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November 17, 2008

AGENDA ITEM 5a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Housing Program Update

II. PROGRAM: Real Estate

III. RECOMMENDATION: Information Only

IV. ANALYSIS:

The Real Estate Portfolio Performance Report (QPR) for the quarter ending June 30, 2008 is being reported to the Investment Committee at this November meeting according to CalPERS' long-standing Quarterly Reporting Schedule for Real Estate. Given the substantial decline in the value of the housing component of the Real Estate program consistent with market conditions, this agenda item is intended to present a more detailed report and snapshot of the Housing program and performance.

Comprehensive Review and Restructuring of the Housing Program

Housing Program Profile

In 1992 the Single Family Housing program began in response to the Savings and Loan liquidity crisis. The program's objective is to act as a diversifier in the Real Estate portfolio and to achieve an appropriate risk adjusted rate of return. CalPERS initially selected five partners and the program's investment focus was Single Family vertical construction in California only. In 1994 a Land Acquisition & Development (A&D) component was added to the program to develop California residential land for sale to builders. In 1994, the program also added three new partners. In 1999 both the Single Family and A&D components consolidated into a National Housing Program permitting investments outside of California. The program expanded greatly between 2004 and 2006 in response to attractive opportunities in markets with strong economic growth, high employment, projected population and employment growth, and attractive

demographics and demand. Today the program is comprised of approximately 288,000 lots in 20 states with a current investment historical cost basis of $9.36 billion.

Review and Restructuring

A new Senior Investment Officer (SIO) of Real Estate was appointed in January 2007. With concerns over the stress in the housing market and the emerging industry downturn, immediately upon appointment, this SIO and Real Estate Staff initiated a comprehensive review of the Housing program.

The review, which began in February 2007, consists of several phases and is currently on-going. This review valued the existing properties within seven partnerships, analyzed the capital structure of the program, will analyze the performance of all assets in the program in light of existing market conditions and assess the impact of these conditions on the program, and will provide recommendations and action plans designed to structure the program for long term success.

Staff selected LePlastrier Development Consulting (LDC), a nationally recognized housing consultant, from the existing Real Estate consultant pool to perform the first phase review. LDC completed an initial review in December 2007 and recommended an aggressive restructuring. LDC has updated their initial review and is presenting their follow-up report to the Investment Committee today (Attachment 1).

In November 2007, the Investment Committee directed two major initiatives in connection with the Housing program. First, Real Estate Staff recommended and the Board directed an independent appraisal of assets. Four hundred sixty one (461) independent appraisals were completed in August of 2008, reflecting values as of March 31, 2008. The valuations were incorporated into the June 30, 2008 QPR and are being reported to the Investment Committee at this November 2008 meeting. The Real Estate Unit will continue to perform annual Housing program appraisals as of March 31 each year.

In addition, Real Estate Staff recommended and the Board directed the engagement of independent advisors LDC and Morgan Stanley to assist with a detailed partnership review and recommendations for restructuring the program for long term success. This phase of the review has been on-going since January 2008. The guiding principles of this program evaluation are to ensure that the program is consistent with CalPERS' long-standing investment goals, objectives and return profiles. CalPERS' investment program provides for the holding of valuable assets through a variety of market cycles. The Real Estate Unit is positioning the Housing program --which is made up predominantly of long duration assets -- for long-term sustainability and value.

The Real Estate Unit does not anticipate disposing of Housing assets in the current depressed market and intends to hold the vast majority of assets. With the increase in values projected over time, Staff anticipates significant cash flow back to CalPERS and expects a return of and on capital for the retained projects in the program.

Valuation

In November 2007, Real Estate Staff recommended and the Board directed an independent appraisal process encompassing the entire Housing program. The valuations from 461 independent appraisals, with a March 31, 2008 effective date, were incorporated into the June 30, 2008 QPR and are being reported to the Investment Committee at this November 2008 meeting.

At June 30, 2008, the program's fair market value basis is approximately $6.08 billion versus the $9.36 billion historical cost basis. Thus, the Housing program has experienced a substantial (approximately 35%) decline in value of approximately $3.3 billion. Impairments resulting from the appraisal process contributed approximately $3.1 billion to the $3.3 billion total value decline. The remainder is due to previously recognized value declines (impairments). This valuation reflects an independent assessment of values assuming CalPERS were to liquidate assets in the current market.

Performance

- Negative Housing program performance is reflected in the Current Quarter (-106.1%). The magnitude of the negative return is enhanced by the use of leverage.

- The negative Housing program performance has had a significant and material effect on the Total Real Estate Portfolio return.

- The gross returns for the Total Real Estate Portfolio are negative for the current quarter (-12.7%) and 1-year (-11.2%). The gross 3-year (11.6%), 5-year (19.6%) and Since Inception (11.7%) returns are positive.

- The net returns for the Total Real Estate Portfolio are negative for the current quarter (-13.0%) and 1-year (-12.6%). The net 3-year (8.5%), 5-year (15.5%) and Since Inception (10.3%) returns are positive.

- The Total Real Estate Portfolio Current Quarter, 1-year, and 3-year returns, both gross and net, lag the NCREIF benchmark which is

calculated on a gross basis. However, significantly, the 5-year and Since Inception gross and net returns continue to exceed the benchmark.

In addition to the market downturn, the Housing program's performance was impacted by the following contributing factors:

- Housing program commitments expanded and resulted in an exposure that, at its peak, was approximately 20% of the total Real Estate portfolio.
- The Housing program utilized, on a historical cost basis, leverage of approximately 60%, including loan guarantees, thereby significantly increasing the volatility of the program performance.
- There exist over-concentrations of investments in the Housing program by vintage year, geography, and product type.
- Like the majority of industry participants, existing Housing program systems did not identify the scale of the market decline and provide corresponding risk mitigation measures.

Action Plan

CalPERS has responded to these deteriorating market conditions within the housing industry. The Real Estate Staff's focus is, and has been, on completing the Housing program restructuring.

In order to achieve appropriate investment performance for the Housing program in the current and anticipated market environment, Staff has:

- Retained legal, industry and financial advisors to evaluate and pursue appropriate alternatives
- Conducted a comprehensive financial review of assets and funds throughout the housing program
- Completed appraisals of all assets
- Discontinued certain non-viable investments
- Restructured certain outstanding debt and reduced leverage
- Revised system policies and controls. See "Other Measures Taken Since 2007"

Staff and consultants have successfully completed the restructuring of the Shea partnership and are currently working with two other partners, Newland and Hearthstone, toward restructuring the investments.

The McFarlane Weyerhaeuser (MWHP) partnership has undergone partial restructuring. Landsource, co-owned by MWHP, Lennar, and LNR is currently under bankruptcy protection, and we are awaiting more information on the creditors' proposed plan for liquidation of assets. The proposed plan will be subject to a court hearing process, including comment from creditors and debtors. The plan would need approval of the Bankruptcy Court before proceeding.

Three other partnerships, Resmark, IHP, and Wells Fargo, are currently under evaluation and may undergo some level of restructuring.

We will continue to execute upon a strategy to achieve appropriate investment performance and expect the restructuring of our valued partnerships will be largely completed over the next 12 months.

CalPERS is a long term investor. The Housing program, in particular, invests in long-duration assets. CalPERS has sufficient resources to hold valuable assets through depressed market conditions and cycles. The Real Estate Unit is positioning the Housing investments for long-term sustainability and value.

Staff will provide regular progress reports to the Board.

Other Measures Taken Since 2007

- In February 2007, the Real Estate Delegated Authority was revised and approved by the Investment Committee, and will be reviewed again by the Investment Committee in December 2008. Additionally, in February 2007 the Investment Committee enhanced the Real Estate Investment Process. As directed by the Investment Committee, each Real Estate investment opportunity now requires approval by an Internal Review Committee, a recommendation by an Independent Fiduciary, and review by the Board's Consultant.

- In September 2007, the Investment Committee adopted a new Real Estate Strategic Plan. The plan provides a structure and framework for the Real Estate portfolio for the next five to ten years. Since its adoption, Staff has been executing the plan's implementation and providing quarterly reports to the Investment Committee. The Housing program restructuring is a significant element of the plan. The investment approach

adopted by Staff, based on the recommendations of its consultants, is consistent with the strategic plan for the overall Real Estate portfolio.

- In early 2008, Staff completed an interim Real Estate data base for both equity and debt which was developed and implemented by the Portfolio Analytics Performance and Operations (PARO) unit, a newly created Real Estate unit approved by the Investment Committee in the Strategic Plan. This data base identifies portfolio exposures by vintage year, geography, and product type. The database provides Staff with a powerful tool to analyze and manage the portfolio to ensure balance and diversification. A permanent Investment Office data base (AREIS) is currently under development. Additionally, LDC has developed a data base specifically for the Housing program which identifies the program's characteristics including exposures by vintage year, geography, and product type. This data base will be incorporated into AREIS upon its completion.

- Also, as part of the Strategic Plan, the Investment Committee directed a complete redraft of the Real Estate Policy, including reviewing the use of leverage and a complete redraft of the Single Family Housing Policy. The first reading of the redrafted policy was in October 2008, with completion anticipated in 2009.

Staff, PCA-Real Estate Advisors, and consultants will be available to respond to questions of the Investment Committee.

V. STRATEGIC PLAN:

This item will further the following CalPERS Strategic Plan goals:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

This item is provided for information only.

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