



MEMORANDUM

Date: April 19, 2010

To: CalPERS Investment Committee

From: Pension Consulting Alliance, Inc. (PCA)

RE: Real Estate Annual Plan & Review


Pension Consulting Alliance (PCA) has been asked in its capacity as Real Estate Consultant to the Board to provide input regarding the Real Estate Unit's (REU) annual plan and review. In doing so, PCA reviewed the performance of the Real Estate Portfolio (the Portfolio) from 1983 to 2009 and has been actively observing and participating in the change in policies and procedures within the REU.

With respect to performance, PCA observed two distinct periods of portfolio construction and performance. The first period spanned from inception through 2001, and the second from 2002 to 2009. PCA concluded that a shift in the second period to a higher risk investment strategy from a lower risk strategy caused poorer results in the second period than those recorded in the first period.

Beginning in 2002, several important changes in investment strategy increased the overall risk of the Portfolio. Specifically among the most notable changes that increased the Portfolio's risk profile were:

- **Higher amounts of leverage** which lowered income returns and increased exposure to changes in asset value;
- **Recourse debt** which exposed CalPERS to risks beyond the specific assets;
- **Large concentrated investments** such as LandSource, Peter Cooper Village, and Centerpoint increased exposure to specific submarkets and strategies;
- **Looser program guidelines** gave investment partners more discretion to pursue investments outside of their original mandates;
- Shifting commitments from stabilized core investments to **non-stabilized opportunistic investments**, which now comprise more than 40% of the current holdings in the Portfolio;
- A dramatic **increase in the number of manager relationships and commingled investment vehicles** provided less control, poorer governance, and hindered Staff's ability to resolve problems and liquidate assets; and
- **Vintage year concentration** with over \$27 billion of equity commitments made in 2005 and 2006, in part driven by successful market timing dispositions realized by core partners.

Compounding the shift to a higher risk investment strategy between 2002 and 2006, the Real Estate Unit simultaneously moved toward a less formal investment authorization process. As a result, many commitments were made to higher risk vehicles over which staff had less control and were not able to adequately monitor on a portfolio basis. Compounding the issue was the fact that technology-based systems for monitoring and reporting were inadequate to keep up with the pace of the increased portfolio management needs.



Since 2007, the REU has implemented a shift in culture, strategy, policy and procedures. Some key items that have been initiated and are currently under implementation to improve risk management and performance include:

- **Design and Implementation of New Investment Policy** that puts specific controls and limits regarding exposures and leverage;
- **New Delegation of Authority** for Staff;
- **New Investment Decision Making Procedure** that requires discussion in the Investment Review Committee for all investment, financing and disposition decisions that require independent fiduciary and comments from the Board's Real Estate Consultant on decisions reached;
- Development of the **Interim Portfolio Database** that captures exposures by property, geography as well as leverage and debt exposures;
- Development of **AREIS Database** that is currently in the testing phase;
- Development of the **Procedures Manual**;
- Initiation of the new **Alignment of Interest** model that will work as a standard operating agreement for all future separate accounts;
- **Restructuring** of Urban and Housing programs;
- **Broadened Coverage of Appraisal Policy** to non-core separate accounts allowing for greater transparency and more accurate values to improve decision making;
- **Initiation of Partner Review** that will cover all investment managers in the Portfolio to identify those managers that exhibited strong discipline and performance and will be aligned with CalPERS going forward; and
- **Development of Sector Plans** to better position the CalPERS REU to invest in the future.

PCA believes that Staff's initiation and implementation of the items listed above should dramatically reduce the potential for the issues of high leverage, looser program guidelines and vintage year concentration to be repeated. Through the improvement of decision making processes, the creation of information databases and clear diversification guidelines regarding leverage, recourse debt and various exposures, the Staff is better positioned to take advantage of new opportunities for the Portfolio that should present themselves in the distressed commercial real estate market.

As the role of real estate in the overall CalPERS asset allocation is being discussed currently, it is useful to examine past performances. Looking forward, PCA believes CalPERS is on a path to reduce the extent to which leverage, recourse debt, concentration, governance and alignment conflicts, delegation of approval procedures, vintage risk and fund structure can materially influence portfolio returns. CalPERS' experience during the past 28 years suggests that a real estate strategy focused primarily on direct investment in core-risk type properties has provided a more attractive risk adjusted return than the more aggressive opportunistic strategy. PCA finds significant merit in the overall context of the CalPERS investment program in pursuing a less aggressive strategy, with more controls, than was in place between 2002 and 2006.

PCA is available to discuss and answer questions of the Investment Committee.