicable.
- **Document Review**

Items to be reviewed fall into the following categories:

  - Current Due Diligence Questionnaires, Placement Agent Policy, and presentation materials
  - Historical client letters and communications, including capital calls and distribution notices
  - Audited financial statements
  - Offering Materials (e.g. Private Placement Memorandum, Limited Partnership Agreement, Subscription Document)
  - Investment Consultant(s) memoranda
- **Public Information Review**
  - IOP, in conjunction with the assigned Investment Consultant, gather and review information that is publicly available, including Form ADV, about the manager and key individuals at the firm.
- **Reference Calls**
  - IOP performs reference calls, e.g. former employers/colleagues, current investors, former investors, vendors, investment partners, etc.
- **Operations Review and Due Diligence**
  - The assigned Investment Consultant conducts a full operational review and issues an Operational Due Diligence (ODD) memorandum.
  - IOP review the completed ODD memorandum.
  - PSERS' Internal Operational Due Diligence Manager will also conduct an ODD review and summarize the findings in a memo to the AIC.
- **Investment Review and Due Diligence**
  - IOP prepare their memoranda of recommendation that address key aspects of the investment, generally including firm overview, market opportunity, portfolio fit, past performance, and identified risks.
  - The assigned Investment Consultant conducts a full investment review and issues an Investment Due Diligence (IDD) memorandum.
  - IOP review the completed IDD memorandum.



- **Allocation Implementation Committee (AIC) Review and Approval**
  - The AIC, an internal Investment Office committee, of which the CIO is a member, reviews the IOP and assigned Investment Consultant memoranda and supporting information. The AIC votes and, if approved unanimously, the applicable portfolio manager can recommend the investment to the Board.
- **Preliminary Legal/Side Letter Negotiation**
  - IOP may provide legal documents to PSERS' Office of Chief Counsel (OCC) and Investment Operations groups depending on the closing date of the fund.
- **Board Approval**
  - The IOP and assigned Investment Consultant recommendation memoranda are provided to the Board in advance of the Board meeting.
- **Contracting/Legal Negotiations**
  - Upon Board approval, the IOP coordinate final legal reviews with the OCC and Investment Operations groups. Identified matters will be addressed via a side letter when necessary. The side letter will obligate the External Manager to abide by all applicable and then-current PSERS Board Policies (e.g. Placement Agent Policy, disclosure of political contributions), unless otherwise approved by the Board.
  - Once the contracts have been approved and executed by the OCC, IOP, and PSERS' Executive Office, the contracts are sent, if necessary, to the Office of Attorney General for review and execution.

## **B. Co-Investments and Secondaries (excluding PA Co-Invest Program)**

Set forth below are the key elements for co-investments and secondaries. As of the date of this policy, co-investments and secondaries are only permitted to be entered into alongside existing External Managers (within the applicable asset class) in PSERS' portfolio, except for co-investment opportunities located in Pennsylvania (PA Co-Invest Program). PA Co-Invest Program discussed in item C below.

- **Sourcing and Identification**
  - IOP are offered potential co-investments and secondaries through existing fund investments
- **Manager Discussions and Analysis**
  - IOP will engage in detailed discussions with the External Manager offering the co-investment or secondary opportunity to better understand the merits and risks of the opportunity.



- **Document Review**

Examples include, but are not limited to:

- Investment Committee Memorandum
  - Financial Models
  - Bank / Lender presentation (if available)
  - 3rd Party Investment Consultant Reports (i.e. Quality of Earnings)
  - Audited Financial Statements
  - Offering Materials (e.g. Limited Partnership Agreement, Subscription Document)
  - Relevant investment and deal lead track records
- **Performance Analysis**
    - IOP analyze historical results to prove the merits of an External Manager's investment strategy and the execution thereof.
  - **Public Information Review**
    - IOP will gather and review information that is publicly available about the External Manager sponsoring the co-investment, the key individuals at the firm, and the co-investment entity
  - **IOP Recommendation**
    - IOP prepares a presentation to the AIC that address key aspects of the investment, generally including company overview, market opportunity, portfolio fit, management track record, public information review, identified risks, External Manager concentration risk assessment and a cumulative asset class allocation total for the internal co-investment and secondary investment programs; concluding with a formal recommendation.
  - **AIC Review and Approval**
    - The AIC reviews the IOP recommendation and supporting information. The AIC then votes to approve or decline the co-investment or secondary.
    - The AIC must unanimously approve the co-investment or secondary.
  - **Contracting/Legal Negotiations (when applicable)**
    - Upon AIC approval, the IOP begins legal reviews with OCC. Identified matters will be addressed via a side letter when necessary.
    - Upon Board approval:
      - The Office of Attorney General (OAG) has delegated to PSERS execution authority for fully negotiated contracts that meet the following criteria: 1) are with an existing manger, and 2) have immaterial changes from a previous contract.
      - Fully negotiated contracts that do not meet the above criteria must be sent to the OAG for review and approval.



### **C. PA Co-Invest Program**

Co-Investment opportunities located in Pennsylvania sourced from an existing PSERS manager relationship may follow the process outlined in Section V. B of this Policy, or may be assigned to the Investment Consultant as outlined below.

Co-Investment opportunities located in Pennsylvania where PSERS does not have an existing manager relationship, or is assigned by PSERS IOP due to an existing PSERS manager relationship, will be underwritten and approved as follows:

- **Consultant Recommendation**
  - PA Co-investment Program opportunities underwritten and recommended by the assigned Investment Consultant.
- **IOP Staff**
  - Reviews Consultant's recommendation and determines if it will be referred to the AIC for approval
- **AIC Review and Approval**
  - The AIC reviews the consultant recommendation and supporting information.
  - The AIC then votes to approve or decline the co-investment.
  - The AIC must unanimously approve the co-investment.