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2016

CalPERS Investment Committee
Annual Real Estate Program Review
November 2016

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Introduction

Observations

- The portfolio has generated strong nominal and relative returns since 2011
- Portfolio is increasingly meeting the role as assigned in the Strategic Plan
 - Providing diversification and performance during a period of lower equity and fixed income returns
 - Income returns have increased by more than 100 basis points over three years
 - Income distributions have doubled over the last three years
- Recent performance drag most attributable to non-repeating events and emerging market strategies
- Portfolio's risk profile has been substantially reduced
- Staff is continuing to improve portfolio management practices
- Investment beliefs are incorporated into Real Assets Investment Committee (RAIC) decision making

Introduction

Observations Continued

- Real estate fundamentals, supply/demand of rental space, are healthy
- Strategic portfolio is expected to produce attractive returns over next twelve months
- Global capital markets continue to make it difficult to deploy capital; Managers and Staff are being disciplined in meeting CalPERS' risk and return thresholds and not chasing transactions
- Portfolio is better positioned for the next correction
- Longer-term performance continues to suffer from investment decisions made during the last cycle

Meaningful Updates

Over the past year:

- Approval of Strategic Plan Update; recommitment to role of real estate
 - Significant work required to fully implement
 - AREIS mapping, segment plans, partnership restructuring
- Completion of secondary sale of legacy/non-core holdings
- Approval of New Real Assets Policy
 - Investment Policy and Procedures Guidelines (IPPGs) and Desk Procedures in development will require scrutiny to confirm consistency with Strategic Plan and INVO wide practices
- Continued restructuring of Real Assets Unit human resources
 - Significant changes in individual roles and responsibilities in short-term
 - Growth from within– internal promotions and mentoring to build skills, cohesion, and morale
 - Supporting stronger common systems, processes and analytics in the longer-term
- Ongoing work on operational data, governance, and controls
 - Performance reporting and valuation
 - Risk assessment systems

Meaningful Updates

In Support of Enterprise-Level Initiatives

- Portfolio is increasingly well aligned with role of real estate in overall portfolio
- Portfolio is producing results that support the CalPERS Real Assets Strategic Plan
- Business model is embracing Vision 2020 objectives
- Furtherance of Environmental, Social and Governance initiatives
 - Energy optimization efforts; monitoring of best practices implementation by managers
 - Continued capital deployment to strong emerging manager program
 - Emphasis on Responsible Contractor policies
 - Manager expectations program
- Investment Beliefs now part of decision-making at many levels
- Further cost savings through new incentive fee model
 - Greater stability and visibility on fees
 - Maintain alignment

Investment Beliefs

1. Liabilities must influence the asset structure.
CalPERS invests in real estate to generate income, provide diversification, and as an inflation hedge.
2. A long term investment horizon is a responsibility and an advantage.
Real estate is a private, illiquid asset class; assets are generally held for longer periods of time.
3. CalPERS investment decisions may reflect wider stakeholder views.
Targeted investment programs are being used effectively in the RE program.
4. Long-term value creation requires effective management of three forms of capital: financial, physical, and human.
The RE Portfolio continues to improve governance and engagement on ESG initiatives.
5. CalPERS must articulate its investment goals and performance measures and ensure clear accountability for their execution.
RE contributes to the delivery of the long-term target return of the Fund. Benchmarking remains challenging.
6. Strategic asset class allocation is the dominant determinant of portfolio risk and return.
RE provides diversification from global equities and other growth assets.
7. CalPERS will take risk only where we have a strong belief we will be rewarded.
The majority of the RE portfolio is invested in lower risk, lower volatility investments.
8. Costs matter and need to be effectively managed.
The RE portfolio invests primarily through separate accounts that offer lower fees than funds.
9. Risk is multi-faceted and not fully captured through measures such as volatility or tracking error.
Staff continues to improve risk management in RE through investment process, analysis, and reporting.
10. Strong processes and team work and deep resources are needed to achieve CalPERS' goals and objectives.
RAU brings teamwork and improved processes to bear; staff compensation remains an issue.

SWOT Analysis – Real Estate Program

Strengths

- Strategic Plan bearing fruit
- Strong actual and relative performance
- Significant reduction of risk in the portfolio—leverage, currency, control, development
- Improved internal environment and culture—wider inputs and collegial collaboration from different investment areas likely to reduce risk
- Further cost efficiencies
- Stability of business plan
- Clearly articulated role of real estate
- Investment Beliefs (direction from Board)
- Strong beliefs regarding labor and the RCP Policy

Weaknesses

- Staff is resource constrained
- Senior staff is managing significant change
- Policy supporting documents taking longer to develop than anticipated
- Reliance on external managers, some of whom are captive to CalPERS

Opportunities

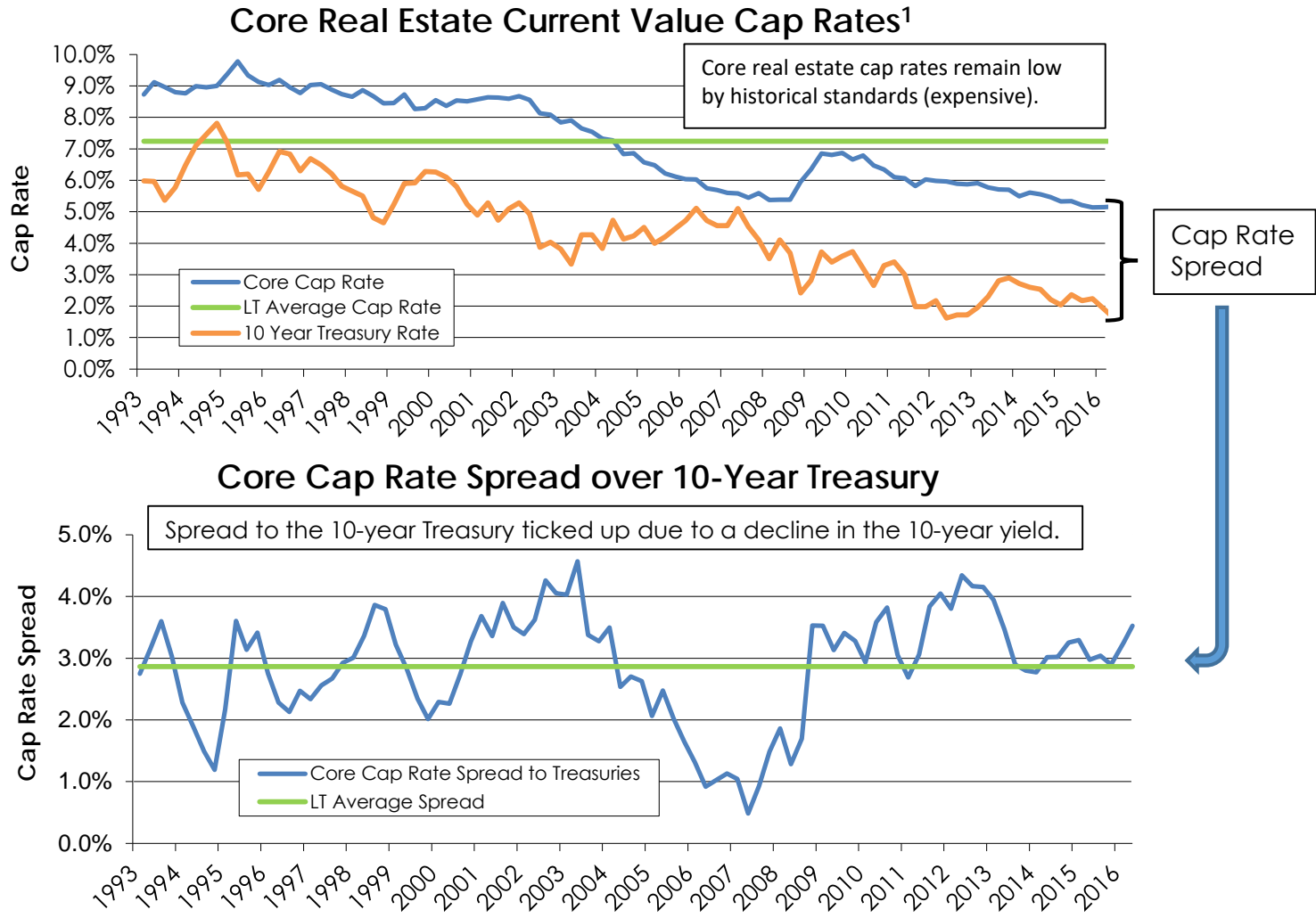
- Continue moving the portfolio towards the objectives established in the Strategic Plan
- ESG initiatives and staffing gaining increased traction
- Proactively identify and pursue opportunities consistent with Plan, especially those that play to size
- Explore new strategic partnerships with like-minded investors
- Explore a more cohesive and efficient debt structure for the portfolio's leverage at the System level, rather than the manager level

Threats

- Highly competitive market for new acquisitions that meet CalPERS' risk/return objectives
- CalPERS' emerging markets fundamentals are sluggish and volatile
- Size makes certain market sector investments practically unfeasible
- Growth of net operating income moderating across all property sectors

MARKET DATA

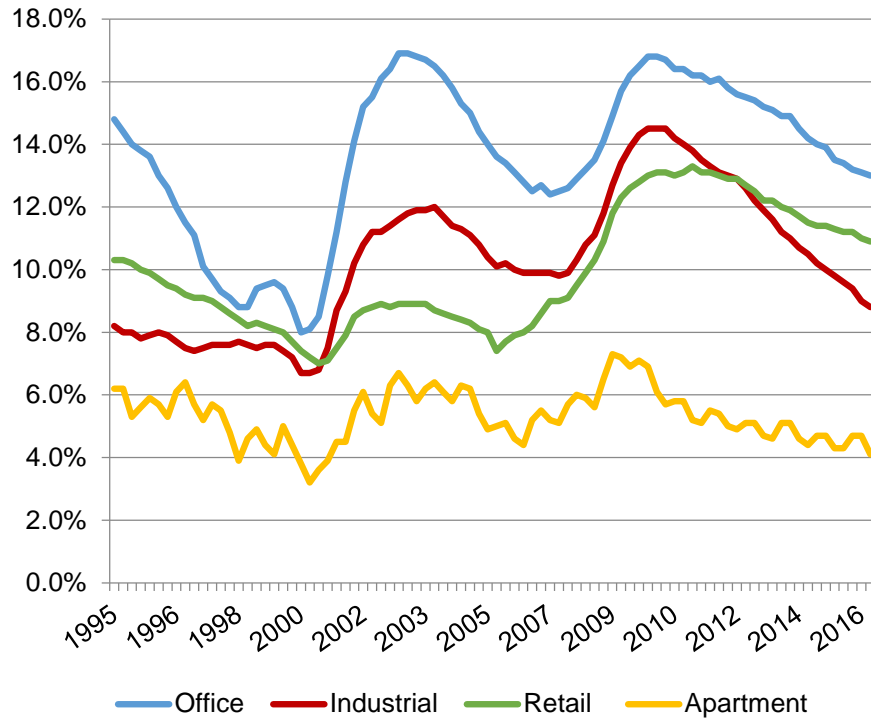
Core Cap Rates



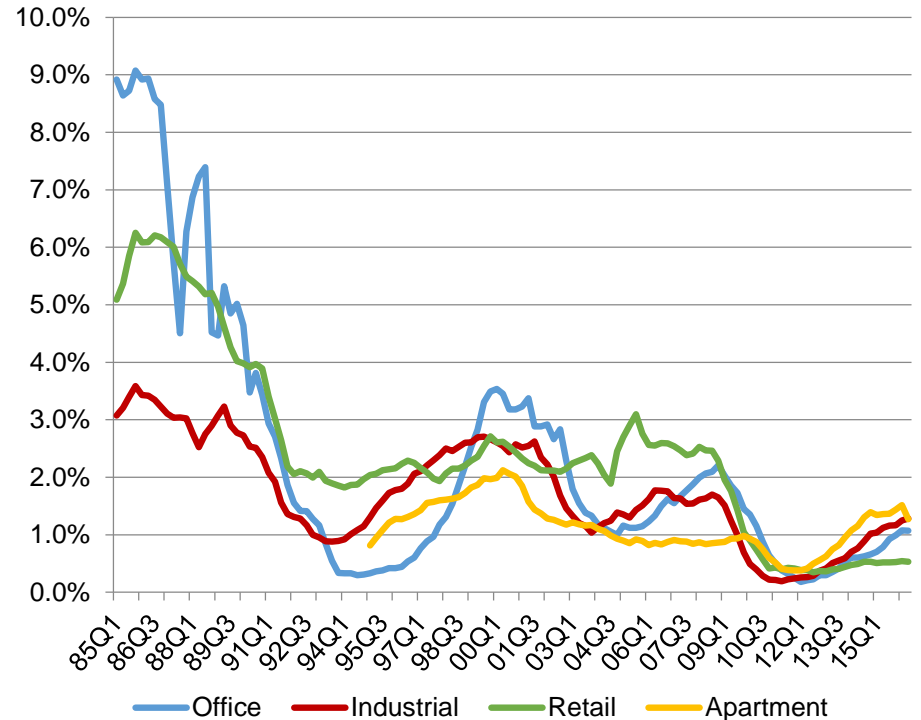
¹A cap rate is the current annual income of the property divided by an estimate of the current value of the property . It is the current yield of the property. Low cap rates indicate high valuations. Sources: NCRIEF, www.ustreas.gov

Real Estate Fundamentals

U.S. Average Vacancy Rate



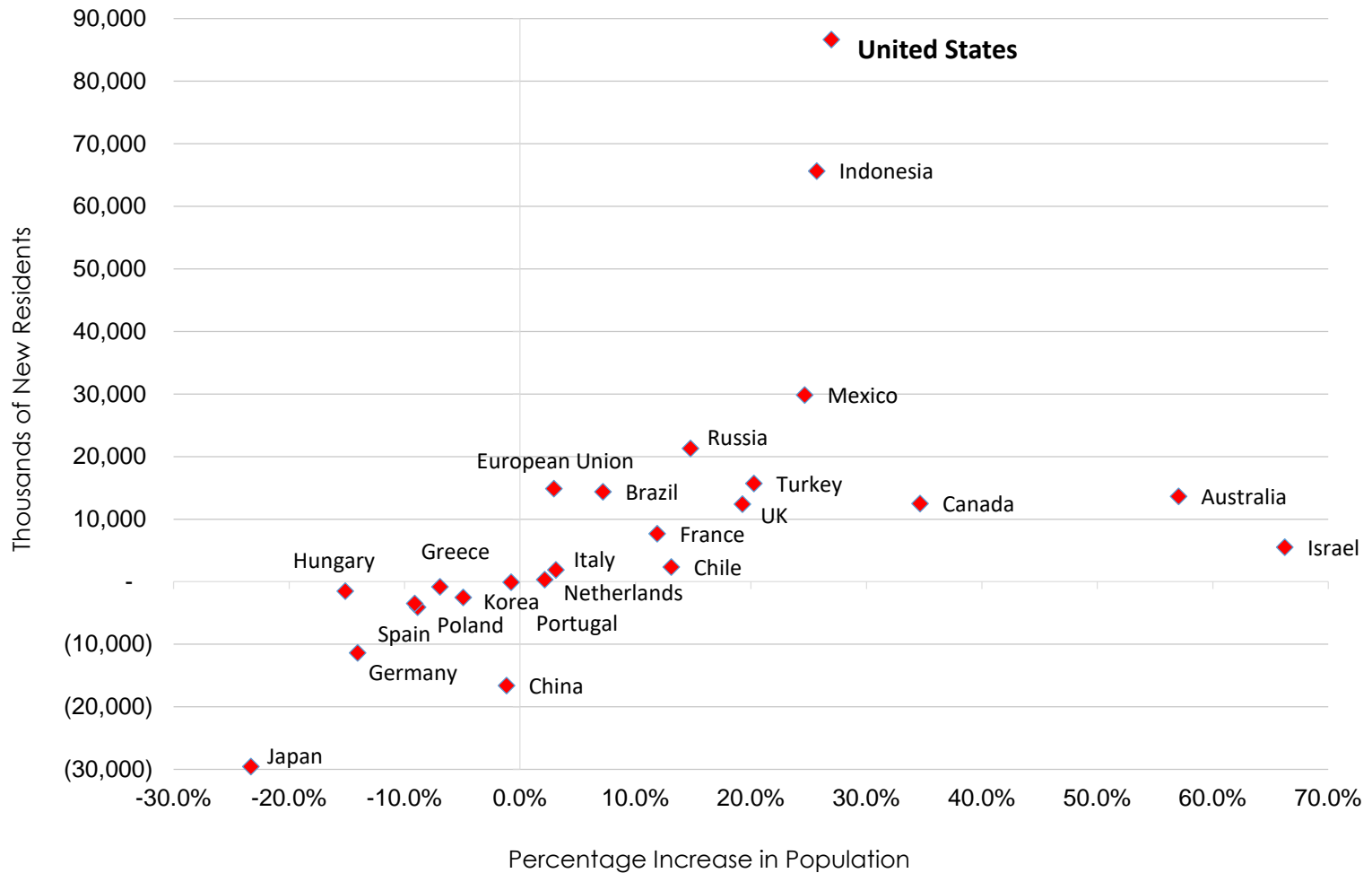
Additions to Stock Over Prior 4 Quarters as a Share of Total Stock



Source: AEW

Expected Population Growth

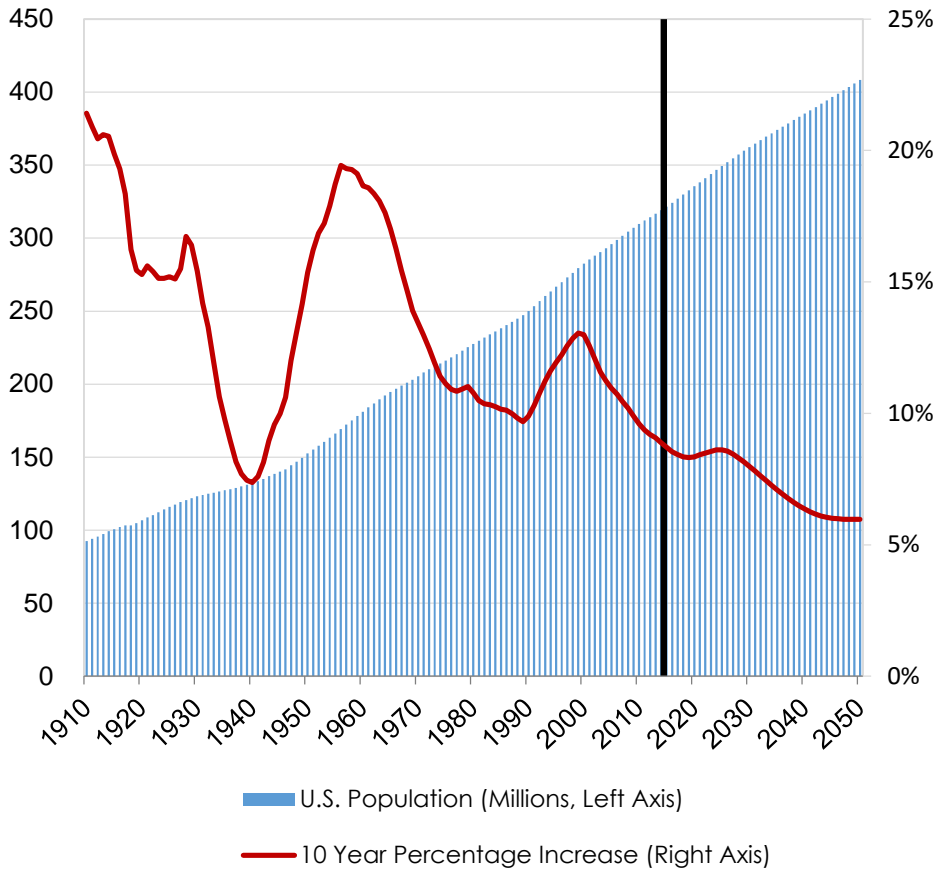
Expected Population Growth 2015-2050



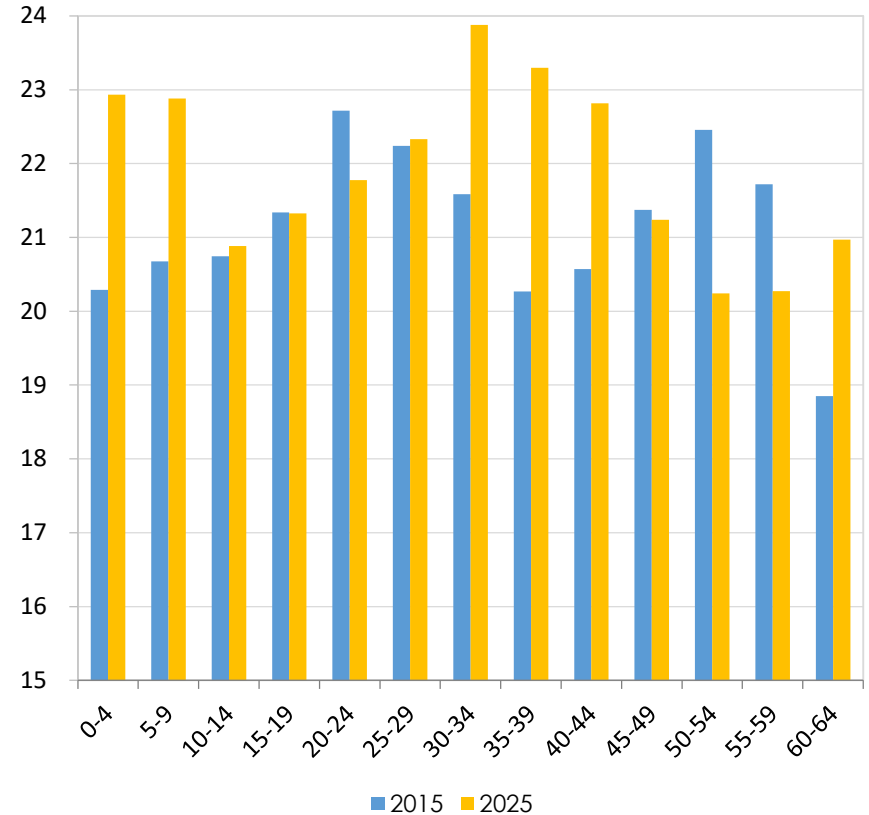
Sources: AEW, Organisation for Economic Co-operation and Development (OECD)

Expected Population Growth

U.S. Expected Population Growth 2015-2050



U.S. Population by Five-Year Age Cohorts (millions)



Source: AEW

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