



Investment Committee

Item Number 4a – Open Session

Subject: Real Estate Policy Revision – Agility for Collaborative Model – Second Reading

Presenter(s): Chairperson

Item Type: Consent Action

Date & Time: July 8, 2021 – 0 minutes

Attachment(s): Attachment 1 – Proposed New Policy with Markups
Attachment 2 – Proposed New Policy Clean Version
Attachment 3 – RFA Recommendation Letter

PowerPoint(s): None

POLICY

The CalSTRS Real Estate Investment Policy (Teachers' Retirement Board Policy Manual, Section 1000, Page J-1), which governs the management of the Real Estate program, seeks to ensure that a diversified portfolio of real estate assets is developed to meet the California State Teachers' Retirement System's objectives, within acceptable risk parameters.

HISTORY OF THE ITEM/ PURPOSE

CalSTRS reviews its policies periodically and updates them as appropriate given evolving market conditions, practices, and opportunities. The Real Estate Policy was most recently revised in July 2017 and focused on the addition of "Transitional-Core" within the Core portfolio, expanding the leverage test on the Transitional-Core holdings to the portfolio level and removing duplicative language.

The purpose of the policy change is to add agility for implementing the Collaborative Model.

Staff proposed changes to the Real Estate Policy at the June 2021 Investment Committee meeting. The Committee members discussed the recommended changes with staff and their consultant RFA (formally known as RCLCO) and asked for one clarification related to the prohibition on displacement of low-income households in CalSTRS controlled investments within Affordable Housing programs. During further review of the policy, staff and RFA discussed one additional change that was not included in the First Reading. Staff, with RFA's concurrence, recommends additional monitoring and compliance on leverage cure periods in the

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event leverage ratios are exceeded. Both Investment Prohibitions and Portfolio Leverage modifications are included in the attached revision.

RECOMMENDATION

Staff recommends, and the board consultant, RFA, concurs, the Investment Committee approve the proposed revisions to the policy.

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CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

REAL ESTATE INVESTMENT POLICY

INVESTMENT BRANCH

~~JUNE~~ JULY 2021

J. Real Estate Investment Policy

EXECUTIVE SUMMARY

In accordance with the CalSTRS Investment Policy and Management Plan, IPMP, the California State Teachers' Retirement System Board, has established an allocation for investment in real estate. The primary objective is to achieve a rate of return that corresponds to the amount of risk outlined in the Real Estate portfolio risk/return composite approved by the Investment Committee. Secondary objectives are to provide a stable cash flow to the investment portfolio and to provide a hedge against inflation and improve diversification of the overall investment portfolio.

The CalSTRS' Real Estate investment assets are to be invested, administered, and managed in a prudent manner for the sole benefit of its participants and beneficiaries, in accordance with the California Constitution, the Teachers' Retirement Law, and other applicable statutes. No investment instrument or activity prohibited by the IPMP shall be authorized for the Real Estate portfolio.

The design of the Real Estate investment policy ensures that investors, managers, consultants, or other participants selected by CalSTRS take prudent and careful action while managing the Real Estate portfolio. The purchase, management, and sale of all types of real estate investments is performed by external professionals (managers) who are monitored and evaluated by internal investment officers, an external real estate consultant, and/or independent fiduciaries.

CalSTRS believes that environmental, social, and governance, ESG, issues can affect the performance of our investments. As a result, the CalSTRS ESG Policy has been developed as a tool that both internal and external investment managers are expected to use to assess the impact of these risks when making investments on behalf of CalSTRS.

As with all other plan assets, these policies cannot be altered without explicit direction from the Board. The internal investment officers and independent fiduciaries operate under the direction of the Chief Investment Officer, CIO. The external real estate consultant reports directly to the Board. Detailed procedures and guidelines for Real Estate portfolio is maintained separately.

PROGRAM OBJECTIVES

The strategic objectives of the Real Estate portfolio are as follows:

- A. To generate an enhanced yield to the actuarial earnings rate assumption.
- B. To provide stable cash flows
- C. To provide a hedge against inflation
- D. To provide improved diversification to the overall CalSTRS Investment Portfolio.

PERFORMANCE OBJECTIVES

CalSTRS Real Estate portfolio includes core, value add, and opportunistic strategies which, in aggregate, are structured to achieve a long-term total return in excess of the Real Estate Policy Benchmark.

PROGRAM BENCHMARK

The benchmark for Real Estate portfolio will be the NCREIF Open End Diversified Core Equity (ODCE) value weighted index net of fees.

PROGRAM STRUCTURE

The asset allocation target and range for the portfolio shall comply with the guidelines set forth in the IPMP. Adjustments from actual to target allocation shall be implemented within a timeframe consistent with the provisions set forth in the IPMP.

Risk Return Levels

Over the long-term, the Real Estate portfolio shall be divided into three segments: 1) Core 2) Value Add, and 3) Opportunistic. Allocations to the Core, Value Add, and Opportunistic segments shall be made to maximize the total return to CalSTRS while mitigating risk. As a moderate risk investor, CalSTRS' long-term allocation ranges and long-term target allocations to these portfolios shall be:

Portfolio Segment	Policy Portfolio	Allocation Ranges
Core	60%	50% - 75%
Value Add	20%	10% - 30%
Opportunistic	20%	10% - 30%

It is recognized that the real estate asset class is cyclical. The table above depicts the targets and ranges for the various portfolio segments over the long-term. However, in response to changing market conditions, as well as other relevant factors, the actual allocation may vary within the recommended ranges. From time to time, the actual allocations of the portfolio may fall outside the recommended ranges. In these instances, adjustments from the actual to the prescribed allocation range shall be implemented over a reasonable time frame (within a one to three-year period, unless otherwise specified), with ample consideration given to preserving investment returns to CalSTRS.

As investments in the value add and opportunistic portfolio mature, their characteristics may become core-like. CalSTRS staff and the consultant shall monitor the portfolio for instances when changes of the classification of certain investments are warranted. Reclassifications must be mutually agreed upon by staff and consultant and reported to the Investment Committee.

The table below illustrates the key characteristics of Core, Value Add, and Opportunistic classifications. Refer to the Real Estate Guidelines for complete descriptions.

	Core	Value Add	Opportunistic
Property Profile	<ul style="list-style-type: none"> • Existing building • Substantially leased 	<ul style="list-style-type: none"> • Existing building • Repositioning or light renovations 	<ul style="list-style-type: none"> • Development • Major renovation • Distressed
Cash Flow	<ul style="list-style-type: none"> • Predictable • Long-term • High credit quality • Bond-like 	<ul style="list-style-type: none"> • Short/Medium term • Improved through hold period 	<ul style="list-style-type: none"> • Little to no cash flow
Expected Returns	<ul style="list-style-type: none"> • 6-9% • Significantly derived from cash flow 	<ul style="list-style-type: none"> • 9-13% • Balance between cash flow and appreciation 	<ul style="list-style-type: none"> • 13%+ • Majority derived from appreciation
Capital Expenditures	<ul style="list-style-type: none"> • Low 	<ul style="list-style-type: none"> • Moderate 	<ul style="list-style-type: none"> • High
Occupancy	<ul style="list-style-type: none"> • Fully Occupied or near Full Occupancy 	<ul style="list-style-type: none"> • Partially Occupied 	<ul style="list-style-type: none"> • Little to no occupancy

Non-U.S. Investments

The allocation range for non-U.S. investments shall be 0 percent to 30 percent of the NAV of the total Real Estate portfolio. Investments outside the U.S. will be classified as core, value add, or opportunistic taking into account any additional country-specific risks.

Eligible Investment Types

Real estate investments may include direct or indirect equity investment in real estate (including all rights and interests incident thereto) such as (i) interests in corporations, partnerships, and other entities whose primary business is the acquisition, development, and operation of real property including publicly traded, or private real estate investment trusts (“REITs”) and real estate operating companies (“REOCs”); (ii) participating or convertible participating mortgages or other debt instruments convertible to equity interest in real property based on investment terms (and not merely by foreclosure upon default); (iii) options to purchase real estate, leaseholds, and sale-leasebacks; and (iv) all other real estate related securities such as lower or un-rated tranches of pre-existing securitized or structured debt instruments such as mezzanine debt, which have equity features.

Eligible Ownership Vehicles

For CalSTRS to meet its objectives in the real estate asset class, staff will select appropriate vehicles with structural aspects that provide for maximum liquidity and control while mitigating risk, and the highest level of accountability on the part of management and alignment of interests with CalSTRS. All vehicles are subject to pre-approved guidelines and, whenever possible, clearly defined investment strategies.

	Control	Ownership	Liquidity
Separate Account	Discretion of all major decisions	Full CalSTRS ownership	High
Joint Venture	Majority control	Partners co-invest to increase alignment	High
Closed-Ended Fund	Advisory board	Commingled with other partners	Low
Open-Ended Fund	Moderate	Commingled with other partners	Moderate
REITs	Buy/Sell discretion	Variable; minority ownership	High
REOC	Discretion of major business decisions	Variable	Low
Debt Structures	Moderate	Variable	Moderate-High

For further details regarding investment vehicles, refer to Real Estate Investment Guidelines.

RISK MANAGEMENT

The Real Estate Policy and the Real Estate investment activities are subject to the CalSTRS IPMP. Risks associated with investing in Real Estate projects, assets, and vehicles will be mitigated sufficiently to allow for a reasonable risk adjusted return. Potential risks associated with the Real Estate portfolio include, but are not limited to, the following:

Portfolio Leverage

CalSTRS shall employ leverage in the Real Estate portfolio in order to moderate equity risk and enhance investment returns. Such leverage may exist at the portfolio, manager, or investment level. Leverage may increase the volatility of the Real Estate portfolio so careful consideration will be given to the impact of leverage on the investment and portfolio risk. In addition, limitations on the amount of leverage at the individual asset or investment entity level as well as debt service coverage requirements, will be reviewed and negotiated by staff. Restrictions on recourse, credit facilities, cross collateralization and debt service ratios will also be vetted and approved by staff.

Leverage will be measured and monitored depending on CalSTRS level of control. Staff will strive to negotiate control of major decisions including leverage levels whenever possible. These “Controlled Structures” are typically Separate Accounts and Joint Ventures where CalSTRS is the majority investor. “Non-Controlled” structures are typically commingled funds where CalSTRS is a minority partner with typical limited partner rights.

Management of leverage will be delegated to staff subject to levels in the table below. Leverage will be monitored by staff and the Real Estate Consultant and reported to the board in the Semi-Annual Reports. [To the extent that leverage exceeds the maximum allowable, within a reasonable time frame as outlined in the Real Estate Investment Guidelines.](#)

Structure	Portfolio Leverage Limit
Controlled Structures	50%
Non-Controlled Structures	65%

Environmental Liability

CalSTRS encourages the prudent use of sustainable development methods and operational practices when reasonable and economically feasible. CalSTRS will prudently accept environmental exposure and potential liability in a manner consistent with overall industry standards applicable to institutional investors acting in a like manner under similar circumstances.

Discretionary Authority

Discretionary authority is delegated to staff subject to conditions in the table below.

Manager Category	New Allocation or Individual Investment / Total RE NAV	New Allocation plus existing NAV / Total RE NAV	Manager Rating (Tiering)	IC Notification Required
New Manager	Above 3%	NA	NA	Yes
Existing Manager	Above 10%	Above 30%	Tier 3	Yes

Investment Manager Diversification

To reduce risk, the real estate portfolio shall be diversified by investment manager. No single investment manager shall manage more than 30 percent of the net asset value of targeted real estate portfolio at the time of allocation.

RESPONSIBLE CONTRACTOR POLICY

The California State Teachers' Retirement System has a deep interest in the condition of workers employed by CalSTRS and its advisors. CalSTRS, through the CalSTRS Responsible Contractor Policy, supports and encourages fair wages and fair benefits for workers employed by its contractors and subcontractors, subject to fiduciary principles concerning duties of loyalty and prudence, both of which further require competitive returns on CalSTRS real estate investments. CalSTRS endorses small business development, market competition, and control of operating costs. The CalSTRS believes that an adequately compensated and trained worker delivers a higher-quality product and service. CalSTRS requires its real estate managers to abide by the Responsible Contractor policy on all applicable investments.

INVESTMENT PROHIBITIONS

Affordable Housing

CalSTRS will not invest in strategies that are intended to capitalize on the displacement of low-income households. Any rent-regulated housing units that are demolished as such investment or project must be replaced with new rent-regulated housing units; and any persons lawfully residing in rent regulated housing that are displaced as a result of such strategies receive relocation benefits in accordance with relocation requirement as mandated by the local housing authority or by state or federal relocation laws, if applicable.

This section shall not prohibit investment in existing low-income housing tax credit or multifamily housing revenue bond financed assets with regulatory agreements that limit, among other things, allowable rent increases. However, such regulatory agreements do expire. Without replacement financing from regulatory authorities, this may cause certain assets to revert to market rate. [The prohibition shall apply to all private Real Estate investment strategies in which](#)

[CalSTRS has a controlling interest and](#) ~~This prohibition~~ is detailed in the Real Estate Investment Guidelines.

MONITORING, VALUATION AND REPORTING

CalSTRS' investments in real estate shall be valued at least annually on a fair market value basis. In certain circumstances, when it is inappropriate or not possible to value investments at market, an alternate method of valuation shall be used. All monitoring and reporting will be in accordance with industry best practices and NCREIF guidelines. Performance will be reported semi-annually as part of the overall investment performance review.

POLICY MONITORING AND MODIFICATION

The Real Estate Consultant shall monitor the investment process for compliance with this policy and report to the CalSTRS Investment Committee as requested.

Consistent with all other plan assets, the Board or the Investment Committee may or shall review and alter this policy periodically as deemed appropriate and in keeping with its fiduciary standards.

The Real Estate policy shall be reviewed periodically to determine if modifications are necessary or desirable. Any changes shall be subject to the approval of the Investment Committee.

Revised February 2, 2006

Revised to adjust allocation ranges, definitions of core and tactical portfolios, discretion limits to staff, and to introduce public-traded investments on July 13, 2007.

Revised to place the portfolio into core, value add and opportunistic categories; adjust allocation ranges for these categories and add language for leverage limitations; and add new benchmarks for these new categories on June 3, 2010.

Revised to accommodate benchmark availability and performance evaluation requirements as well as adjustments to Cash Transfer Limitations on November 3, 2011

Revised to add ESG Risks Policy reference on September 10, 2013

Revised to change benchmark to ODCE on April 4, 2014

Revised to update two sections of the policy document to align the portfolio to current market conditions and the conclusions contained in the 2015

Asset Allocation Study on November 4, 2015

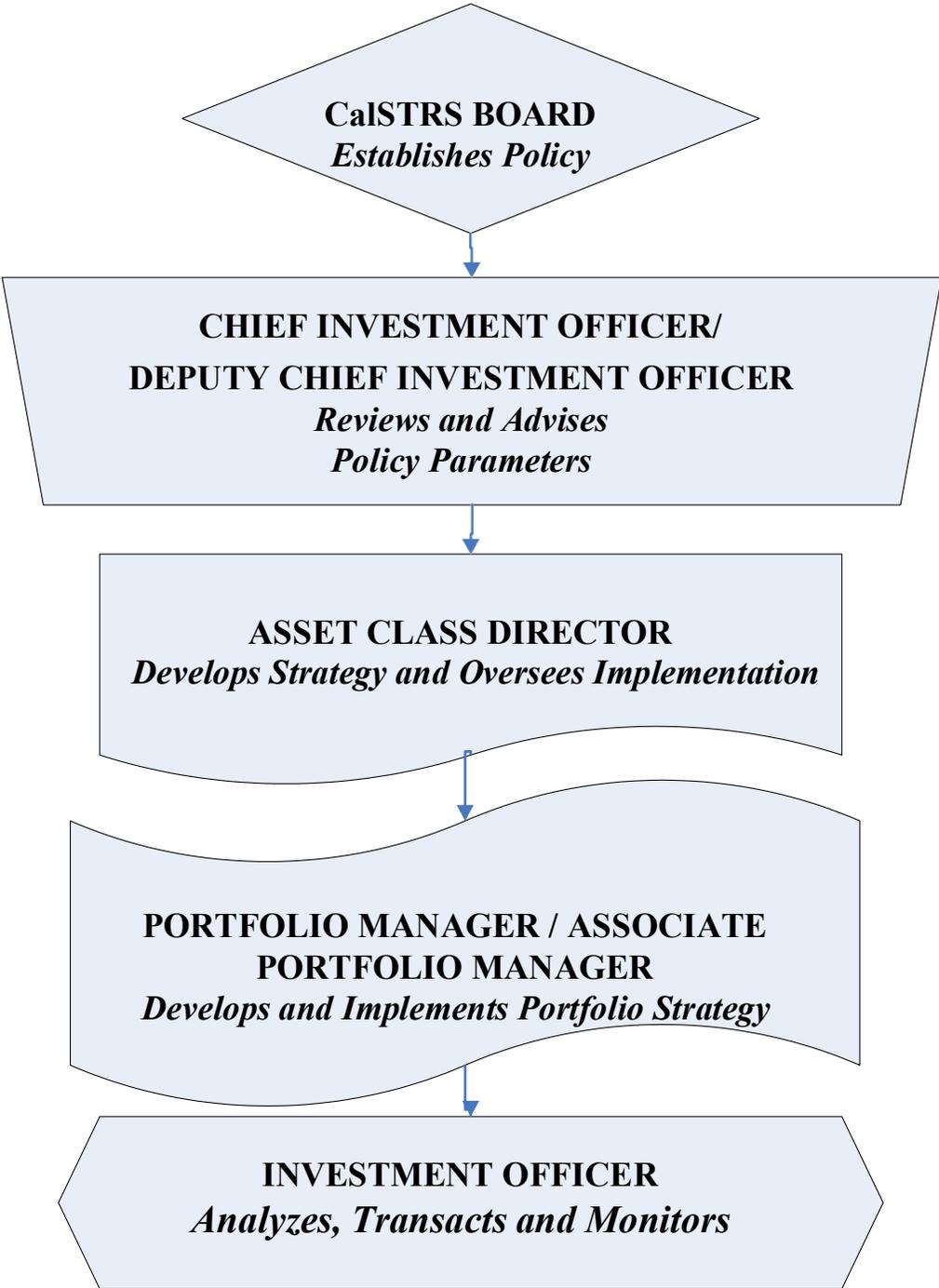
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Revised to give staff the ability to manage the portfolio using strategies consistent with those implemented within the NCREIF ODCE index on July 12, 2017

[Revised to reflect new format and agility for implementing the Collaborative Model including segmenting portfolio by Control and Non-Control on July 8, 2021](#)

Exhibit 1

POLICY IMPLEMENTATION FLOWCHART



Portfolio Activity

GLOSSARY

CAPITAL IMPROVEMENTS – Expenditures that cure or arrest deterioration of property or add new improvements to prolong its life.

CO-INVESTMENT – Investments where the management organization has a capital investment and ownership share.

COMMINGLED FUND – A term applied to all open-ended and closed-ended pooled investment vehicles designed for institutional tax-exempt investors. A commingled fund may be organized as a group trust, partnership, corporation, insurance company separate account, private real estate investment trust, or other multiple ownership entity.

- **Open-ended Fund** – A commingled fund with no finite life, which allows continuous entry and exit of investors, and typically engages in ongoing investment purchase and sale activities.
- **Closed-ended Fund** – A commingled fund with a stated termination date, with few or no additional investors after the initial formation of the fund. Closed-ended funds typically purchase a portfolio of properties to hold for the duration of the fund and, as sales occur, typically do not reinvest the sales proceeds.

FAIR MARKET VALUE – The highest price a property would bring if exposed for sale in the open market by a willing seller to a willing buyer with both parties being fully informed of all the uses and purposes to which the property is reasonably adaptable and available.

INVESTMENT MANAGER – A company that, by contractual agreement, provides property investment opportunities and/or property asset management services.

JOINT VENTURE – A structure wherein CalSTRS and a partner form a partnership to purchase and/or operate an investment, or investments.

LEVERAGE – The use of borrowed funds to increase purchasing power and, ideally, to increase the profitability of an investment.

LIMITED PARTNERSHIP – A partnership with both general and limited partners in which the general partner manages the business and assumes full liability for the partnership obligations with the liability of the limited partners generally restricted to their capital contributions.

NCREIF INDEX – National Council of Real Estate Investment Fiduciaries Index; a property-level performance benchmark for institutionally owned real estate, calculated on a quarterly basis.

NET ASSET VALUE (NAV) – Represents total assets at fair market value minus liabilities.

NEW FIRM - Investment Manager with whom CalSTRS Real Estate has a contractual relationship of less than one year.

ODCE - The ODCE Index is comprised of open-end funds, with investments in equity positions in stable properties in the United States across diversified regions and property types. These investments typically reflect lower-risk strategies which utilize low leverage, and also provide a degree of liquidity due to being open-ended.

OPPORTUNISTIC – A phrase characterizing an investment in underperforming and/or undermanaged assets typically purchased from distressed sellers, utilizing high levels of leverage with the expectation of near-term increases in cash flow and value.

TOTAL RETURN – The sum of the income and appreciation returns.

VALUE-ADDED – A phrase commonly used by investment managers to describe a management approach to a property with the connotation that their skills will add value, which otherwise would not be realized.

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REAL ESTATE INVESTMENT POLICY

INVESTMENT BRANCH
JULY 2021

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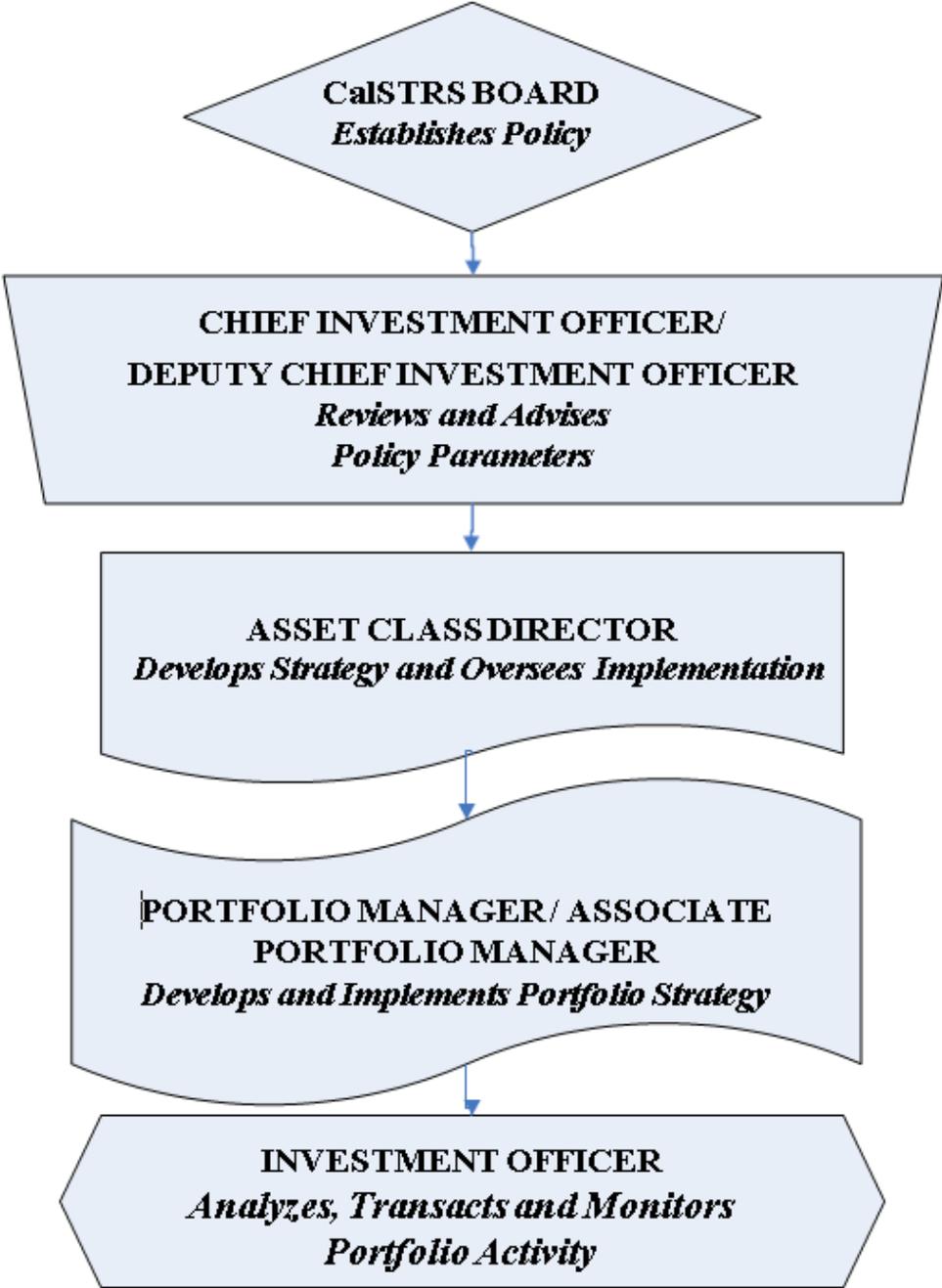
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POLICY IMPLEMENTATION FLOWCHART



GLOSSARY

CAPITAL IMPROVEMENTS – Expenditures that cure or arrest deterioration of property or add new improvements to prolong its life.

CO-INVESTMENT – Investments where the management organization has a capital investment and ownership share.

COMMINGLED FUND – A term applied to all open-ended and closed-ended pooled investment vehicles designed for institutional tax-exempt investors. A commingled fund may be organized as a group trust, partnership, corporation, insurance company separate account, private real estate investment trust, or other multiple ownership entity.

- **Open-ended Fund** – A commingled fund with no finite life, which allows continuous entry and exit of investors, and typically engages in ongoing investment purchase and sale activities.
- **Closed-ended Fund** – A commingled fund with a stated termination date, with few or no additional investors after the initial formation of the fund. Closed-ended funds typically purchase a portfolio of properties to hold for the duration of the fund and, as sales occur, typically do not reinvest the sales proceeds.

FAIR MARKET VALUE – The highest price a property would bring if exposed for sale in the open market by a willing seller to a willing buyer with both parties being fully informed of all the uses and purposes to which the property is reasonably adaptable and available.

INVESTMENT MANAGER – A company that, by contractual agreement, provides property investment opportunities and/or property asset management services.

JOINT VENTURE – A structure wherein CalSTRS and a partner form a partnership to purchase and/or operate an investment, or investments.

LEVERAGE – The use of borrowed funds to increase purchasing power and, ideally, to increase the profitability of an investment.

LIMITED PARTNERSHIP – A partnership with both general and limited partners in which the general partner manages the business and assumes full liability for the partnership obligations with the liability of the limited partners generally restricted to their capital contributions.

NCREIF INDEX – National Council of Real Estate Investment Fiduciaries Index; a property-level performance benchmark for institutionally owned real estate, calculated on a quarterly basis.

NET ASSET VALUE (NAV) – Represents total assets at fair market value minus liabilities.

NEW FIRM - Investment Manager with whom CalSTRS Real Estate has a contractual relationship of less than one year.

ODCE - The ODCE Index is comprised of open-end funds, with investments in equity positions in stable properties in the United States across diversified regions and property types. These investments typically reflect lower-risk strategies which utilize low leverage, and also provide a degree of liquidity due to being open-ended.

OPPORTUNISTIC – A phrase characterizing an investment in underperforming and/or undermanaged assets typically purchased from distressed sellers, utilizing high levels of leverage with the expectation of near-term increases in cash flow and value.

TOTAL RETURN – The sum of the income and appreciation returns.

VALUE-ADDED – A phrase commonly used by investment managers to describe a management approach to a property with the connotation that their skills will add value, which otherwise would not be realized.

MEMORANDUM

DATE: June 17, 2021

TO: Investment Committee, California State Teachers' Retirement System

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

SUBJECT: Proposed Real Estate Investment Policy Revisions – Second Reading

INTRODUCTION

Staff is in the process of revising and updating the Real Estate Investment Policy (“Policy”) and the Real Estate Guidelines, which contain detailed procedures and guidelines for the real estate portfolio for internal purposes. The Investment Committee discussed the proposed revisions to the Policy and provided feedback in June. Below we highlight revisions since the first reading:

KEY CHANGES AND RATIONALE

Portfolio Leverage

Staff has added additional language to provide for a “cure” period in the situation that leverage is outside of policy limits. The addition of a cure period allows staff to bring the portfolio back to compliance over time, rather than make immediate changes to the portfolio which could have adverse consequences. The specific timeframe for compliance will be specified in the Real Estate Guidelines, which is consistent with cure periods noted in investment policy statements for other asset classes. RFA agrees that Staff’s additional language is prudent.

Investment Prohibitions

Based on feedback from the Investment Committee, Staff has added language to clarify that the prohibition on strategies that are intended to capitalize on the displacement of low-income households applies only to vehicles where CalSTRS has a controlling interest and thus has the authority to control the investment strategy.

CONCLUSION

RFA concurs with Staff’s proposed revisions. As we noted with the first reading, RFA will review the revised version of the Real Estate Guidelines referenced in the Policy when complete in order to ensure alignment with the Real Estate Investment Policy.