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To: CalPERS - Investment Committee

From: Pension Consulting Alliance, LLC (PCA)

CC: Theodore Eliopoulos, CIO; Paul Mouchakka, MID

RE: Real Assets Strategy Plan Update – Real Estate

In our capacity as Real Estate Consultant to the Board of Trustees, PCA has worked with Staff to update the 2011 Strategic Plan for the real estate component of the Real Assets program. The revised Strategic Plan continues to adhere to the investment principles established in the 2011 Strategic Plan. By many measures, both quantitative and qualitative, the 2011 Strategic Plan and improvements in policies, procedures, and personnel have served the System well during the past five years. CalPERS' Staff have made significant progress in aligning the real estate portfolio with the needs of the System, especially compared to the real estate portfolio of 2008. Recent returns have been strong, and many risks have been eliminated or reduced. At the same time, the Update makes various adjustments to sub-portfolio categories to enhance portfolio management, support integration of the Real Assets teams, and better align the overall Real Assets program with CalPERS' enterprise-level mission and values.

The Update makes no big changes to the central implementation tenets for real estate instituted by the 2011 Strategic Plan. Rather, the revisions contained in the Update build on the stability of the business model that has been established over the last five years and fine tune the organization and implementation of the real estate program. Importantly, the proposed changes in the Update do not introduce meaningful new investment themes or risks and keep the focus of Staff's resources on the areas of greatest impact. These changes will further support the real estate portfolio in its efforts to meet the role of real estate in current and anticipated market conditions.

The role of real estate can be summarized as:

- Economic diversification of equity risk;
- Durable and sustainable cash flows; and
- Partial inflation hedge

In accordance with this role, the real estate program will continue to be anchored by low to moderately leveraged investments made in core (i.e., stabilized and leased) properties in the United States. These investments generate the majority of their total return through income. The Update maintains minimum target allocations of 75% to core and 75% to US.



PCA believes a focus on domestic core properties achieves the prescribed role of real estate and reduces risk in the overall portfolio. Additionally, the Update continues to adhere to lessons learned from the previous downturn during which CalPERS suffered substantial losses in the value of its real estate portfolio. As previously described by Staff and PCA, the losses suffered in real estate were primarily attributable to: (a) vintage-year concentration, (b) investments in non-core assets, and (c) the use of high amounts of leverage. Real estate is likely to remain a cyclical asset class. CalPERS will, therefore, experience other periods of underperformance in real estate compared to the targeted nominal returns from time to time in the future. However, PCA believes that with continued proper oversight, a moderately levered, core-oriented portfolio can weather a potential re-pricing of assets and slower economic growth (or recession).

In addition to a domestic core program, the Update continues to allow non-core investments as well as international investments in developed and emerging markets. The non-core investments will have a new limitation on development investments of 10%. This is intended to allow for the creation, from time to time, of new core assets in markets that offer limited opportunities to acquire existing stabilized assets. PCA believes these non-core and international real estate investments can be beneficial to the overall plan, but should play a relatively small role in the real estate investment program.

The Update continues the focus on investment through private investment vehicles and, more specifically, scalable separately managed accounts. CalPERS intends to further reduce the number of manager relationships in the real estate portfolio as a means of more efficiently utilizing finite Staff resources, maintaining strong governance provisions, increasing alignment, and controlling costs. A smaller number of long-term partnerships will also allow Staff to integrate investment beliefs and ESG matters into portfolio management in a more meaningful and disciplined manner.

The Update provides for a new leverage pilot program, which will explore the potential benefits and risks associated with the use of in-house gearing for an unleveraged real estate separate account. Details have yet to be determined and implementation of the program is subject to ISG approval. PCA will be closely involved in the evolution of this program.

Finally, the Update reduces complexity and improves risk management by reclassifying the underlying sub-portfolios within the real estate portfolio. A vestige of the post-crisis portfolio workout is the current delineation of investments between "Legacy" (i.e., not aligned with the role of real estate) and "Strategic" (aligned with the asset class role). Ongoing asset sales combined with the recent secondary sale of CalPERS' LP interests in commingled funds has significantly reduced the Legacy portfolio to the point where the delineation between Legacy and Strategic no longer meaningfully serves portfolio management efforts. Similarly, the distinctions between Domestic Base, Domestic Tactical and International Tactical portfolios have become less useful.



The reclassification of investments based on risk profile (i.e., core, value add, opportunistic) and economic segment (i.e., essential, commercial, consumer, residential and specialized) should provide more meaningful insight into portfolio concentrations and overall risk profile. The International segment is a bit of an outlier as it does not describe fundamental economic drivers of real estate property. Even so, this reclassification effort combined with similar efforts across the infrastructure and forestland portfolios should contribute to improved investment decision making, analysis and reporting.

Taken together, the proposed modifications contained within the Strategy Plan Update serve to better organize and align the Real Asset Unit with its own mandate and the overarching mission and values of CalPERS. PCA will work as the Board's advocate with Staff to modify the investment policy and procedures manual for real estate, as well as make any other necessary adjustments to investment decision making processes and portfolio monitoring systems.

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