MEMORANDUM

Date: March 4, 2013

To: Theodore Eliopoulos, Senior Investment Officer – CalPERS

CC: Allan Emkin – PCA, David Glickman – PCA
Randy Pottle – CalPERS, Jim Hurley – CalPERS, Bob Langhi – CalPERS

From: Pension Consulting Alliance, Inc. (PCA)

RE: Interim Policy Limits

In our role as the Real Estate Consultant to the Board, Pension Consulting Alliance, Inc. (PCA) has been asked to opine on the proposed extension of interim Real Estate Policy limits for two additional years, from June 30, 2013 to June 30, 2015 and from June 30, 2015 to June 30, 2017. Staff initially proposed extending the June 30, 2013 interim policy limit by one year and leaving the Long-Term Strategic Limit target date at July 1, 2015 to Investment Committee as part of the Real Assets Program Updated in December 2012. However, current market conditions combined with delayed timing for certain key portfolio transactions means the real estate portfolio is unlikely to meet these shorter-term targets. Given the high degree of compliance with the existing interim policy limits, **PCA recommends that Staff's request to extend the Real Estate Policy limits be supported**, so that Staff may have adequate time to prudently address the remaining out-of-policy issues**.**

The following tables outline the policy limits as they currently stand and CalPERS' exposure as of September 30, 2012. The numbers in red are or would be out of compliance as of July 1, 2013.

Investment Parameters	Interim (thru 6/30/13) Range/Limit as % of Total	Interim (thru 6/30/15) Range/Limit as % of Total	Long-Term Strategic Range/Limit as % of Total	NAV % as of 9/30/2012
Strategy				
Base	0 - 100%	25 - 100%	60 - 100%	0.4%
Domestic Tactical	0 - 100%	0 - 60%	0 - 30%	55.5%
International Tactical	0 - 30%	0 - 25%	0 - 15%	8.3%
Legacy	n/a	n/a	n/a	35.8%
Risk Classification				
Core	20 - 100%	50 - 100%	75 - 100%	43.4%
Value Add	0 - 50%	0 - 40%	0 - 25%	20.4%
Opportunistic	0 - 60%	0 - 40%	0 - 25%	36.2%
REITS	0 - 10%	0 - 7.5%	0 - 5%	4.9%
Property Type				
Office	45%	45%	45%	14.9%
Industrial	45%	45%	45%	15.5%
Retail	45%	45%	45%	21.5%
Multifamily	45%	45%	45%	14.9%
For Sale Residential & Land Dev.	15%	10%	10%	12.3%
Hotels	10%	10%	10%	5.2%

Mixed-Use	10%	10%	10%	4.7%
Other Property Types 2	15%	10%	10%	11.0%
Geography				
Developed Markets	75 - 100%	75 - 100%	75 - 100%	90.9%
Developed - US	60 - 100%	70 - 100%	85 - 100%	86.0%
Developed - ex US	0 - 25%	0 - 25%	0 - 25%	14.0%
Emerging Markets	0 - 15%	0 - 15%	0 - 15%	9.0%
Frontier Markets	0 - 5%	0 - 5%	0 - 5%	0.1%
REAL ESTATE PROGRAM	**7 - 13%**	**7 - 13%**	**7 - 13%**	**9.0%**

Investment Parameters	Interim (thru 6/30/13) Range/Limit as % of Total	Interim (thru 6/30/15) Range/Limit as % of Total	Long-Term Strategic Range/Limit as % of Total	Actuals as of 9/30/2012
Loan to Value (LTV)				
Total Portfolio	60%	55%	50%	40.7%
Core	50%	50%	50%	41.0%
Value Add	65%	60%	50%	24.1%
Opportunistic	75%	65%	50%	43.7%
Debt Service Coverage Ratio				
Total Strategic Portfolio	n/a	≥ 1.0	≥ 1.5	n/a
Strategic Core	≥ 1.5	≥ 1.75	≥ 2.0	2.28
Recourse Debt				
Total Permitted Amount	10% of lower of current NAV or Target NAV			2.8%

The real estate portfolio is in compliance with all but four of the interim targets currently set for July 1, 2013, and is already in compliance with most of the long-term targets. The key area where the portfolio is out of compliance is in portfolio diversification by risk classification, namely the allocation to Core.

Staff has pursued two strategies to rebalance the portfolio distribution by Risk Classification: (i) through acquisition of more core properties, and (ii) through the liquidation of opportunistic investments. Staff's attempts to rebalance the portfolio distribution by risk classification through new acquisitions have been challenged by two primary factors.

The first factor is that executing new operating agreements under the approved alignment of interests model has taken longer than expected. Staff intends to add additional managers in FYE 2014 to help accomplish this objective, a decision with which PCA concurs. Secondly, core asset pricing in CalPERS' target markets has been at levels which make it hard for CalPERS' managers to make investments in which they can reasonably expect to generate returns in excess of CalPERS' actuarial liabilities. As a result, it has been challenging to significantly increase CalPERS' exposure to Core through acquisitions. It is anticipated that larger portfolio-level transactions may come to market over the next two years, and it is possible that CalPERS will be able to meet the current long-term strategic limits by 2015 by acquiring larger portfolios of assets, although with the attendant risk of vintage year concentration.

Alternatively, CalPERS can partially rebalance the real estate portfolio risk classification by selling opportunistic Legacy investments at a more aggressive pace. Such a liquidation process could have the short-term detrimental impact of reducing the overall real estate investment percentage allocation. However, PCA is in favor of this for two reasons: (i) these investments are not consistent with the role of real estate in the overall portfolio given their risk characteristics (leverage, alignment, control/governance, fees), and (ii) the management of these investments is highly specialized and time consuming.

While the portfolio also remains out of compliance relative to Strategy parameters, PCA finds this divergence to be of lesser concern. The divergence is caused by two primary factors, (i) the delay in establishing new core partnerships and reclassifying existing holdings into said partnerships and (ii) the aforementioned challenges making new acquisitions of stabilized assets in CalPERS' targeted markets. PCA anticipates that Staff will make progress in bringing the Base allocation within the Policy target range over the coming 12 months.

In summary, the high level of overall compliance and the continued challenges with prevailing market conditions and their impact on CalPERS' ability to restructure the real estate portfolio contribute significantly to PCA's support of extending the interim policy limits.