MEMORANDUM

Date: January 18, 2014

To: Members of the Investment Committee
California Public Employees' Retirement System

CC: Theodore Eliopoulos – CalPERS, Allan Emkin – PCA

From: Pension Consulting Alliance, Inc. (PCA)

RE: Real Assets/Real Estate Delegated Authority – Annual Delegation Limits

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In our role as the Real Estate Consultant to the Board, Pension Consulting Alliance, Inc. (PCA) has been asked to opine on the proposed revision of the Real Assets Delegation Resolution for Professional Staff. The specific policy revision under consideration relates to the existing limits on Staff's annual ability to make commitments to new investments for the Total Real Estate portfolio and Base Core portfolio.

Currently, the Annual Delegation Limit, as defined in the Delegation Resolution, limits the allocation to new investments for the Total Real Estate portfolio and Base Core portfolio by using the LESSER of two constraints. The first constraint is an annual hard dollar cap (currently $7 billion for the Total Real Estate portfolio and $6 billion for the Base Core portfolio). The second limit is an amount equal to a percentage formula that is driven by the Real Estate Program Policy Target Amount (30 percent of the Real Estate Program Policy Target Amount for the Total Real Estate portfolio and 25 percent of the Real Estate Program Policy Target Amount for the Base Core portfolio).

PCA reviewed the various merits of Staff's request and the risks of changing the hard dollar cap limit across a range of scenarios, including its elimination. The primary merits for Staff's request are increased flexibility and congruence with overall portfolio size. CalPERS, by emphasizing direct investments and seeking reliable core investments, now has its managers pursue individual assets of the largest scale and value. While a single asset investment of more than one billion dollars would be one of the largest investments in CalPERS' real estate history, it would not be unusual in prevailing market conditions nor inconsistent with CalPERS' Real Estate Strategic Plan. It is possible, though not necessarily likely, that the current hard dollar cap could impair the Staff and Managers' ability to commit to new investments. This could occur later in a year when investment activities, approved at the beginning of the year through the managers' Annual Investment Plans, have used up much of the capacity, and yet a large, prospective acquisition is consistent with the Strategic Plan. Further, Staff is attempting to achieve the increased target allocation to real estate, which necessitates increasing the pace at which private equity real estate investments are made.

Balancing these aspects were two elements of potential increased risk: First, that the increase to, or removal of, this limit (that is, a larger absolute ability to invest) would increase the possibility of vintage risk. In other words, if the current percentage limit was invested in a year (or in more than one year consecutively) without regard to a hard dollar cap, then the System might have an undue concentration exposure during a specific point in the real estate cycle. **For example, if there was an 11% allocation to real estate and no absolute dollar cap, then the Staff could commit approximately $9.3 billion in a single year. The $9.3 billion commitment would represent approximately 38% of the Total Real Estate portfolio's value. Given the cyclical nature of real estate, this concentration of investments in any single year has proven to be very risky in previous cycles.**

Second, PCA believes that a request to exceed the limit is a decision which warrants Investment Committee participation. As the hard dollar cap is raised (or eliminated), there is less likelihood that significant decisions about making outsized vintage year investment decisions (making larger "market timing" bets in illiquid private equity real estate markets) would receive the same level of scrutiny from the Investment Committee. Further, the potential exists that some material transactions, with heightened concentration and counterparty risks, might not be presented to the Investment Committee that would otherwise be presented using the existing limits.

At this stage, PCA feels that it is in the best interests of the System for Staff to continue to highlight significant private real estate investments to the Investment Committee. It is also good portfolio management practice to highlight in annual Investment Committee presentations how pacing models and target allocations relate to prevailing market conditions, particularly as real estate becomes a larger portion of the Investment Committee's overall asset allocation model.

In summary, the evolution of the overall portfolio and the real estate investment program, and the continued challenges with prevailing market conditions, lead PCA to support Staff's request to revise the Delegated Authority hard cap limit to $8 billion for the Total Real Estate portfolio and $7 billion for the Base Core portfolio, and to encourage continued transparency and communication to the Investment Committee on material vintage year allocations and individual investment decisions.