CALSTRS

Investment Committee

Item Number 6b – Open Session

Subject: Receive Real Estate – Semi-Annual Performance Report, Period Ending September 30, 2020

Presenter(s): Robert Charles Lesser & Co. (RCLCO)

Item Type: Information

Date & Time: March 4, 2021 – 15 minutes

Attachment(s): Attachment 1 – RCLCO's Q3 2020 Semi-Annual Performance Summary for the Real Estate Program

PowerPoint(s): RCLCO's Q3 2020 Semi-Annual Real Estate Program Summary Review

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PURPOSE

This item is required and governed under the reporting guidelines of the CalSTRS Real Estate Investment Policy (Teachers' Retirement Board Policy Manual, Section 1000, Page J-1) and is a crucial part of the Investment Committee's annual work plan.

HISTORY

On a semi-annual basis, the Real Estate Consultant reviews the performance report for the CalSTRS Real Estate Portfolio. Due to the nature of the investments and timing of appraisals and partnership reporting, this report is lagged and therefore covers periods ending September 30, 2020. The semi-annual reporting packet has been condensed to align with the investment reporting guidelines approved in June 2016. This report is critical to the monitoring and oversight responsibility of the Investment Committee.

PURPOSE

Due to the specialized nature of this asset class, the Investment Committee has retained a specialty consultant, Robert Charles Lesser & Co. (RCLCO), who prepared a summary (Attachment 1) and written report. While the report includes one-year returns, the Investment Committee is encouraged to focus on the ten, five, and three-year results due to the long-term nature of the asset class.

- RCLCO will present an oral report highlighting key issues across the CalSTRS Real Estate Portfolio.
- The portfolio data in the report is prepared by State Street Bank's Alternative Investment Solutions Group with input from RCLCO; it is fully customizable to meet the Investment Committee's needs.
- RCLCO will use this opportunity to alert the Committee of any areas of concern, needed policy revisions, or issues that warrant further review.

RECOMMENDATION

Staff recommends that, upon the oral report from Taylor Mammen & Ben Maslan, the Investment Committee receive the report for the record.

RCLCO FUND ADVISORS

MEMORANDUM

DATE: February 8, 2021

TO: California State Teachers' Retirement System

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

SUBJECT: Semi-Annual Open Session Report Cover Memo; As of September 30, 2020

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.

PORTFOLIO HIGHLIGHTS

- Real estate net asset value (NAV) totaled $36.1B as of Q3 2020, representing 12.7% of the total CalSTRS Fund (~$283.4B), below the current target allocation to real estate of 14%, but within the policy range of 11%-17%. The portfolio is compliant with the target allocations by investment strategy and is within the permitted leverage limits as outlined by the CalSTRS Investment Policy Statement ("IPS").
- The CalSTRS real estate portfolio has met or exceeded the benchmark ODCE Index return over the past 1-, 3-, 5-, and 10-year periods. The 1-, 3-, 5 and 10-year net returns have outperformed the benchmark by 298, 289, 217, and 87 basis points, respectively. When excluding Legacy assets, the portfolio outperformed the benchmark over the 1-, 3-, 5 and 10-year periods by 802, 497, 523, and 242 basis points, respectively.
- Since the Q1 2020 Semi-Annual Report, the real estate portfolio grew by $2.3 billion (a 6.9% increase in portfolio size). Although the portfolio remains largely comprised of direct investments, the proportion of controlled assets declined from 78% in 2019 to a current 70%.
- The allocation of assets by risk profile has remained largely unchanged since the previous Semi-Annual report, with a current distribution of 63% to core, 18% to value-add, 16% to opportunistic assets, and 3% to Legacy assets. Approximately 17% of the portfolio is allocated to global investments, equating to a NAV of $5.8B as of Q3 2020, with the largest allocation to Europe.

MARKET HIGHLIGHTS

The COVID-19 pandemic produced a global economic shock, significantly distressing the U.S. economy and real estate markets along with it. GDP shrank by 3.5% in 2020 and historic job losses occurred. Broader vaccine distribution, combined with additional fiscal stimulus, will likely lead to a rebound in 2021 and 2022. RFA expects job growth recovery to lag GDP growth, particularly for lower-end service, hospitality and retail jobs.

The effects on real estate vary by property type. Multifamily operating performance has been relatively resilient and saw improvement in Q4, although Class A product has suffered more significantly and has shown signs of declining fundamentals. Going forward, declining savings and shifting demographics are expected to increase demand for rental housing. Industrial properties have continued to outperform, with the increasing share of e-commerce as a percentage of retail sales expected to sustain strong demand. The impact on office is uncertain, but a substantial amount of tenants are requesting rent relief, absorption is negative, and vacancy has increased. Longer-term, it remains to be seen whether telecommuting becomes a more permanent and accepted practice, and whether this translates into sustained declines in demand. The hospitality and retail sectors have experienced the most severe impact to date; hotel fundamentals and retail sales have worsened in the last months of the year, and the pandemic has exacerbated many of the secular trends away from brick and mortar sales that the retail sector was already experiencing.

RFA
RCLCO FUND ADVISORS

DISCLAIMERS

CRITICAL ASSUMPTIONS

Our analysis depends on the correctness and completeness of data available as of the date of this memo. The future performance of the global, national, and local economy and real estate market, and other factors similarly outside our control may vary. Given the fluid and dynamic nature of the economy and real estate markets, as well as the uncertainty surrounding particularly the near-term future, it is critical to monitor the economy and markets continuously. Stable and moderate growth patterns are historically not sustainable over extended periods of time; the economy is cyclical; and real estate markets are typically highly sensitive to business cycles. Further, it is very difficult to predict when an economic and real estate upturn will end.

Our analysis cannot predict unusual economic shocks on the national and/or local economy, potential benefits from major "booms" that may occur, or the residual impact on the real estate market and the competitive environment of such a shock or boom. Also, it is important to note that it is difficult to predict changing consumer and market psychology.

As such, we recommend the close monitoring of the economy and the marketplace, and updating this analysis as appropriate.

GENERAL LIMITING CONDITIONS

Reasonable efforts have been made to ensure that the data contained in this study reflect accurate and timely information and are believed to be reliable and comprehensive. This study is based on estimates, assumptions, and other information developed by RCLCO Fund Advisors from its independent research effort and general knowledge of the industry. No responsibility is assumed for inaccuracies in reporting by any data source used in preparing or presenting this study. This memo is based on information that to our knowledge was current as of the date of this memo, and RCLCO Fund Advisors has not undertaken any update of its research effort since such date.

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