

1. PURPOSE

¶A. The purpose of this statement is to delineate the investment policy and guidelines and to establish the overall investment strategies and discipline of the Pension Reserves Investment Management Board (hereinafter referred to as “PRIM” or the “Board”). This policy is intended to allow for sufficient flexibility to capture investment opportunities, yet provide parameters that ensure prudence and care in the execution of the investment program.

¶B. This policy is issued for the guidance of fiduciaries, including Trustees, staff professionals, investment managers, custodians, and investment consultants, for managing the assets of the Pension Reserves Investment Trust (PRIT) Fund. The policy is intended to provide a foundation from which to oversee the management of the Fund in a prudent manner. It also states the standards and disciplines adopted so that Trustees can effectively evaluate the performance of the PRIM staff, investment managers, custodians, and investment consultants.

2. MISSION STATEMENT AND LEGAL AUTHORITY

¶A. The Pension Reserves Investment Trust Fund and the Pension Reserves Investment Management Board, which oversees the Trust, were established by Act of the General Court (Chapter 661 of the Acts of 1983) to address the large unfunded pension liability of the public employees retirement systems of the Commonwealth of Massachusetts. Subsequent legislation (Chapter 315 of the Acts of 1996) vested in the PRIM Board authority over all retirement assets of the Commonwealth, including those previously held in the Massachusetts State Teachers' and Employees' Retirement Systems Trust. Additionally, the PRIT Fund serves as an investment vehicle for the retirement systems of Massachusetts authorities, counties, cities, and towns that choose to invest in the PRIT Fund (the "PRIT core") or its particular asset classes ("segments").

¶B. The mission of the PRIT Fund is to ensure that current and future benefit obligations are adequately funded in a cost-effective manner. The PRIT Fund therefore seeks to maximize the total return on investment, within acceptable levels of risk for a public pension fund. Under current law, by the year 2023 the PRIT Fund will have grown, through annual payments in accordance with a legislatively approved funding schedule and through the total return of the fund, to an amount sufficient to meet the then existing pension obligations of the Commonwealth. The Commonwealth has adopted a schedule of state pension appropriations that assumes a long-term actuarial rate of return for the PRIT Fund of 8.25%.

¶C. The nine-member PRIM Board, as trustees for each retirement system that invests in the PRIT Fund, has authority to employ an Executive Director, outside investment managers, custodians, consultants, and others it deems necessary; to formulate policies and procedures; and to take such other actions as necessary and appropriate to manage the assets of the Fund. See M.G.L. ch. 32, sec. 23(2A)(e).

3. FIDUCIARY STANDARDS

¶A. As trustees of the PRIT Fund, members of the PRIM Board are fiduciaries. Accordingly, PRIM Board members are required to:

1. Act solely in the interest of the participating retirement systems' participants and beneficiaries, for the exclusive purpose of providing benefits and defraying the reasonable costs of managing the systems' pension assets.
2. Act with "the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."
3. Diversify the investments of the Fund in order to minimize the risks of large losses, unless under the circumstances it is clearly prudent not to do so.
4. Act in accordance with the PRIT Fund's authorizing statute and governing documents.

See M.G.L. ch. 32, sec. 23(3).

¶B. Fiduciary standards of conduct also apply to the PRIM Board's staff, investment managers, custodians, investment consultants, and others who exercise discretionary authority or discretionary control over the management or disposition of PRIT Fund assets. See M.G.L. ch. 32, sec. 1.

4. DUTIES AND RESPONSIBILITIES

¶A. **Board.** The Board is responsible for establishing the policies and guidelines by which the PRIT Fund is managed, and the PRIM Board is operated.

¶B. **Committees of the Board.** To assist the Board in carrying out its duties, it has established three standing committees as described below. The role of each committee is to make recommendations to the Board within its stated area of responsibility. See By-Laws of the Massachusetts PRIM Board, Article II, sec. 8. (In June 2003, the Administration & Audit Committees joined to be one committee.)

1. **Administration & Audit Committee.** The Administration & Audit Committee reviews all issues related to the administration of the PRIM Board. The Committee's responsibilities include but are not limited to: recommending amendments to PRIT's Operating Trust and the By-Laws of the PRIM Board; hiring and terminating staff; authorizing and eliminating staff positions; establishing a staff salary structure; conducting Executive Director evaluations; and overseeing the custodian of the PRIT assets, the PRIM operating budget and financial statements, staff and trustee travel, and office management. The Administration & Audit Committee oversees the annual audits of the PRIT Trust and the PRIM Board, including the selection and hiring of auditors, the review of the completed audits, and the responses to auditors' findings.
2. **Investment Committee.** The Investment Committee reviews all investment related policy, performance, and management issues. The Investment Committee reviews and recommends to the Board the broad asset allocation among various asset classes. For all asset classes other than real estate and timber, the committee also reviews and recommends investment structure, recommends hiring and terminating investment managers and consultants, and monitors investment performance.
3. **Real Estate/Timber Committee.** The Real Estate/Timber Committee reviews all policy, performance and management issues related to investment in Real Estate and Timber. The Real Estate/Timber Committee reviews and recommends to the Board the structure of the real estate asset class, the timber asset class, the hiring and terminating real estate/timber investment managers and consultants, and acquiring or disposing of properties where this authority is not delegated to another fiduciary. The Real Estate/Timber committee also monitors real estate investment results and real estate manager performance and organizational issues.

¶C. **Staff.** The Executive Director, with the assistance of staff, has the responsibility and authority to assist the Board and its committees in establishing investment and administrative policy; to implement the policies and programs established by the Board; and to report to the Board on the status of the Fund and the operations of PRIM.

¶D. **Investment Managers**. The Board employs professional investment managers and gives them discretion, consistent with specified objectives and guidelines, to manage the PRIT Fund's assets. The Board and staff do not directly manage any PRIT Fund portfolios. Each investment manager operates under a formal contract that delineates its responsibilities and appropriate performance expectations, and that includes a formal set of investment guidelines and administrative requirements for management of each portfolio. The Board reviews the investment performance of these managers against their stated objectives at least quarterly.

¶E. **Consultants**. The Board may utilize the services of one or more investment management consultants to assist the Board and staff in performance review, asset allocation studies, investment structure analyses, manager screening and selection, investment research and other matters of investment policy, procedures, and implementation. The analysis and recommendations of the consultants may be considered by the Board in conjunction with other available information for the purpose of making informed and prudent decisions.

¶F. **Custodians**. The Board retains one or more custodian banks or trust institutions to hold the assets of the PRIT Fund. The custodian accounts for and assists in the settlement of all transactions executed by PRIM's investment managers and makes available to the Board and to staff information with respect to the holdings, transactions, and performance of the PRIT Fund.

5. BOARD GOVERNANCE CHARTERS AND POLICIES

¶A. At the February 3, 2004 Board meeting, the PRIM Board approved the hiring of Cortex Applied Research, Inc to provide board governance consulting and fiduciary education services. On June 11, 2004, all board members attended Cortex's Board Governance Workshop. The result of the workshop and Cortex's recommendations were the following PRIM Board Governance Charters and Policies:

1. Charter for the PRIM Board
2. Administration Committee Charter
3. Audit Committee Charter
4. Real Estate Committee Charter
5. Investment Committee Charter
6. Charter for the Chairman
7. Executive Director Charter
8. Executive Director Evaluation Policy and Evaluation Survey
9. Board Education Policy
10. Board Communication Policy
11. Code of Conduct
12. Board Self-Evaluation Policy and Self-Evaluation Guide

¶B. The Board adopted the policies and charters on October 5, 2004 and will review each policy and charter at least once every three (3) years to ensure that it remains relevant and appropriate.

¶C. The Board Governance Charters and Policies approved by the PRIM Board on October 5, 2004 are located at Appendix J.

6. INVESTMENT OBJECTIVES

¶A. PRIM's overall objective is to achieve the highest level of investment performance that is compatible with its risk tolerance and prudent investment practices. Because of the long-term nature of the Commonwealth's pension liabilities, PRIM maintains a long-term perspective in formulating and implementing its investment policies, and in evaluating its investment performance. Investment performance is measured by three integrated long-term objectives: 1) the actuarial target rate of return, 2) the investment policy benchmark, and 3) peer universe comparisons.

¶B. The *actuarial target rate of return* is the key actuarial assumption affecting future Commonwealth funding rates and pension liabilities. Investment performance that exceeds or underperforms the target rate may materially impact future funding rates and liabilities. The PRIM Board seeks to have a long term investment performance that will reasonably exceed its actuarial target rate of return of 8.25%.

¶C. The *investment policy benchmark* is calculated by applying the investment performance of the asset class benchmarks to the Fund's asset allocation targets. The investment policy benchmark permits the Board to compare the Fund's actual performance to a passively managed proxy, and to measure the contribution of active investment management and policy implementation.

¶D. PRIM also compares its total fund performance to appropriate public plan sponsor *comparison universes*. A universe comparison permits PRIM to compare its performance to large statewide public and other pension plans. (While PRIM seeks to rank consistently in the top half of comparable public pension funds, the Board recognizes that other funds may have investment objectives and risk tolerances that differ substantially from PRIM's.)

¶E. PRIM expects to meet or exceed these objectives over its long-term investment horizon. Over shorter periods, the expected volatility of markets and unique objectives of PRIM relative to other pension plans may not favor PRIM's strategic investment policies.

7. ASSET ALLOCATION

¶A. The Board recognizes that over the long-term, asset allocation is the single greatest contributor of return and risk to the PRIT Fund. The Asset Allocation Plan embodies the Board's decisions about what proportions of the Fund shall be invested in domestic and international equity and fixed income securities, real estate, alternative investments, and, where appropriate the various sub-asset classes of each. At reasonable intervals of not more than three to five years, the Board will undertake a comprehensive review of its Asset Allocation Plan and its underlying assumptions, including: the Commonwealth's current and projected pension assets and liabilities; long-term capital markets rate of return assumptions; and the Board's risk tolerances. The comprehensive review will identify: a reasonable time horizon and investment strategy for matching assets and liabilities; a fund level total return target; and an optimal allocation among available asset classes and sub-asset classes. The Board shall examine the Asset Allocation Plan annually, and shall consider adjustments to the Plan as may be appropriate given the Plan's long-term nature and objectives.

The Board's most recent Asset Allocation Plan is attached as Appendix A.

¶B. The actual asset allocation mix will deviate from the Asset Allocation Plan's target due to market movement, cash flows, and manager performance. Material deviations from the asset allocation targets can alter the expected return and risk of the PRIT Fund. Accordingly, the Board will rebalance the PRIT Fund portfolio in accordance with written guidelines (the "rebalancing policy") to maintain the Asset Allocation Plan. When an asset class exceeds its allocation tolerance, the asset class will be rebalanced to the target allocation in a timely and cost effective manner.

The Board's most recent rebalancing policy is attached as Appendix B.

8. PUBLICLY TRADED SECURITIES

¶A. Most of the PRIT Fund's assets are invested in publicly traded securities. The PRIM Board expects to meet its return objectives and achieve adequate portfolio diversification by investing in different types of publicly traded securities, in various market segments in the United States, other developed countries, and emerging markets, through discretionary investment managers with appropriate investment styles.

The Board's current publicly-traded securities portfolio structure is described at Appendix C.

¶B. In constructing and managing its publicly-traded securities portfolios, the Board is guided by the following considerations:

1. **Market efficiency.** The ability of active management to add value over a reference index varies with the efficiency of the relevant markets. In more efficient markets, the Board prefers passive management because of its low cost and low risk of underperformance. In less efficient markets, the Board opts for active management because of the greater potential for outperformance.
2. **Style Neutrality.** Because different styles of investment management are favored in different economic and market environments, and because of the Board's long-term perspective, the Board seeks to maintain a style neutral portfolio.
3. **Derivatives.** The Board prohibits managers from using derivative securities (i.e., securities whose value derives from another security or index) for PRIM's accounts unless PRIM has expressly permitted the use of derivatives in the managers' investment guidelines and such use would be consistent with PRIM's investment objectives. (For example, index managers may use exchange traded futures to manage the cash position of the portfolio due to contributions or withdrawals resulting from hiring, termination, or rebalancing; fixed income managers may use exchange traded futures as a substitute for the underlying U.S. Treasury exposure or to hedge interest rate risk; and currency overlay managers may use forward foreign exchange contracts to control exchange rate risks.)
4. **Leverage.** The Board prohibits the use of derivatives, leverage, or other credit enhancements to increase any underlying investment risk.
5. **Securities Lending.** The Board may lend its publicly traded securities through an agent to other market participants, or to another principal, in return for compensation. PRIM seeks to assess fully the risks, such as counterparty and reinvestment risk, associated with each aspect of its securities lending program. In addition, the Board requires that the risks assumed and the administrative resources committed to monitor those risks are commensurate with the program's income potential.

6. **Separate Accounts.** Whenever practical, the Board makes its publicly traded securities investments through a separate account structure because of the superior control and flexibility that it provides.

9. ABSOLUTE RETURN AND U.S. EQUITY PORTABLE ALPHA

A. Hedge funds represent a distinctive investment style that is different from traditional, long only funds. A fundamental difference is that hedge fund managers emphasize absolute, rather than relative returns. They also use a much wider range of investment techniques, such as leverage, short selling and derivatives to achieve their objectives. A properly constructed portfolio of hedge funds is expected to deliver an absolute return with lower risk than equities. It should also have a low correlation with other asset classes and therefore help diversify the PRIT Fund. PRIM's goal is to retain a portfolio of managers that employ strategies constituting a well-diversified hedge fund portfolio. PRIM's objective in launching a hedge fund strategy is to reduce the volatility of the total fund while continuing to maximize returns in a variety of market environments.

B. The Board has two options for gaining exposure to this asset class. First, the Board may invest in fund of hedge fund managers, which are organizations that construct portfolios of hedge funds on behalf of investors. Secondly, the Board may choose to invest directly in hedge fund managers, effectively eliminating the layer of fees incurred with fund of hedge funds. Given the complexity of these investments and this asset class, these funds of hedge funds would provide an immediate knowledge base and access to top quality, closed funds through existing relationships. Furthermore, these funds of hedge funds would provide instant exposure to the asset class until the Board and Staff is more comfortable. Once an appropriate period of time has elapsed, the Board may elect to supplement these investments with and/or liquidate some of these portfolios and invest directly in single strategy managers.

C. In June 2003, as part of the PRIM Board's asset allocation review, the Board voted to invest 5% in absolute return strategies through fund of funds managers. The Absolute Return program is a dedicated asset class with a benchmark of T-bills + 4%.

D. In February, 2006, as part of the PRIM Board's asset allocation review, the Board voted to invest 5% in a U.S. Equity Portable Alpha Program. The portable alpha program includes both beta overlay as well as a fund of funds program. The U.S. Equity Portable Alpha program resides in the Domestic Equity portfolio with a benchmark of S&P 500.

E. The Board's current absolute return and U.S. Equity Portable Alpha portfolio structure is described at Appendix G.

10. ALTERNATIVE INVESTMENTS

¶A. Alternative Investments are private market (that is, non-publicly traded) investments in domestic and international venture capital and special equity. The Alternative Investment portfolio is designed to enhance the total Fund performance by generating a long-term rate of return equal to or greater than 5% over the long-term performance of the S&P 500 index, and by providing the Fund with added diversification.

¶B. The PRIM Board expects to achieve adequate portfolio diversification by investing in different types of alternative investments, in different partnerships, with managers representing various investment styles, concentrating on a variety of industries and locations. Further diversification will be sought by consistently making commitments to alternative investment funds over a sustained period of time, thereby limiting the portfolio's exposure to funds that are raised in the same year.

The Board's current alternative investments portfolio structure is described at Appendix E.

¶C. The Board will allocate its investments broadly over two categories: venture capital and special equity, principally acquisition (buyouts).

1. **Venture Capital** includes partnerships focused on investing in companies in a range of stages of development from start-up/seed-stage, to early stage, to later-stage. Venture capital-related investments will be a smaller percentage of the Alternative Investment portfolio due to the reduced capacity of the venture industry to absorb capital, and the higher risk associated with venture capital funds.
2. **Special Equity** includes acquisitions, equity infusion capital, recovery investments, subordinated debt, and special situations (a category which represents a diversified strategy across many sub-categories). Acquisition-related investments (i.e. leveraged buyouts, growth buyouts, industry consolidations, special situations) will comprise a majority of the Alternative Investment portfolio. This is because acquisition-related investments represent the largest portion of the private equity industry's investment opportunities by capital, and have attractive risk and reward characteristics. Subordinated debt, and distressed debt investments will play a much less significant role; these investments are generally expected to generate lower rates of return.

¶D. The Board will be disciplined in applying investment criteria: if investments in a particular sub-market (such as early-stage venture capital) cannot be found that meet the Board's criteria for quality, expected return, and risk, the investment category should be de-emphasized until market conditions improve. The Board will not make investments solely for the sake of diversification.

¶E. PRIM staff will direct the sale of securities distributed by its investment managers as soon as possible, and will not attempt to market-time the sale of distributed securities in order to increase investment returns.

¶F. At the December 6, 2005 Board Meeting, the PRIM Board approved a maximum allocation limit of 20% to any one fund.

¶G. The PRIM Board approved an allocation of up to 10% of our annual commitments to small and emerging managers at the April 6, 2004 PRIM Board meeting. The criteria for the small and emerging manager program, as approved by the PRIM Board, are presented below.

Criteria

- ❑ The goal of this program is to provide returns greater than our traditional private equity program.
- ❑ PRIM will target to commit up to 10% of its annual private equity allocation to emerging funds.
- ❑ PRIM will target to commit up to 20% of an emerging fund's total committed capital.
- ❑ In most cases, emerging funds should achieve a minimum size of \$100 million and should have at least one additional institutional investor.
- ❑ The general partners must demonstrate a relevant private equity track record that is attributable to either the firm or the individual general partners. Additionally, this track record should be consistent with the firm's current strategy. PRIM understands that these track records in many instances will be shorter than those of the funds presented in PRIM's traditional Alternative Investments program.
- ❑ First time funds in which the Principals have no relevant track record will not normally be considered.
- ❑ The funds must demonstrate that they have developed appropriate internal controls and reporting capabilities that are consistent with institutional expectations.

11. REAL ESTATE

¶A. Real estate investments are traditional private market (that is, non-publicly traded) equity-oriented investments in real properties or publicly traded real estate securities. Private market investments in real estate include direct ownership through separate accounts or indirect investments in commingled funds or other forms of collective investment vehicles which own underlying real estate. Publicly traded real estate securities include real estate investment trusts (“REITs”), real estate operating companies (“REOCs”) or real estate related companies (collectively, “Public Real Estate Securities”). The Real Estate Portfolio is designed to provide stable income returns, with low risk, and added diversification based upon the historical low correlation between real estate and equity or fixed income investments.

¶B. The Board currently allocates its real estate investments in three categories: Private Core; Private Core with value enhancement opportunities (“Value”); and Public Real Estate Securities.

1. **Private Core** investments are operating and substantially leased (80% or greater occupancy at the time of investment) institutional quality traditional property types (e.g., apartment, office, retail, industrial and R&D office). These investments are relatively low risk.
2. **Value** investments are institutional quality traditional property types that offer the opportunity to enhance value by alleviating an identifiable deficiency, expanding an existing investment, or utilizing higher levels of debt. These investments are of moderate risk.
3. **Public Real Estate Securities** include investments in publicly-traded, equity-oriented REITs, REOCs, and other real estate related companies. These investments provide greater liquidity and possess greater price volatility than private equity real estate.

The Board’s current real estate portfolio structure is described at Appendix F.

¶C. The Board expects to achieve adequate portfolio diversification by investing in different property types, in a variety of geographic locations, with different managers.

¶D. The Board believes that prudent and conservative use of third party leverage may be appropriate for certain real estate investments.

¶E. All real estate investments will be made, managed and sold by and at the discretion of qualified real estate investment managers. Whenever practical, the Board makes its real estate investments through a separate account structure because of the superior control and flexibility that it provides. At the April 1, 2005 board meeting, the PRIM Board delegated to the Real Estate Committee the authority to review and approve

future joint venture investments entered into by PRIT's real estate managers under their separate account management contracts.

12. TIMBER

A. Timber investments are traditional private market (that is, non-publicly traded) equity-oriented investments in timber properties. Private market investments in timber include direct ownership through separate accounts or indirect investments in commingled funds or other forms of collective investment vehicles which own underlying real estate. Investment returns from timberland investments are derived from the net cash flow generated from the sale of trees (referred to as stumpage sales) combined with capital appreciation from the biological growth of the trees. The timber Portfolio is designed to provide added diversification based upon the historical low correlation between timber and equity or fixed income investments. The Board's current timber portfolio structure is described at Appendix F.

B. The Board expects to achieve adequate portfolio diversification by investing in different tree types, in a variety of geographic locations, with different managers.

C. All timber investments will be made, managed and sold by and at the discretion of qualified timber investment managers. Whenever practical, the Board makes its timber investments through a separate account structure because of the superior control and flexibility that it provides.

13. CURRENCY MANAGEMENT

¶A. PRIM’s foreign investments are subject to “currency risk”: the possibility that underlying investment values may fluctuate due to changes in foreign exchange rates vis-a-vis the U.S. dollar. Currency risk can be mitigated by “currency hedging”: reducing or eliminating exposure to foreign currency risk through the use of foreign currency derivative securities, such as forward contracts, options, and futures. To determine whether or not to hedge, and if so in what proportion, PRIM must weigh currency risk against the costs of hedging and the counterparty risk associated with entering into forward foreign exchange contracts.

¶B. PRIM’s currency hedging shall have as its sole purpose the reduction of currency risk. Under no circumstances shall any manager be permitted to engage in currency speculation. Accordingly, managers shall not undertake cross-hedging, but shall in all cases hedge PRIM’s currency exposure back to the U.S. dollar.

14. INVESTMENT SERVICES SELECTION PROCESS

¶A. PRIM’s investment services selection process is open, competitive, objective and designed to insure that the Board has access to a broad array of the highest quality service providers that have the experience and capabilities to provide investment services to PRIM.

¶B. To procure investment services, PRIM staff, in conjunction with a consultant where appropriate, drafts and issues a Request for Proposals (“RFP”). The RFP provides background information on PRIM, outlines the proposal specifications and selection process, and requests detailed information on all topics relevant to the services sought. The RFP is advertised in industry publications, local publications, or both.

¶C. A Search Committee (typically comprised of staff, consultant where appropriate, and representatives of the Board and its pertinent Committee) reviews the proposals received, making objective judgments based solely on the selection criteria outlined in the RFP. The Search Committee may interview finalists, undertake site visits, and conduct such other due diligence as is prudent under the circumstances. The Search Committee’s recommendation is presented to the pertinent Committee for review. If approved, the Committee brings that recommendation to the Board, which may vote to accept or reject the recommendation. If accepted, the Board delegates to the Executive Director the authority to carry out the recommendation. Staff then takes the steps necessary to hire the service provider, including negotiation of contract terms.

¶D. The Board typically issues RFP’s for consultant, custodian, and auditing services every three years. The Board issues RFP’s for investment management services as needed (e.g., following termination of an existing manager).

¶E. The Board may consider hiring “emerging managers”, i.e., investment managers with performance track records shorter or assets under management fewer than PRIM’s typical investment criteria. Recognizing that there are additional risks to hiring such managers, in all cases PRIM must identify clear off-setting *investment* benefits to the Fund. The investment services offered must be compelling in focus and strategy, economically rewarding, and not easily obtained from other managers with longer track records or more substantial organizations. (For example, because established, successful venture capital firms typically do not need to raise money from new investors, PRIM may need to consider investing with “first time funds” whose general partners may have shorter track records).

¶F. **Selection of Alternative Investments.** Because Alternative Investments typically cannot be sourced through competitive bidding, the Board has developed a process to source, evaluate, and select these investment opportunities as they arise.

1. Selection Criteria. The PRIM Board will select investments based on the due diligence and resulting recommendation of its staff and consultant. The following criteria will be considered when selecting investments for recommendation:

- a. The partnership’s strategy must fit PRIM’s goals and risk and return objectives.

b. The partnership's strategy must make sense in the current market environment: that is, sufficient investment opportunities must be available for the investment manager to fulfill its objectives.

c. The individual general partners should have experience working together as a team.

d. The past investment results of the investment manager must be superior, and the investment manager's prior investment experience should be representative of the strategy proposed for the current investment opportunity.

e. The investment manager should have experience with the complete investment process (from initial investment through realization) in a number of transactions in varying economic cycles.

f. In order to maintain its venture capital allocation while maintaining rigorous investment criteria, PRIM will be prepared to:

i. Accept smaller commitments: Because venture capital funds are typically much smaller than special equity funds, they require smaller commitments. To meet its allocation targets and to help establish long-term relationships with quality venture capital firms, PRIM will have no minimum commitment for venture capital funds.

ii. Streamline its investment process: venture capital partnerships are able to raise capital quickly, and thus the time from fund raising to closing can be significantly shorter than that for special equity partnerships. In order to participate in such partnerships, PRIM's Investment Committee and Board must be willing, on occasion, to review and approve investment opportunities between regularly-scheduled Board meetings.

iii. Consider non-traditional track records: To participate in quality "first-time funds", PRIM must be prepared to evaluate general partners' investment track records outside limited partnership vehicles.

2. Selection Process. The PRIM Board selects investments in accordance with the following process:

a. Every investment opportunity is reviewed by the consultant so that the selection criteria listed above are applied consistently to each opportunity.

b. Extensive due diligence will be conducted on opportunities that appear to meet the selection criteria and that the consultant and PRIM agree may be appropriate for investment.

- c.** If favorable, the consultant's analysis and due diligence will be set forth in a written recommendation to invest. This recommendation, together with the recommendation of the PRIM staff, will be presented first to the PRIM Investment Committee, and then, provided the Committee concurs, to the PRIM Board for final approval.
- d.** If the Investment Committee concurs, a recommendation is made to the Trustees, who make the ultimate decision whether to invest during public board meetings. However, it is often difficult to obtain due diligence materials in a timely manner due to the timing of Investment Committee meetings and public meetings. Therefore, PRIM Staff, with a third-party consultant's consensus, can approve investments in existing relationships. PRIM Staff only utilizes this process when an investment's closing is in conflict with PRIM's Investment information available to the Investment Committee and Trustees for their comments prior to any commitment. Following any discussions, PRIM's Executive Director is authorized to formally approve the investment.

15. INVESTMENT GUIDELINES

¶A. The PRIM Board selects its managers based on the contributions that its investment style and process are expected to make to the overall portfolio. The manager's Investment Objectives and Guidelines, which are a part of each publicly traded securities and real estate manager's Investment Management Agreement, documents PRIM's performance expectations and the manager's role in the portfolio. (The limited partnership agreements for alternative investments include provisions outlining the General Partner's investment objectives and guidelines; these provisions are typically less stringent than those found in PRIM's Investment Management Agreements.) PRIM uses the Investment Objectives and Guidelines to control risk on a portfolio-wide basis.

¶B. The objectives first establish relative and absolute performance expectations. The manager is expected to perform in the top half of its peer universe over a three to five year period. Absolute performance expectations are a function of the efficiency of the asset class. (For example, it might be realistic to expect that a small cap domestic equity manager could exceed the performance of its reference index by 200 basis points annualized, over a three to five year period, while a core fixed income manager may not be able to add more than 50 to 100 basis points.) The guidelines then delineate which investments and strategies the manager is permitted to use to achieve its performance objectives, and which investments and strategies it is prohibited from using. Finally, the guidelines specify the characteristics a manager's portfolio is expected to display. These characteristics are used to monitor a manager's adherence to his investment style to insure that the manager is continuously fulfilling its role in the PRIM portfolio.

16. MONITORING INVESTMENT MANAGERS

¶A. By monitoring PRIM's investment managers, PRIM's staff extends the initial due diligence into a formal monthly, quarterly, semi-annual, and annual process which regularly verifies whether the manager is meeting PRIM's objectives and other requirements. In the broadest sense, the monitoring process is intended to confirm that the reasons PRIM initially hired the manager still obtain. The process should disclose whether there has been any deviation from the investment philosophy and process, the personnel responsible for management of the product are still in place, the organization continues to be stable, performance meets expectations, and the manager strictly adheres to its investment guidelines. The underlying principle of the monitoring program is to insure that *all* risks to which PRIM is exposed through the use of outside investment advisors have been identified, understood, and, to the extent possible, controlled.

¶B. The monitoring process focuses on five areas:

1. Compliance with reporting and valuation requirements.
2. Compliance with investment guidelines.
3. Continuity of investment philosophy and process.
4. Stability of personnel and organization.
5. Performance.

¶C. **Publicly Traded Securities Managers**. Staff conducts and documents quarterly reviews for each manager. Portfolio reviews are conducted at least semi-annually, and more frequently when any aspect of PRIM's relationship with a manager is a source of concern. Staff conducts annual site visits to the manager's premises to confirm that the infrastructure is in place to support the investment process. Portfolio reviews and site visits are documented and the meeting notes or call reports kept in each manager's file. Staff provides the Board with regular performance reports, and advises the Board of other matters as appropriate.

¶D. **Absolute Return and Portable Alpha Managers**. Staff receives monthly performance and detailed risk reports from each manager. Staff aggregates manager data and performs analysis on the overall portfolio, paying careful attention to underlying hedge fund manager overlap and strategy / sector concentrations, to ensure proper diversification across the total PRIM Absolute Return portfolio. Staff also conducts monthly conference calls with each manager to discuss underlying drivers of performance. These drivers include:

- Market overview
- Strategy commentary
- Top and bottom performers
- Manager additions/terminations

In addition, staff conducts portfolio reviews at least semi-annually and more frequently when any aspect of PRIM's relationship with a manager is a source of concern. Annual site visits to the manager's premises are conducted to confirm that appropriate infrastructure is in place to support the investment process. Staff also mandates that each fund of hedge fund manager allow PRIM to meet underlying hedge fund managers. And finally, staff provides the Board with regular performance reports, and advises the Board of other matters as appropriate.

¶E. **Alternative Investments Managers.** The PRIM Board's additional goals in monitoring the Alternative Investment portfolio are to take full advantage of the rights offered PRIM through its limited partnership agreements and to ensure that its investments are winding down in a timely manner. In addition to regular performance and portfolio reviews, meetings with general partners, and site visits, PRIM will:

1. Serve on limited partnership advisory boards, but only where there is a compelling fiduciary reason to do so (e.g., an especially large investment by PRIM in the partnership, an investment in a new market or strategy, or lack of coverage by the consultant).
2. Ensure adherence to partnership agreements by reviewing allocations and distributions, expenses, timing issues and restrictions, valuations, amendments, potential conflicts of interest, reporting requirements, and timely fund terminations.

¶F. **Real Estate Managers.** The monitoring regime described in ¶C, above, also applies to Real Estate Managers. In addition, recognizing the illiquid nature of its Private Core and Value real estate investments, PRIM will:

1. Undertake appraisals (by retaining a recognized appraisal firm) of all properties with a cost basis of over \$25 million not less frequently than once every three years.
2. Undertake annual audits (by retaining a nationally recognized auditing firm) of all separate account portfolios having a market value of over \$25 million.
3. Conduct property site visits from time to time, as appropriate.

¶G. **Timber Managers.** The monitoring regime described in ¶C, above, also applies to Timber Managers. In addition, recognizing the illiquid nature of its Timber investments, PRIM will:

1. Undertake appraisals (by retaining a recognized appraisal firm) of all properties with a cost basis of over \$25 million not less frequently than once every three years.
2. Undertake annual audits (by retaining a nationally recognized auditing firm) of all separate account portfolios having a market value of over \$25 million.

3. Conduct property site visits from time to time, as appropriate.

17. INVESTMENT EXPENSES

¶A. In negotiating investment management fees, PRIM seeks to align the interest of its managers with the Fund's interests. Accordingly, PRIM typically employs performance based management fees, such that the investment manager shares with PRIM the risks of underperformance as well as the benefits of outperformance vis-a-vis the relevant benchmark.

¶B. PRIM pays asset-based management fees when performance fees are not appropriate to the manager's role in the portfolio. (For example, the role of PRIM's passive publicly traded securities managers is to replicate index performance; the primary role of PRIM's currency overlay manager is to reduce currency risk.)

¶C. PRIM should capitalize on the economies of scale intrinsic to its relatively large portfolios. Accordingly, fees charged to PRIM should typically rank among the lowest paid to any manager for comparable investment management services.

18. SECURITIES BROKERAGE

¶A. PRIM’s investment managers are required to use their best efforts to obtain for PRIM the most favorable net price and execution available. Accordingly, PRIM expects its managers to minimize trading expenses (e.g., brokerage commissions) while insuring that maximum value is received.

¶B. PRIM believes that current brokerage industry practice of bundling the cost of services provided to investment managers with the cost of execution makes it difficult for plan sponsors to measure these costs. PRIM does not pay for services with “soft dollars” by directing securities trades to specific brokerage firms. PRIM requires its managers to report, at a minimum on an annual basis, all so-called “soft dollar” services which they purchase with PRIM’s commission dollars. PRIM reviews those services to insure that all such practices are engaged in for the exclusive benefit of PRIM and its beneficiaries. PRIM also supports, and urges its managers to encourage, “unbundling” of investment management, brokerage, and research services.

¶C. PRIM seeks to minimize the trading and other transaction costs its investment managers incur on PRIM’s behalf. PRIM’s efforts to minimize such costs, however, must be consistent with its managers’ obligation to secure the best net price and execution in trading for PRIM’s account; further, these efforts must not entail disproportionate administrative burdens on PRIM staff or consultants.

Refer to Appendix D for the policy the Board approved on November 27, 2001.

19. FINANCIAL REPORTING

¶A. At least annually, the Board shall cause a nationally recognized Certified Public Accounting firm to audit the Trust and the operations of the Board.

¶B. Security transactions are recorded by the Custodian on the trade date of the securities purchased or sold. The cost of a security is the purchase price or, in the case of assets transferred to PRIT by a participating retirement system, the market value of the securities on the transfer date. In addition,

1. The PRIM Board shall present publicly traded securities investments at fair value using the custodian's independent pricing service. Securities for which valuations are unavailable are reported at their fair value as determined by the investment managers responsible for such investments under the general supervision of the PRIM Board.
2. Investments in real estate and timber are valued quarterly by the investment advisors under consistently applied procedures. The PRIM Board's staff and consultant review such valuations under the general supervision of the PRIM Board. Audits of individual portfolios and appraisals of the core property investments are conducted annually.
3. Alternative Investments are valued quarterly by the investment partnerships under consistently applied procedures. The PRIM Board's staff and consultant review such valuations under the general supervision of the PRIM Board. The financial statements of the individual partnerships are audited annually by independent accounting firms.

¶C. Dividend income and interest income are accrued as earned. Investment income on real estate and alternative investments is recorded when cash is received.

¶D. Gains and losses from sales of investments are calculated on the average cost method.

¶E. The accounting records of PRIT are maintained in U.S. dollars. Investment securities and other assets and liabilities denominated in a foreign currency are translated into U.S. dollars at the prevailing rates of exchange at period end. Purchases and sales of securities, income receipts, and expense payments are translated into U.S. dollars at the prevailing exchange rate on the respective dates of the transactions.

¶F. In accordance with appropriate audit guidelines that may from time to time be established, PRIM shall acknowledge in a timely way any investments which have suffered a loss in value and whose loss is of a permanent nature. The purpose of this realization is to remove those investments whose value has been reduced to zero and which otherwise would continue to be carried with a unrealized loss. For proper accounting procedures, it is preferable to realize such loss and, thereby upon the realization of such loss, reduce the cost basis within the portfolio by the amount of the

original investment. This permanent impairment strategy shall only be employed in those cases where the loss has no viable means of recovery and a minimum of six months has transpired from the time at which the value was reduced to zero.

20. EXERCISE OF SHAREHOLDER RIGHTS

¶A. The PRIM Board recognizes that publicly traded securities and other assets of the PRIT Fund include certain ancillary rights, such as the right to vote on shareholder resolutions at companies' annual shareholders' meetings, and the right to assert claims in securities class action lawsuits or other litigation. The Board will prudently manage these assets of the Fund for the exclusive purpose of enhancing the value of the PRIT Fund for its participating systems' members and beneficiaries, by, for example, adopting and implementing a proxy voting policy and undertaking productive, cost-effective action to exercise its rights as shareholders or claimants in litigation.

The PRIM Board's most recent proxy voting policy is attached at Appendix H.

21. ECONOMICALLY TARGETED INVESTMENT PROGRAM

Adopted 8/14/03

¶A. PRIM recognizes its obligations under Massachusetts law include a responsibility to seek out investment opportunities that will benefit the economic climate of the Commonwealth as a whole, provided that such investments are consistent with the Board's obligations to the members and beneficiaries of its participating retirement systems. (See M.G.L. ch. 32, sec. 23(2A)(h)) Accordingly, in cases where investment characteristics, including returns, risk, liquidity, compliance with allocation policy, and others, are equal, PRIM will favor those investments that have a substantial, direct and measurable benefit to the economy of the Commonwealth.

¶B. Such Economically Targeted Investments ("ETI's") must meet the following criteria:

1. Investments must target risk-adjusted, market-rate returns and provide net returns equivalent to or higher than other available investments, at commensurate levels of risk. Economic or social benefits will not justify a lower return on any PRIM investment. When evaluating ETI opportunities, PRIM will discount projected returns for any subsidies, deferral of income, higher risk levels, and other concessions to reach a real rate of return for comparison with other ETI and non-ETI investment alternatives. Similarly, ETI benefits will not justify higher investment risk. However, where appropriate, the PRIM staff, its managers, and its consultants will actively seek out and develop guarantees, third party recourse, hedging, and other acceptable and customary risk management vehicles to reduce or eliminate risk in ETI investments.
2. Investments must not exceed a reasonable weighting in the portfolio, including tracking the degree of exposure to the Massachusetts economy and ensuring appropriate geographic diversification. Investments should maintain the overall portfolio's compliance with its asset allocation strategy. ETI benefits will not justify deviation from the Asset Allocation Plan adopted by the PRIM Board.
3. Investments should be placed with an experienced and capable manager through an objective and transparent process. Investments should be managed by qualified discretionary investment managers. PRIM will not make any direct investments.
4. Investments should target a "capital gap" where there are likely to be underserved markets.
5. Investments must be tracked (both investment performance and collateral benefits) and managed with the same rigor and discipline imposed on other investments. Investments should be reviewed and monitored by PRIM staff and consultants without disproportionate expenditure of time and resources.