RCLCO FUND ADVISORS

MEMORANDUM

DATE: August 22, 2023

TO: California State Teachers' Retirement System

FROM: RCLCO Fund Advisors (RFA) – Taylor Mammen, Ben Maslan, Sriyas Pande, and Amber Hughes

SUBJECT: Semi-Annual Open Session Report; As of March 31, 2023

INTRODUCTION

RFA's semi-annual report is as of Q1 2023. Goals and objectives that the semi-annual report evaluates include: a Q1 real estate allocation target of 15%; a net return that exceeds the NCREIF NFI-ODCE Index, a hedge against inflation and stable cash flow generation, an allocation based on property stage (stable and value creation) to maintain an appropriate risk profile; and an appropriate level of leverage, with a loan to value (LTV) limit of 50% for the controlled portfolio and 65% for the non-controlled portfolio.

PORTFOLIO HIGHLIGHTS

- The real estate portfolio has outperformed both its target return benchmark and inflation over all measurable time periods over the last decade. The portfolio has generated a 10-year net TWR of 9.8%, outperforming the ODCE benchmark return of 8.5% by ~130 basis points, and a 5-year net TWR of 8.8%, outperforming the ODCE benchmark return of 6.6% by ~220 basis points. Over shorter time periods, the portfolio generated a 3-year net TWR of 10.3% and 1-year net TWR of -1.8%, outperforming the ODCE by ~280 and ~210 basis points, respectively.
- The real estate portfolio had a NAV of ~$50B as of Q1 2023, comprising ~15.8% of the total CalSTRS Fund (~$316.5B), slightly above the target allocation of 15%, but within the permitted range of 12% to 18%. The portfolio is compliant with the targeted allocation by investment strategy and is within the permitted leverage limits for the control and non-control portfolios of 50% and 65%, respectively.
- The allocation to office properties decreased 137 basis points over the past six months. When excluding life science office properties, the allocation to office is in line with the benchmark. The portfolio continues to be underweight industrial and multifamily properties by 10% and 9%, respectively, which could create a performance drag going forward as these property types have exhibited among the strongest net operating income growth.

MARKET HIGHLIGHTS

- Real estate fundamentals generally declined in Q2 2023, and signs of near-term risk emerged in most property types (except industrial which remains strong).
- Private real estate returns remained negative in Q2 as NFI-ODCE and NPI posted quarterly returns of -2.7% and -2.0%, respectively, driven by negative appreciation return.
- Real estate transaction volumes declined another 8% QoQ to $81B in Q2, driven by sharp quarterly drop-offs in retail and hotel volumes. Trailing 4Q totals decreased 49% to $500B and were down by at least 30% for all property types.
- Real estate debt will likely remain scarce and expensive, as lending officers continue tightening in the wake of regional bank troubles. Institutional dry powder rose slightly in Q2, but investors generally remain cautious. CRE distress and loan delinquencies are rising, adding downside risk to the market outlook.