

MEMORANDUM

DATE: February 11, 2022
TO: California State Teachers' Retirement System
FROM: RCLCO Fund Advisors (RFA) – Taylor Mammen, Ben Maslan, Cecilia Galliani
SUBJECT: Semi-Annual Open Session Report; As of September 30, 2021

INTRODUCTION

RFA has reviewed the CalSTRS portfolio, policies and limitations, previous recommendations and activities, as well as current and forecasted economic, capital market, and property market conditions. Current goals and objectives that the semi-annual report evaluates include: a Q3 real estate allocation target of 14%; a net return target benchmarked to the NCREIF NFI-ODCE Index for the core portfolio, 50 basis points over the ODCE for the value add portfolio, and 300 basis points over the ODCE for the opportunistic portfolio; allocation based on property stage (stable and value creation) to maintain an appropriate risk profile; and an appropriate level of leverage, with a limit of 50% for the control portfolio and 65% for the non-control portfolio.

PORTFOLIO HIGHLIGHTS

- ▶ Real estate net asset value (NAV) totaled \$42.0B as of Q3 2021, representing 12.8% of the total CalSTRS Fund (~\$327.7B), below the current target allocation to real estate of 14%, but within the policy range of 11% to 17%. The portfolio is compliant with the target allocations by investment strategy and is within the approved permitted leverage limits, as outlined by the CalSTRS Investment Policy Statement ("IPS"). Since Q1 2021, the real estate portfolio grew by \$4.4 billion, primarily driven by appreciation, and increased from 12.2% to 12.8% of the total CalSTRS portfolio. Approximately 80% of the portfolio is invested in controlled investments.¹
- ▶ The allocation of assets by risk profile is 61% to core, 19% to value-add, 19% opportunistic, and 2% to Legacy assets. The portfolio continues to be underweight to the industrial and multifamily property types, which could create drag as these are current and projected winners in the near- to medium-term.
- ▶ The CalSTRS real estate portfolio has exceeded the benchmark ODCE Index return over the past 1-, 3-, 5-, and 10-year periods, including and excluding Legacy assets.² CalSTRS' real estate returns have been outsized over the past year, driven by appreciation. Income and appreciation returns have been relatively stable over the 3-, 5-, and 10-year time horizons.
- ▶ CalSTRS' real estate debt totals \$28.2B as of Q3 2021, an increase of \$3.7B since Q1 2021. When measured in percentage terms, the LTV of the portfolio increased slightly to 41%. The LTV of the control portfolio is 37%, and LTV of the non-control portfolio is 50%. Importantly, the increase in leverage ratios has been driven by less risky core assets.

MARKET HIGHLIGHTS

Real estate markets generally continued to improve during the 2021. Traditional office was the exception, with increasing vacancies, decreasing rents, and negative absorption. Transaction volumes were up 89% over 2020, and institutional dry powder fell due to increased deal flow; however, equity and debt capital remain plentiful. Private real estate returns were exceptionally high in Q4 2021, with the two main indices (the NFI-ODCE and NPI) posting record quarterly returns – 8.0% for ODCE and 6.1% for NPI – in 4Q. For the past year, ODCE and NPI total returns were 22.1% and 17.7%, respectively. Industrial continues to show outsized strength, with YOY rent growth accelerating to 7%. Industrial NPI returns were a record 43.3% for full year 2021. Multifamily also continued to outperform; rents grew by 9% YOY, and vacancies fell sharply in 2021.

¹ Control investments are those which CalSTRS maintains control over acquisitions, dispositions, and financing, or has high liquidity in normal market conditions.

² Commingled closed-end opportunistic funds coming out of the Great Recession.