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MEKETA
INVESTMENT GROUP

# MEMORANDUM

**TO:** Members of the Investment Committee, CalPERS
**FROM:** Meketa Investment Group
**DATE:** March 15, 2021
**RE:** Semi-Annual Real Estate Performance Review as of December 31, 2020

In our role as the Board Real Estate Consultant, Meketa Investment Group ("Meketa") conducted a semi-annual performance review of the Real Estate Portfolio ("the Portfolio") based on data provided in Wilshire's California Public Employees' Retirement System ("CalPERS") Real Assets Performance Analysis Review for the period ended December 31, 2020, and selected CalPERS reports.[1] This memorandum provides the Portfolio performance data and information on key policy parameters, along with summary market commentary.

## Performance[2]

### Portfolio-Level Returns

CalPERS ("the System") assigns the goals of diversification from public securities, current income and inflation protection to its real assets portfolios, of which real estate comprises 84.1%. The Portfolio's diversification is serving the System, as different property sectors experience varying demand and supply dynamics. Similarly, CalPERS' focus on highest quality locations and materials that attract credit worthy tenants provides defensive characteristics. Across real estate markets, no property type or geographic region necessarily outperforms over the long-term, so diversification is critical.

This became more apparent during the quarter's results reported for December 31, 2020, which reflected property operations during the second full quarter of the COVID pandemic, July 1 through September 30, 2020.

It is also crucial to keep in mind that real estate is a long term, illiquid asset, and shorter term, quarter to quarter changes in value, based on third party appraisals, may not necessarily reflect long term trends in either direction.

[1] Real Assets Program Allocation, Characteristics, and Leverage Reports (pdf) and Datasheets (Excel), Period Ending September 30, 2020, and Real Assets Quarterly Performance Report, Partnership Financial Statements as of September 30, 2020.

[2] Per Wilshire's CalPERS Real Assets Performance Analysis Review for the period ended December 31, 2020 reported with a 1-quarter lag, so effectively as of September 30, 2020.

Overall returns have moderated for both CalPERS and the broader market. CalPERS' Real Estate Portfolio returns trailed the benchmark during all periods presented. Measured by a percentage of Loan to Value, CalPERS has historically used more leverage than the benchmark (32.5% versus the benchmark of 23.1%). When property values are rising, this accelerates returns. When values decline, this detracts from performance. Measured by the 3.2x multiple of Net Operating Income to debt service, (coverage ratio), and the strength of the tenancies, this is nevertheless a prudent level of debt. Both LTV and DSRC are well within policy guidelines of <50% and >1.5, respectively.

| **Net Returns** | **1 Year (%)** | **3 Year (%)** | **5 Year (%)** | **10 Year (%)** |
|---|---|---|---|---|
| Real Estate Returns | (0.0) | 3.4 | 4.9 | 9.1 |
| Real Estate Policy Benchmark[1] | 0.4 | 4.2 | 5.6 | 9.2 |
| Over (under) Performance | (0.4) | (0.8) | (0.7) | (0.1) |

## Performance Attribution

The portfolio posted a positive 0.8% current income during the quarter, while valuations declined by 0.1%. Among core holdings, regional mall retail property investments, to which CalPERS has a material overweight compared to the benchmark, and which account for 18.0% of the portfolio, declined by 3.6%. These investments have produced a 9.8% total net return since inception. These assets declined in value as properties were temporarily closed to slow the spread of the virus. As of late summer, these properties had all re-opened. While there is no assurance that merchants will all survive the next surge in COVID during the winter months, the CalPERS malls are well located and have financially strong and experienced joint venture partners operating them.

The other portion of CalPERS' retail holdings, grocery-anchored shopping centers, which amount to 9.0% of the portfolio, posted a 0.6% total net return for the quarter, which is an improvement from the 4.2% decline in the prior quarter. The grocery-anchored shopping centers have been impacted primarily by the temporary closure of the small businesses, including restaurants, that lease in-line stores.

As of this reporting period, the core portfolio, representing 84.0% of the Real Estate Portfolio, produced strong longer term returns of 6.3% for the five-year return against MSCI/PREA benchmark returns of 5.6%. Virtually all core properties are held directly in lower cost separate accounts (as opposed to investing in open end commingled pools). These long-term strategic partnerships anchor the Portfolio. It is important to note that, just four years ago, the Core portion represented just 55% of the Real Estate Portfolio, and that efforts continue to transition the Portfolio away from legacy, non-strategic risks towards higher quality, stabilized assets that serve the role of the asset class.

[1] CalPERS Real Estate Policy Benchmark, with historical composition as follows: As of July 1, 2018 is the MSCI/PREA US ACOE Quarterly Property Fund Index (Unfrozen), Net of Fees. From July 1, 2011 through June 30, 2018, the Policy Benchmark was the NCREIF Fund Index Open-End Diversified Core Equity, Net of Fees. The. Policy Benchmark results are shown on a blended basis during the relevant trailing periods.

| Net Returns As of September 30, 2020 | NAV ($ billion) | 1 Year (%) | 3 Year (%) | 5 Year (%) | 10 Year (%) |
|---|---|---|---|---|---|
| Core | 30.8 | 0.8 | 3.9 | 6.3 | 12.2 |
| Value Add | 2.8 | 3.0 | 2.0 | 4.3 | 6.0 |
| Opportunistic | 3.1 | (9.3) | 0.3 | 0.2 | 4.6 |
| Real Estate Policy Benchmark[1] | -- | 0.4 | 4.2 | 5.6 | 9.2 |

## Key Policy Parameters

The Real Estate Portfolio is compliant with all key parameters related to diversification and other limits applicable at the Portfolio level, as demonstrated in the following table.

| Key Portfolio Parameter | Policy Range/Limit | NAV 9/30/20 Exposure |
|---|---|---|
| Risk Classification | (%) | (%)[2] |
| Core | 75-100 | 88.2 |
| Value Add | 0-25 | 7.2 |
| Opportunistic-All Strategies | 0-25 | 4.6 |
| Geographic Region | (%)[3] | (%) |
| United States | 75-100 | 92.6 |
| International Developed | 0-25 | 2.9 |
| International Developing | 0-15 | 4.5 |
| International Frontier | 0-5 | 0.0 |
| Manager Exposure[4] | (%) | (%) |
| Largest Partner Relationship | 20 max | 16.8 |
| Investments with No External Manager | 20 max | 0.0 |
| Leverage[5] | | |
| Loan to Value | 50% max | 32.5% |
| Debt Service Coverage Ratio | 1.5x min | 3.2x |

1 CalPERS Real Estate Policy Benchmark, with historical composition as follows: As of July 1, 2018 is the MSCI/PREA US ACOE Quarterly Property Fund Index (Unfrozen), Net of Fees. From July 1, 2011 through June 30, 2018, the Policy Benchmark was the NCREIF Fund Index Open-End Diversified Core Equity, Net of Fees. The. Policy Benchmark results are shown on a blended basis during the relevant trailing periods.
2 Real Assets September 30, 2020 Characteristics Report Datasheet, calculated based on asset-level risk category and NAV.
3 Geographic NAV policy ranges effective as of December 16, 2019.
4 Real Assets Allocation Report Datasheet, calculated based on manager- and account-level NAV. Percent calculated using NAV plus total unfunded commitments for relationships and Real Assets Program ($54.9 billion).
5 Real Assets September 30, 2020 Leverage Report.

## Implementation

The Real Estate Portfolio had a market value of $37.3 billion at the end of the current reporting period, representing 84.1% of the Real Assets program and 8.4% of the total portfolio. Including Forestland and Infrastructure, the Real Assets program currently comprises 10.0% of the total portfolio against a long term target allocation of 13%, within the policy range of 8% to 18%. CalPERS has a very small exposure to overseas properties, and almost no exposure to the hospitality industry in its private real estate holdings.

The CalPERS business model for real estate emphasizes control, transparency, alignment and governance. CalPERS' market advantages are its size, scale and ability to hold assets for longer periods. The implementation of this business model is primarily through direct investing with separately managed accounts, in which CalPERS has effectively complete control. Cancellable separate accounts are created with expert, aligned fiduciary managers/partners. These relationships are overseen by Staff with the benefit of independent consultants' prudent person opinions, and monitored on behalf of the Trustees by the Board Consultant. This provides a replicable, scalable model that can grow as the Total Fund size grows, and invest within the strategic ranges based on market conditions and alternative investments available to the Total Fund. As the System grows and markets evolve, this method of investing helps control risk and reduce costs.

CalPERS continues to be an industry leader in creating and embracing Responsible Contractor Policies and ESG best practices at its properties. Additionally, during the last five years, the Staff has made progress harmonizing several of the private asset classes under the Real Assets Unit. This has improved continuity of decision-making, risk mitigation and reporting, as well as providing increased knowledge across INVO. This is consistent with a System wide, Total Fund approach rather than a collection of independent asset "silos."

## Real Estate Market Commentary:
## Disruption Continues, and While One Puzzle Has Been Solved, Many Others Await

The country has had a change in Federal Administration, and control of the Congress is held by one party. Many of the same "known unknowns" that arose a year ago are still not resolved and may be even less clear. Whether and when the new administration will be able to effect compromises for the benefit of the most effected by the tragic health crisis and the staggering unemployment is not clear. The levels of Federal intervention and total stimulus, to individuals, companies, cities and states is also unknown. If the stimulus can provide aid to the most vulnerable, then consumer activity for necessities like heat, shelter, food and health care will be improved, and landlords will have somewhat less about which to worry. Delivery of vaccines has not occurred broadly yet, and there is currently confusion as to when it is reasonable to expect that they will be widely available. If the unprecedented polarity continues to disable the crucial work of restoring health and the economy, then we can likely expect the economy to be flat to down again in 2021.

While low interest rates drive liability-based investors away from fixed income and towards alternative assets, of which core commercial real estate is one, the pandemic has significantly halted transaction volume. The uncertainties concerning space utilization cast longer shadows than ever before on future projections of absorption and rental rate growth. Increased attention is focused on changes in the way the world works, shops, sleeps and accesses health care. Consequently, industrial properties, life science properties, data centers and cell towers are all in record demand. Retail properties must adapt, which requires significant capital. The rate at which office buildings will be re-occupied is not at all precise. It will vary on tenant usages, public transportation, climate and a host of other factors. Meketa believes that this re-setting will not be clear for at least another 12-18 months, and shorter term investment results are likely to be less homogenous across regions and property types.

As a governor on the engine of declining values, however, competition for acquisitions continues to be fierce, as institutions increasingly seek larger private commercial real estate allocations. A rising public equity market has made more capital available merely from the "Denominator Effect" and a desire to keep fully invested at target percentage levels. This increased supply of capital has caused prices to remain full for the types of assets that CalPERS seeks as consistent with its long term strategy. Meketa believes that CalPERS' strategic, long-term tilt to the historic centers of population and employment growth is sound. However, as a result of the virus, we shall all see lots of attention on less dense (read, suburban and low rise) assets and to permanent increases in on-line shopping.

Notwithstanding the inability to perform due diligence on site, fundraising has continued mightily. Consolidations among real estate investment managers has given birth to new offerings of size at a record pace. On some level, these fund managers are direct and indirect competition for CalPERS, and the size of the new funds allows them to bid for assets previously too rich without significant concentration risk.

Interest rates are still at very attractive levels for spread investing, and given the lack of alternatives for current return, serve to maintain strong interest in leveraged property purchases. To the extent that demand drives cap rates lower, and they continue to average their historic range of 150-250 basis points above the risk free rate of the ten year Treasury bond, then declines in value due to lower occupancies and slower growth of effective rental rates will be mitigated. New construction of most property types (exceptions are data centers and "last mile" distribution and fulfillment centers) is disciplined.

## Conclusion

The twin shadows of the virus and unemployment continue to loom over the property markets around the world. Like other asset classes, so much of the private real estate sector's future hinges on the delivery of the vaccine and therapeutics, mutations of the virus, and subsequent changes in behavior by real estate occupants and investors, driven by the twin long-term trends represented by technology and migration. The transaction and financing markets continue to be challenging for core buyers, core sellers and property owners, who are neither buying nor selling. Nonetheless, CalPERS' continued discipline, long-term investment horizon in this illiquid asset class, and focus on the role of the asset class should continue to serve the needs of the System.

Please do not hesitate to contact us if you have questions or require additional information.

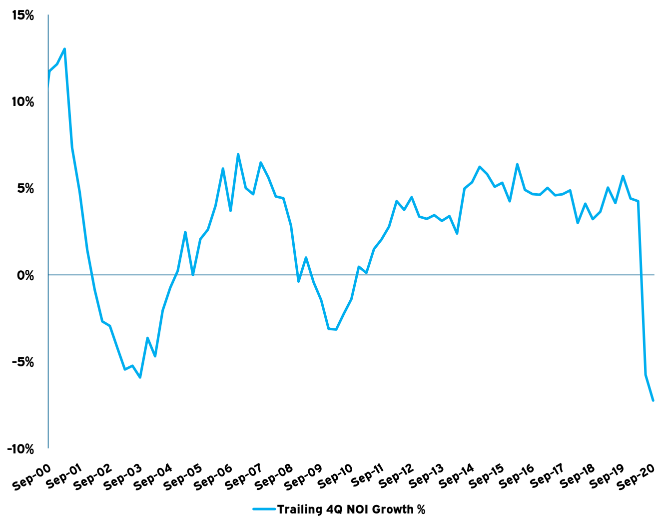
SPM/CF/jls

## Attachment

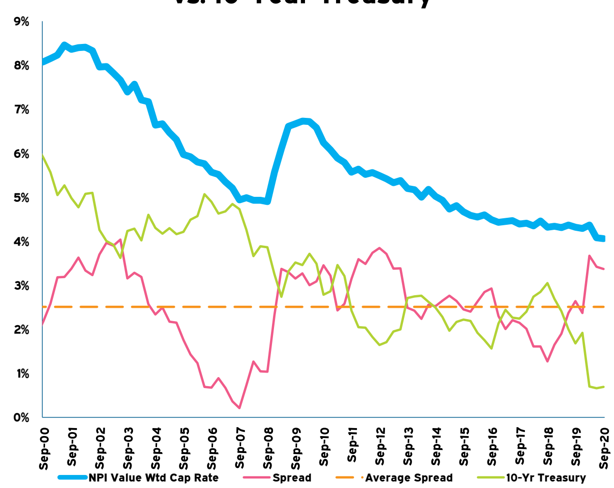
### Real Estate Market Views

- Uncertainty in the marketplace is causing volatility; active dislocation across public markets and expected in private real estate markets.
- COVID-19-related disruption producing wide dispersion of returns across different property types and markets, with clear winners (data centers, life sciences, single family rentals) and losers (retail, hospitality). The longer-term prospects for other sectors like office are still murky.
- Localized distress is expected in the near to medium term. Price discovery is ongoing as the transaction market has largely paused. Some traditional lenders are retracting.

**NOI Growth**[1]




**Real Estate Capital Markets Cap Rates vs. 10-Year Treasury**[2]




[1] Source: NCREIF.

[2] Source: NCREIF and US Department of the Treasury.