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Policy 1986-02-A: *Investment*

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A. Introduction

The purpose of this policy is to provide the basis for the State System of Higher Education (the "System") to manage responsibly the funds in its custody in accordance with the investment philosophy and objectives herein articulated. Under Act 188 of 1982, responsibility for the establishment of such policy is vested in the Board of Governors.

B. Investment Philosophy

The State System of Higher Education, in keeping with its legal status as a system of public universities, recognizes a fiduciary responsibility to invest all funds prudently in accordance with ethical and prevailing legal standards. In addition, the State System recognizes that the funds in its custody can be classified according to purpose, time frame for use, source, and other similar classifications. Differential investment guidelines and objectives are required to manage various funds classifications appropriately and optimally.

Regardless of funds classifications, certain general tenets apply. Investments in all classifications should seek to minimize investment risks while maximizing asset value. Adequate liquidity should be maintained so assets may be held to maturity. Reasonable portfolio diversification should be pursued to ensure that no single security or investment or class of securities or investments will have a disproportionate or significant impact on the total portfolio. Investments may be made in U.S. dollar-denominated debt of high quality U.S. and non-U.S. corporations. Investment performance in all classifications should be monitored on a frequent and regular basis to ensure that objectives are attained and guidelines are followed.

C. Definitions

Locally Managed Funds - Those funds which, by covenant or preexisting conditions, must be managed by a university or other designated representative.

Long-Term Investment Funds - Those funds which comprise the endowment, quasi-endowment, and life-income groups, as defined by the National Association of College and University Business Officers (NACUBO); further, this shall mean those funds which are not current in nature, i.e., the principal of which is not needed to finance current operations.

Operating Funds - Those current funds that generally accrue as a function of state appropriations, tuition and fees, auxiliary operations, contracts and grants, and gifts and donations. These funds shall be invested in the System Investment Fund (the "Fund"), which will be comprised of two portfolios—the Short-Term Portfolio and the Intermediate-Term Portfolio. "Operating Funds" are further classified as follows:

- **Short-Term Operating Funds** - Those funds which will be required to satisfy projected expenditures during the fiscal year; they are further identified as those funds between the high point and the low point of the annual cash projection of the System. These funds will comprise the Short-Term Portfolio of the Fund.

- **Intermediate-Term Operating Funds** - Those funds which are not projected as being required to satisfy expenditures during the fiscal year; they are further identified as the low point on the annual cash flow projection for the System. These funds will comprise the Intermediate-Term Portfolio of the Fund.

D. Investment Oversight

The Finance, Administration, and Facilities Committee of the Board of Governors of the System (the "Committee") and Treasury staff (the "Staff") shall be charged with the responsibility of monitoring the performance of all System investments and reporting on an annual basis to the Board of Governors and the Executive Council through the Chancellor.

The performance of the Fund's investment manager(s) will be actively monitored by the Staff, who will report any meaningful observations and performance deviations to the Committee in a timely manner. Quarterly performance will be evaluated versus appropriate benchmarks, but emphasis will be placed on relative performance over longer investment periods. In addition to performance measurement, the Staff will monitor for consistent implementation of investment strategy and philosophy, appropriate risk controls, adherence to stated guidelines, and any material changes in the investment manager's organization and/or investment personnel.

A Treasury Report consisting of various financial and investment information, including, but not limited to, performance of all System investments, investment balances, and a debt profile, shall be prepared quarterly and presented for review to the director, Office of Internal Audit and Risk Assessment. The most recent Treasury Report will be reviewed by the vice chancellor for administration and finance and presented by him/her biannually to the chair of the Committee.

E. Duties and Responsibilities of the Investment Manager(s)

Investment managers are expected to comply with the following list of duties and responsibilities; these items will be communicated in writing to all investment managers, along with any specific guidelines or constraints to the investment mandate.

1. Promptly inform the Staff in writing regarding all significant and/or material matters and changes pertaining to investment of the Funds, including, but not limited to, investment strategy, portfolio structure, tactical approaches,

ownership/organizational structure, professional staff, financial condition, guideline changes, and all Securities and Exchange Commission (SEC) and other regulatory agency proceedings affecting the investment management firm.

2. Promptly execute all responsibilities associated with the investments in a manner consistent with long-term interests and objectives of the Fund. Each investment manager shall keep a record of actions required in the management of the portfolio and comply with all regulatory obligations related thereto.

3. Use the same care, skill, prudence, and due diligence under the circumstances then prevailing that experienced investment professionals acting in a similar capacity and fully familiar with such matters would use in similar activities for similar investment portfolios with similar aims in accordance and in compliance with applicable local, state, and federal laws, rules, and regulations, including, but not limited to, those pertaining to fiduciary duties and responsibilities.

F. Investment Objectives and Guidelines for Operating Funds in the System Investment Fund

Safety of principal and liquidity are the top priorities for the investment of the Fund. Within those guidelines, income optimization should be pursued. Speculative investment activity is not allowed. Speculative investment activity includes, but is not limited to, investing in asset classes such as commodities, equities, or venture capital; investing in futures, private placements, letter stocks, or unlisted securities; or entering into short sales, option contracts, or utilizing leverage. The operating funds of the State System shall be invested and reinvested in the following types of instruments with qualifications as provided.

1. United States Government Securities, which includes obligations issued or guaranteed by the United States Treasury, United States Federal Agencies, and United States Government Sponsored Enterprises (GSEs). At all times, at least 20% of the market value of the Fund shall be invested in U.S. Government Securities including repurchase agreements. However, debt obligations issued directly by GSEs that are not explicitly guaranteed by the United States Government are limited to 5% of the Fund's assets, as measured on a market-value basis; GSE guarantor obligations related to mortgage-backed securities are not included in the 5% limitation.

2. Repurchase Agreements

   a. Such agreements shall require that the underlying collateral be direct obligations of the United States Treasury, excluding interest-only and principal-only Treasury securities (IO and PO Strips), and the collateral be in the custody of the State System or its agent. At all times, the market value of the collateral plus the accrued interest on the security to the date of valuation must equal at least 102% of the invested principal. Repurchase agreements with maturities beyond 30 days should comprise less than 10% of the Fund, as measured on a market-value basis.

   b. Reverse repurchase agreements, used to take advantage of unique market opportunities, where the relative value of securities with similar terms can be exchanged for gain only, and not to leverage the Fund or speculate on interest rate directions. Proceeds of the transaction are to be reinvested in highly liquid securities with minimal credit and duration risk.

   c. Repurchase agreements and reverse repurchase agreements may be entered into only with parties having a short-term credit rating of "Prime-1" ("P-1") by

Moody's Investors Service, or the equivalent by Standard & Poor's, and a long-term rating of "A" or above by Moody's Investors Service, or the equivalent by Standard & Poor's. No more than 5% of the market value of the Fund may be invested with a single repurchase agreement dealer.

d. The total allocation to repurchase agreements in the Fund shall be limited to 30% of the market value of the Fund.

3. Commercial Paper, which shall mean unsecured promissory notes issued either in discount or interest-bearing form by a corporation and which carries a Moody's Investors Service "P-1" or "Prime-2" ("P-2") rating, or the equivalent by Standard & Poor's subject to the restrictions below.

   a. For issues rated "P-1," no more than 5% of the market value of the Fund shall be invested in any single issuer of commercial paper at any given time.

   b. For issues rated "P-2," issuers must be U.S. corporations with a long-term debt rating of "Baa2" or better by Moody's Investors Service; no more than 3% of the market value of the Fund shall be invested in any single issuer of commercial paper that is rated "P-2;" the "P-2"-rated commercial paper must have a maximum maturity of 30 days; and no more than 5% of the market value of the Fund assets may be invested in commercial paper and corporate bonds in which the issuer has a long-term credit rating of "Baa2" or "Baa1" from Moody's Investors Service, or the equivalent by Standard & Poor's.

   c. The Fund shall not invest in asset-backed commercial paper (ABCP) that carries a rating below "A-1/P-1."

4. Certificates of Deposit and Bank Notes from commercial banks with a maturity of up to and including two years, provided that any such issuing bank shall have a Moody's Investors Service "P-1" rating, or the equivalent by Standard & Poor's. No more than 5% of the market value of the Fund shall be invested in any single issuer of certificates of deposit.

5. Bankers Acceptances, defined as short-term financing agreements secured by the accepting bank and the goods purchased, which shall be limited to banks whose parent companies bear a Moody's Investors Service "P-1" rating, or the equivalent by Standard & Poor's, provided that no more than 5% of the market value of the Fund shall be invested in any single issuer or guarantor of Bankers Acceptances.

6. U.S. Money Market Funds that are substantially of the same kinds, classes, and investment grades as those eligible for investment under the provisions of this Policy.

7. Municipal Bonds with a long-term debt rating of "A" or better by Moody's Investors Service, or the equivalent by Standard & Poor's. Investments in municipal bonds will not exceed 20% of the market value of the Fund. No more than 5% of the market value of the Fund shall be invested in any single municipal issuer, and municipal bond investments must be diversified by geography. On a combined basis, no more than 10% of the market value of the Fund shall be exposed to a single municipal bond guarantor.

8. U.S. dollar-denominated Corporate Bonds, whose allocation shall not exceed 20% of the market value of the Fund. Within the corporate bond allocation, 15% of the

securities must carry a long-term debt rating of "A" or better by Moody's Investors Service, or the equivalent by Standard & Poor's; 5% of the corporate securities may be rated between "Baa2" and "Baa1" by Moody's Investors Service or the equivalent by Standard & Poor's. Corporate bond issues rated below "A," or the equivalent by Standard & Poor's, shall be restricted to a maximum final maturity within five years of the date of purchase.

9. Collateralized Mortgage Obligations (CMOs) and mortgage pass-through securities rated "Aaa" by Moody's Investors Service, or the equivalent by Standard & Poor's, and composed entirely of securities guaranteed by U.S. Government Agencies or U.S. GSEs, excluding interest-only, principal-only, and inverse floating-rate securities. The combined total of CMOs and mortgage pass-through securities shall not exceed 20% of the market value of the Fund. CMOs and mortgage pass-through securities held within the Short-Term Portfolio must have an estimated average life of less than 15 months; and CMOs and mortgage pass-through securities held in the Intermediate-Term Portfolio must have an estimated average life of less than seven years.

10. Asset-Backed Securities, rated "Aaa" by Moody's Investors Service, or the equivalent by Standard & Poor's. The total of asset-backed securities shall not exceed 20% of the market value of the Fund. No more than 5% of the market value of the Fund shall be invested in any single commercial paper conduit issuer.

11. System Investment Fund Loans

    a. System Notes, defined as an intermediate debt obligation of one of the PASSHE universities. System Notes may be issued as an intermediate-term project financing alternative to tax-exempt bonds. The term of the loan is not to exceed five years. Construction projects requiring financing including System Notes must be approved by the Board of Governors.

       There shall not, at any time, be more than 20% of the–market value of the Fund invested in System notes nor more than 5% of the market value of the Fund invested in System Notes of any single entity, unless a waiver to these limitations is expressly approved by the Committee.

    b. Bridge Notes, defined as a short-term obligation of one of the PASSHE universities. This security is issued as needed to meet project construction cash flow needs in anticipation of permanent future financing through the issuance of tax-exempt bonds managed by the Treasury Office of the Office of the Chancellor. These notes are usually issued for 12 months or less. Construction projects requiring financing including Bridge Notes must be approved by the Board of Governors.

12. With prior written approval from the chair of the Committee, the Fund may invest in publicly traded debt securities, which:

    a. Are direct obligations of affiliates of System member institutions; and

    b. Possess a Committee on Uniform Securities Identification Procedures (CUSIP) number; and

    c. Total investment in the debt of said affiliates is limited to a maximum of 0.5% of the market value of the Fund.

In all securities types, variable rate notes are allowed; however, investment in variable rate demand notes (VRDN), variable rate demand obligations (VRDO), or auction rate securities (ARS) is prohibited. The interest rate on the variable rate notes must reset at least annually. The interest rate must be based on a well-known, readily published, generally accepted index, such as the London Inter Bank Offer Rate (LIBOR), U.S. Treasury Bills, or Fed Funds. The interest rate must be directly related to the index not leveraged, deleveraged, or inversely related. Securities with interest rate caps are not permitted.

With regard to select permitted investments described above, the following limitations apply.

- The combined total investments in commercial paper, certificates of deposit, bank notes, and bankers acceptances may not exceed 30% of the total market value of the Fund; and

- The combined total of commercial paper issued by financial institutions, certificates of deposit, bank notes, and bankers acceptances and corporate obligations issued by financial institutions may not exceed 40% of the total market value of the Fund.

The Fund shall not engage in securities lending activity.

Commercial paper, certificates of deposit, bank notes, and bankers acceptances may be split-rated; however, the credit rating cannot be below quality levels indicated above and, when calculating quality exposure, the lower rating must be used. Securities that are rated acceptable by one rating agency and unrated by the other are acceptable for purchase.

Each security in the Intermediate-Term Portfolio will have an "interest rate risk value" of ten or less at the time of purchase. Interest rate risk value is defined as follows. For securities with a positive or zero convexity, the "interest rate risk value" is equal to the duration measured in years. For securities with negative convexity, the "interest rate risk value" is equal to the duration measured in years plus the absolute value of the convexity measure. All securities that comprise the Intermediate-Term Portfolio shall have a maximum final maturity of ten years or less, with the exception of corporate bond issues rated below "A" by Moody's Investors Service, or the equivalent by Standard & Poor's, which shall be restricted to a maximum final maturity of five years, measured at the date of purchase.

Callable bonds, excluding mortgage-backed securities, shall comprise no more than 10% of the market value of Fund assets. Reporting should identify callable bonds in the portfolio and list the call date for each bond. Duration and convexity of the mortgage-backed security allocation should be reported on a monthly and quarterly basis.

Securities that fall below the minimum standards for purchase, as described herein, should be noted on the monthly report and monitored closely. Dispensation of the monitored security will depend upon the relative risk presented to the portfolio and market conditions at the time. Any action regarding the security shall be documented and reported to the Committee at its next quarterly briefing.

G. Further Investment Objectives and Guidelines for the Short-Term Portfolio and the Intermediate-Term Portfolio

1. Short-Term Portfolio

    a. All securities that comprise the Short-Term Portfolio shall have a maximum final maturity of 15 months or less.

    b. The Short-Term Portfolio shall be maintained at a level sufficient to fund the System's operations plus an amount to cover any unforeseen emergency. Cash flow forecasts should be maintained and updated on an ongoing basis and submitted monthly along with other reporting requirements to the System.

    c. The Short-Term Portfolio shall be measured against the Standard & Poor's U.S. Commercial Paper Index, U.S. 3-month LIBOR, the Three-Month Treasury Bill Index, and the Barclays Capital Short-Term Government/Credit Index, or then prevailing, comparable, generally accepted market indices that have been approved by the Committee and Staff.

2. Intermediate-Term Portfolio

    a. A portfolio duration target of 1.8 years should be maintained with an upper limit of 2.5 years. The portfolio's weighted average convexity shall be greater than -0.5. The duration of the Intermediate-Term Portfolio may be maintained outside the target range or in excess of the upper limit with the approval of the Staff.

    b. The portfolio will be measured against the Barclays Capital 1–3 Year Government/Credit Bond Index and the Barclays Capital 1–3 Year Government Bond Index, or the then prevailing, comparable, generally accepted market indices that have been approved by the Committee and Staff.

    c. The portfolio will be accounted for on a constant dollar-in, dollar-out basis, and the yield and income will be reported monthly. The portfolio also will be marked-to-market monthly, and the monthly data will be reported on a quarterly basis.

H. Investment Reporting

1. Along with the requirements mentioned herein, the investment manager shall submit a monthly report that describes significant events that occurred in the portfolio and what actions were taken, and a general narrative discussing the portfolio's activities and general direction.

2. The investment manager shall report total return performance of the investments and their respective benchmarks on a monthly basis, and detailed investment and performance reports will be provided on a quarterly basis. In addition to customary reporting requirements, monthly and quarterly reports shall include yield to maturity, weighted average maturity, convexity, quality distribution, duration distribution, duration by sector, sector allocations, and spread duration for the investments and benchmarks.

3. Monthly and quarterly reporting should include details on the types of instruments classified as cash; risk and sector reporting should look to the underlying issuer of each instrument and include investments in the cash segment of the portfolios.

4. Reports should include the Short-Term and Intermediate-Term Portfolios on a separate and consolidated basis.

5. Equivalent metrics shall be reported for the benchmark indices of the Short-Term and Intermediate-Term Portfolios and shall be included in the monthly and quarterly reports.

6. The investment manager shall promptly report any material changes to the financial or business condition of the investment management firm, as well as any changes to the investment team or investment process. The investment manager must promptly notify The Staff of any material litigation or investigations involving the investment management firm; and,

7. The investment manager will certify, with each monthly report, their compliance with this Policy.

I. Investment Objectives and Guidelines for Long-Term Funds

The long-term funds shall consist of a multi-year corpus which could have either or both a growth and income orientation. The investment objective for long-term funds is to produce the highest total return without undue risk. For funds with primarily a growth orientation, the annual total rate of return should be measured against the Standard & Poor's 500 annual rate of return; for funds with primarily an income orientation, the annual total rate of return should be measured against the Barclays Capital Bond Index or the then prevailing, comparable, generally accepted market indices. Total return is defined as conventional income plus capital gain (loss) or appreciation (depreciation), whether realized or unrealized.

Management of long-term funds shall be the responsibility of the individual university. Each university, with the approval of the local council of trustees, will establish local guidelines for the investment of long-term funds consistent with the provisions contained in this policy. Each university may, with the approval of the local council of trustees, elect to manage and invest these funds using internal staff. Other permissible investment options are as follows: the Common Fund, the American Association of State Colleges and Universities (AASCU) Capital Fund, a professional investment manager, a pooling arrangement between universities for common investment purposes, and/or through a fiduciary agreement with a qualified affiliated organization. The professional manager/affiliated organization will be required to operate within the principles contained within this policy and the guidelines promulgated by the respective university. Procedure/Standard Number 2012-12, *Fiduciary Agreement*, is to be used as a guideline in preparing such a fiduciary agreement. All fiduciary agreements are subject to the approval of the Office of the Chancellor prior to final execution.

At the end of each fiscal year, a statement of operations reflecting beginning of year value, end of year value, income, disbursements, realized and unrealized gains (losses) will be prepared for locally managed long-term investments. A copy of the statement of operations will be submitted to the vice chancellor for administration and finance and presented by him/her annually to the chair of the Committee.

The asset mix of the funds invested should be congruent with the purpose for which the funds were donated and/or are to be utilized. For example, funds with a predominant income orientation (e.g., scholarship funds) should be invested primarily in government and/or corporate securities with a predictable income stream. Funds with a greater emphasis on long-term growth or appreciation should be more heavily weighted toward equities.

Long-term funds shall be invested and reinvested in the following types of instruments with qualifications as provided:

1. United States Treasury and United States agency obligations.

2. Corporate Bonds with a long-term debt rating of "Baa2" or better by Moody's Investors Service, or the equivalent by Standard & Poor's.

3. Taxable-municipal bonds with a long-term debt rating of "A" or better by Moody's Investors Service, or the equivalent by Standard & Poor's.

4. Corporate equities in U.S. dollar-denominated, high quality U.S. and non-U.S. corporations listed on one of the three stock exchanges—New York Stock Exchange, American Stock Exchange, and NASDAQ Stock Exchange—that meet the following minimum criteria:

    a. At least five million shares outstanding and at least $100 million in equity market value and

    b. A "3" or better safety rating by Value Line.

    c. Items I.4.a. and I.4.b. will not be applied to item I.5.b.

5. Equity holdings are restricted to:

    a. U.S. dollar-denominated, high quality U.S. and non-U.S. corporations listed on the New York Stock Exchange, American Stock Exchange, and NASDAQ Stock Exchange that meet the minimum criteria in I.4.a. and I.4.b.

    b. Mutual funds/exchange-traded funds.

    Valuation of equity holdings will be measured on a cost basis. The specific asset classes and strategies to be employed by the investment manager will be approved by the Chancellor or his/her designee in consultation with the chair of the Committee.

6. Covered Call Option, which shall mean to write an option to sell corporate equities owned for more than 30 days at a stated price.

7. Commercial paper, which shall mean unsecured promissory notes issued either in discount or interest-bearing form by a corporation that carries a Moody's Investors Service "P-1" or "P-2" rating, or the equivalent by Standard & Poor's, subject to the following provisions:

a. For issues rated "P1," no more than 5% of the total invested long-term investment funds shall be invested in any single issuer of commercial paper at any given time.

b. For issues rated "P-2," issuers must be U.S. corporations with long-term debt ratings of "Baa2" or better by Moody's Investors Service, or the equivalent by Standard & Poor's. No more than 3% of the total invested long-term investment funds shall be invested in any single issuer of commercial paper that is rated "P-2."

c. No more than 10% of the long-term investment funds may be placed in combined direct commercial paper, letter-of-credit commercial paper, corporate bonds, or corporate equities of a single issuer. There shall not, at any time, be invested in commercial paper more than an aggregate of 25% of the total long-term investment funds of the State System.

8. Certificates of deposit from commercial banks, provided that any such issuing bank shall be rated "C" or better by Keefe, Bruyette and Woods and be insured by the Federal Deposit Insurance Corporation. No more than 5% of the total long-term investment funds shall be invested in any single issuer of certificates of deposit. There shall not, at any time, be invested in certificates of deposit more than an aggregate of 25% of the total long-term investment funds.

9. Bankers Acceptances, defined as short-term financing agreements secured by the accepting bank and the goods purchased, which shall be limited to banks whose parent companies bear a Moody's Investors Service "A Rating," or the equivalent by Standard & Poor's, on long-term securities, provided that no more than 5% of the total investable long-term funds shall be invested in any single issuer or guarantor of Bankers Acceptances. There shall not, at any time, be invested in Bankers Acceptances more than an aggregate of 20% of the total long-term investment funds.

10. Repurchase Agreements. Such agreements shall require that the underlying collateral be direct obligations of the United States Treasury, and the collateral be in the physical possession of the State System or its agent. At all times, the market value of the collateral plus the accrued interest on the security to date of valuation must equal at least 102% of the invested principal. Additionally, the collateral may not have a maturity of more than four years.

11. The Short-Term Investment Fund or the Intermediate-Term Investment Fund of the State System.

12. With the exception of direct obligations of the United States Treasury, no more than 20% of the investable long-term funds may be concentrated in any single industry nor more than 6% in any single company.

13. Investments in commodity futures, margin purchases, short sales, letter stock purchases, or purchase of securities with similar marketability are prohibited.