

MEMORANDUM

DATE: August 22, 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 March, 2022

INTRODUCTION

Goals and objectives that the semi-annual report evaluates include: a Q1 real estate allocation target of 14%;¹ a net return that exceeds the NCREIF NFI-ODCE Index, 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 control portfolio and 65% for the non-control portfolio.

PORTFOLIO HIGHLIGHTS

- ▶ The Real Estate portfolio has outperformed its target return benchmark over the long-term. The Portfolio has generated a 5-year net TWR of 11.4%, outperforming the ODCE benchmark return of 8.9% by 250 basis points, and a 10-year net TWR of 11.3%, outperforming the ODCE benchmark return of 9.9% by 140 basis points. While inflation has accelerated over the past year, real estate returns have significantly outpaced inflation across all time periods. The portfolio has slightly underperformed the record ODCE return of 27.3% over the 1-year period, by 10 basis points, largely due to an underallocation to industrial properties and continued drag from the Legacy² portfolio.
- ▶ Real estate net asset value (NAV) totaled \$49.2B as of Q1 2022, or 16.3% of the total CalSTRS Fund (~\$301.6B), above the current target allocation of 14%, but within the policy range of 11% to 17%. The portfolio is compliant with the target allocations by investment strategy. The allocation of assets by risk profile is 62% to core, 20% to value-add, 18% opportunistic, and 1% to Legacy assets.
- ▶ The portfolio is within the approved permitted leverage limits, as outlined by the Investment Policy and Management Plan ("IPMP"). The LTV of the controlled portfolio decreased over the last six months from 37% to 36% in Q1. The non-control portfolio LTV decreased from 50% to 48% over the last six months.

MARKET HIGHLIGHTS

Private real estate markets continued their strong performance during the second quarter of 2022. Industrial fundamentals continue to be the most favorable of the main property types, with Q2 absorption near record highs, outpacing deliveries by 40% and driving vacancies to a new all-time low of 4.2%. Industrial rent growth further accelerated to 10.1% year-over-year. Office absorption improved markedly in Q2 but still totaled just 20M SF, less than a third of the 65M SF of new supply. Office rent growth was modestly positive, but vacancies increased to 13.8%, underscoring the weakness of office fundamentals. Overall transaction volumes declined 8% quarter-over-quarter to \$160B in Q2, down from their historic high of \$350B in Q4 2021 which capped a record-setting year. Cap rates have been largely flat over the last six quarters at around 5.20%, on average. Anecdotally, some upward pressure is reported due to higher interest rates.

¹ Effective July 1, 2022, the real estate target allocation was increased to the long-term target of 15%.

² Legacy investments are closed-end opportunistic funds coming out of the Global Financial Crisis.