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# Agenda Item 4b(3)

August 15, 2011

**TO: MEMBERS OF THE INVESTMENT COMMITTEE**

**I. SUBJECT:** Emerging Manager Program

**II. PROGRAM:** Real Estate

**III. RECOMMENDATION:** Approve Recommended Emerging Manager Program

**IV. ANALYSIS:**

**OVERVIEW**

CalPERS Real Estate Unit has significant experience investing with emerging managers. Past investments with emerging managers have largely been undertaken without a guiding strategy or overarching aim. Overall performance has not been consistent, some strategies proved successful, however many did not. Please see attached presentation providing additional detail for this agenda item (Attachment 1).

Staff proposes a new approach to emerging manager investment that is characterized by well-defined program parameters; including appropriate and necessary mentoring, and support for emerging managers. Staff recommends starting with a small allocation with the ability to increase allocation after five years of experience. This will allow the Real Estate Unit to use a "walk before you run" approach, giving time to test program assumptions and enhance investment discipline with the goal of producing more consistent successful outcomes.

Staff recommends the Investment Committee approve a new Emerging Manager Program for Real Estate. The proposed five-year Emerging Manager Program consists of two key parts:
1) New Domestic Tactical allocation, not to exceed $200 million, provided to existing managers with proven track records that will select, manage and mentor emerging managers. The program will focus investment on managers and assets located in urban California markets.
2) Track the workforce diversity, in key competency positions, of the Real Estate Unit's existing investment manager firms.

The program would define emerging managers as investment managers with less than $1 billion of assets under management and no more than three prior commingled funds or separate account investment vehicles.

The objectives of the proposed program are to achieve appropriate risk adjusted returns, access investment opportunities that may otherwise not be pursued, and to increase diversity among our pool of investment managers.

**BACKGROUND**

THE CROSSWATER REPORT

The Real Estate Unit retained a consultant to assist in research, design, and program development. Consultant work included the following tasks:

- Gain a full understanding of industry peers' emerging manager programs, including analyzing each investor's definition of emerging manager.
- Interview active fund of fund managers of emerging manager programs and emerging managers.
- Consider how best to: 1) incorporate a mentoring component; 2) outreach to the emerging manager pool; and 3) incentivize existing managers to utilize local emerging manager talent as potential operating partners.

Crosswater Realty Advisors was selected for the emerging manager assignment. Olena Berg Lacy and Ted Leary led the consultant effort. The Crosswater report and principal biographies are attached (Attachment 2). Staff concurs with the report which includes the following:

- Summary of research and findings
- Recommended definition of an emerging investment manager
- Recommended program design including allocation, mentoring component, and investment vehicles
- Implementation plan for locating qualified emerging managers

Key findings of the report include:

- The universe of qualified emerging managers is small – approximately 20 to 50 firms
- Many fund of fund managers are emerging themselves
- Minority/Women-owned Business Enterprises (MWBEs) are more likely to be emerging managers
- Emerging manager definitions vary across institutional investors

Recommended program design:

1. Emerging Manager Investment Strategy
    - $200 million program allocation
    - California urban focus
    - Seasoned investment manager(s) to select, oversee, and mentor emerging managers
    - Program may consist of more than one investment strategy
    - Program implementation must establish a process to identify up to four seasoned managers, which will in turn be responsible for investing with emerging managers
    - Five year term
    - Modest co-invest from emerging managers
    - 50% leverage limit at the asset and fund level
    - Opportunistic risk classification consisting of multiple property types
    - Relationship structure between the seasoned manager and emerging manager will be developed
    - Definition of emerging manager: Investment managers with less than $1 billion AUM and raising their first, second, or third commingled fund and/or separate account investment strategy

2. Establish a process to track the workforce diversity of existing investment manager firms.
    - The proposed tracking process would focus on key competency positions where individual expertise and successful track records could be established creating the potential for spin-offs
    - One source of emerging managers has been spin-offs from existing firms

## STAFF'S REVIEW AND FINDINGS

In addition to the Crosswater report, staff undertook a thorough review of the Real Estate Unit's prior experience with emerging manager strategies. Staff identified:

- Current and prior emerging managers
- Managers that met the current proposed EM definition at the time CalPERS first allocated capital to them, and have since transitioned to become large investment relationships
- Key findings related to performance, lessons learned, and reasons for past poor performance

The Real Estate Unit has 10 emerging manager investment strategies that are active today with over $885.5 million in CalPERS allocation. Of the 10 firms, 4 are of diverse ownership with $475 million in allocation.

If we include prior emerging manager experience with the current exposure noted in the paragraph above, the Real Estate Unit has invested with 16 emerging managers totaling over $1.32 billion in allocation. Seven of the 16 managers are diverse with over $650 million in capital allocation.

The Real Estate Unit's current emerging manager experience includes American Value Partners (AVP) Fund I. AVP is a fund of funds established to create a diversified, multi-manager investment portfolio by investing in discretionary real estate funds and non-discretionary joint venture real estate platforms. The underlying investments are sponsored by small to mid-size real estate investment companies that focus on value-added and opportunistic investments located in the United States. AVP has committed $320 million ($80 million is CalPERS share) of equity to eight managers of which two have diverse ownership.

In addition to the emerging manager exposure noted above, 22 Real Estate managers, that met the current proposed EM definition at the time CalPERS first allocated capital to them, grew to become large investment managers for CalPERS. CalPERS has allocated, in aggregate, $23.45 billion to these managers since inception. The group of 22 managers includes 6 firms with diverse ownership totaling $4.2 billion in aggregated allocation. Many of these managers are now major contributors to our Core, Housing, Opportunistic and International sectors.

Staff compared the performance of emerging managers to program benchmarks (NCREIF and Townsend) and found that while some emerging managers had positive performance, overall emerging managers have not met investment expectations and have under-performed benchmarks.

The key finding in our review of emerging manager strategies, alignment of interest, and performance is that what was done in the past was not successful. Staff has learned many lessons, and identified reasons for much of the past poor performance including the following:

- Lack of structured program and investment strategy
- Poor oversight of inexperienced managers
- Poor governance rights for CalPERS
- Real estate developers do not necessarily make good real estate investment managers

- Lack of discipline and focus on strategy during an escalating market cycle, and lack of size and experience to withstand a market downturn
- Program structure and mentoring are important but are time and resource intensive.

**CONCLUSION**

Based on a review of past experience and consultant recommendations, staff requests the Investment Committee approve the establishment of a new Emerging Manager Program in Real Estate. The recommended Program is intended to establish disciplined investment and heightened oversight with the goal of appropriate risk adjusted investment returns, access to new manager talent, and increased diversity among Real Estate's pool of investment managers. Staff will report to the Investment Committee annually, and at the end of five years, will make recommendations based on the outcome of the proposed Program.

PCA, the Board's Real Estate Consultant, has reviewed this agenda item and will be available at the meeting to respond to questions of the Investment Committee. See consultant opinion letter (Attachment 3)

## V. STRATEGIC PLAN:

This item supports the following strategic 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:

Costs are included in the existing Investment Office budget.

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