RFA
RCLCO FUND ADVISORS

MEMORANDUM

DATE: February 13, 2023

TO: California State Teachers' Retirement System

FROM: RCLCO Fund Advisors (RFA) – Taylor Mammen, Ben Maslan, Cecilia Galliani, Amber Hughes

SUBJECT: Semi-Annual Open Session Report; As of September 30, 2022

INTRODUCTION

RFA's semi-annual report is as of Q3 2022. Goals and objectives that the semi-annual report evaluates include: a Q3 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 its target return benchmark over the last decade. The Portfolio has generated a 10-year net TWR of 11.0%, outperforming the ODCE benchmark return of 9.9% by 110 basis points, and a 5-year net TWR of 11.3%, outperforming the ODCE benchmark return of 9.3% by 200 basis points. The portfolio has generated net TWRs of 20.2% and 12.8% over the 1- and 3-year time horizons, outperforming the ODCE benchmark return of 11.4% by 140 basis points over the 3-year period, and underperforming the benchmark by 70 basis points over the 1-year period (40 basis points excluding legacy investments).
- Real Estate NAV totaled $51.9B as of Q3 2022, comprising 17.2% of the total CalSTRS Fund (~$302.1B), above the target allocation of 15.0%, but within the policy range of 12.0% to 18.0%. The portfolio is compliant with the targeted allocation by investment strategy. The LTV ratios of the controlled and non-controlled portfolio were 36% and 46%, respectively, as of Q3 2022, within the compliance limits of 50% and 65% in the real estate investment policy.
- The portfolio continues to be underweight relative to the benchmark in industrial and multifamily properties, by 10% and 9%, respectively. These underweights could create a performance drag going forward as these property types have exhibited the strongest net operating income growth over all historic time horizons. The allocation to office decreased 2%, and CalSTRS' overweight to office is now only approximately 2% relative to the benchmark (when excluding life science properties).

MARKET HIGHLIGHTS

Real estate operating fundamentals remained strong, but signs of moderation began in Q4 2022 (with the exception of office properties, for which weak fundamentals persisted). Private real estate returns declined sharply in Q4 as the ODCE and posted a quarterly return of -5.0%. Declines were driven by negative appreciation, as 70% of properties in the index had values written down in Q4. Transaction volumes declined 23% QoQ to $130B in Q4, with office and multifamily posting quarterly declines of over 30%. Real estate capital markets are likely to stay sluggish in 2023. Real estate borrowing cost have risen materially as base rates and spreads have increased. Institutional dry powder is constrained by the denominator effect and valuation uncertainty, although wholesale selling is not likely. Transactions should pick up in 2024 once prices reset at 10-20% below peak values.