TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Revised Real Estate Policy – Discretion *(Policy)* ITEM NUMBER: 5

ATTACHMENT(S): 4

ACTION: X DATE OF MEETING: July 7, 2004

INFORMATION: ____ PRESENTER(S): Mike DiRé, Pam Alsterlind, Nori Gerardo Lietz

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Policy

This is the policy document that governs CalSTRS real estate portfolio. The proposed recommendations are the third step in a plan to streamline the investment process.

Executive Summary

At the November 2003 Investment Committee meeting, Staff and Pension Consulting Alliance, Inc. ("PCA") presented a plan: (i) to revise the current aspects of the real estate policies; (ii), to add language addressing assets with environmental issues; and (iii) to propose modifications to the Staff's discretionary authority to make new and follow-on investments. At the direction of the Investment Committee, Staff was instructed to accomplish the above in phases.

At the December 2003 meeting, the Investment Committee reviewed and approved a revised policy. The revised policy document incorporated modifications outlined to the Investment Committee last November. These changes simplified the portfolio classifications into the Core and Tactical categories and provided additional detail and clarity to the overall management of the portfolio. At the February 2004 meeting, the Investment Committee approved a new policy for environmental liability.

For this meeting, and pursuant to the agreed upon schedule, Staff is submitting proposed language for discretionary levels.

Background and Discussion

The issues surrounding the need for a change in discretionary levels were detailed in the November and December board items and are contained in Attachments 1-2. The highly competitive market conditions described in these materials have become even more challenging since the beginning of the year. Staff and PCA believe that streamlining the investment decision process will help CalSTRS compete more effectively in the current environment.

The primary benefits of adjusting the discretionary levels can be summarized as follows:

- A higher level of discretion at the Staff level will allow CalSTRS to compete more effectively on large transactions (either individual assets or portfolio transactions) without compromising our due diligence and underwriting standards; and
- The proposed changes will free up Investment Committee time to be spent on strategic initiatives as opposed to transaction reviews.

The current discretionary guidelines for real estate and the other asset classes are depicted in Table 1.

Table 1 - Discretionary Guidelines – Current

	Fixed Income	U.S. Equities	Alternative Investments	Real Estate
IC approval required for transactions above	$1 Billion	$1 Billion	$400 Million for "add on"	$100 Million for all transactions
Staff approval			$100 Million for "new relationships"	
CIO approval required for transactions above	$750 Million	$500 Million	All transactions	All transactions

Specifically, the real estate discretion issue arises in three contexts for CalSTRS:

(i) Investment decisions regarding the purchase/sale of individual buildings or a portfolio of buildings in amounts over $100 million. These purchases could arise with any CalSTRS real estate manager.

(ii) Investment decisions regarding a commitment to a commingled fund in amounts over $100 million; and

(iii) Investment decisions regarding commitments to new joint venture managers in either the Core or Tactical segments of the portfolio in amounts over $100 million.

Investment decisions regarding individual buildings or portfolios can be time sensitive and sellers will ask whether potential buyers have discretion to close. In the current environment, there are frequently numerous potential bidders for transactions, and ability for speed and surety of closure can take on equal importance to pricing amongst the finalists. Greater flexibility in this area will enable CalSTRS to compete more effectively for these transactions.

Commitments to new commingled funds and new relationships are generally not time sensitive, but are time consuming for the Investment Committee to consider. Historically, staff has delegated authority for allocations less than $100 million.

<u>Recommended Change</u>

> Staff discretion up to, and including, $100 million for initial allocations to new managers with the ability to allocate up to $400 million in follow-on investments with the firm. Upon an individual firm reaching $500 million of allocation, the Staff will present a detailed written analysis of the firm for Investment Committee review. At its discretion, the Investment Committee can require the staff to bring the firm in for a presentation prior to any additional allocations.
>
> For firms that the Investment Committee has either selected through the RFP process, or approved as described above, Staff will have discretionary authority to approve individual transactions up to, and including, $500 million of equity.

All other aspects of the investment process will remain unchanged. Prior to any transaction being closing, Staff will be required to obtain an opinion from a Fiduciary recommending the investment. Additionally, Staff will obtain an opinion from the Consultant that the proposed investment complies with existing real estate policies.

Additionally, Staff will update the Investment Committee in closed session on any large pending transaction, either purchase or sale, over $100 million at the earliest possible date, pursuant to a written report in the closed session activity status reports. Staff will also identify those potential new managers in the due diligence process along with a description of the proposed strategy the firm would implement for CalSTRS.

An example of the potential closed session disclosure is shown in closed session materials. If approved, these descriptions would be part of the closed session activity status report on a going forward basis. As can be seen, this status report lists all large core investments of size at the various stages of pursuit by CalSTRS through our fiduciaries. This gives the Investment Committee the ability to:

- Monitor the types of investments Staff is pursuing;
- The opportunity to query Staff and Consultant on the pipeline; and
- The opportunity to request an early stage approval by the Investment Committee.

In Staff's and PCA's opinion, it is appropriate investment policy for the Investment Committee to retain discretion over approving significant capital allocations to new investment strategies.

Any major new proposed initiatives warranting capital allocations on a programmatic basis will be brought to the Investment Committee for approval. An example of such an initiative would be the previously approved allocations for urban investments in California.

Table 2 summarizes the proposed revisions to the policies for allocated staff discretion.

Table 2 - Discretionary Guidelines – Proposed

	Individual Building /Portfolio Transactions (Separate Accounts)	**Commingled Funds**	**Programmatic Joint Ventures/New Strategies**
IC approval required	Investments over $500 Million of equity	Over $100 Million of equity for "new relationships" Approval of any firm that has received up to, and including, $500 Million of equity in Staff allocations, for additional capital allocations	New strategies and new relationships with capital allocations over $500 Million of equity
CIO approval required	Investments greater than $50 Million of equity	All transactions	All transactions
Real Estate Director	All transactions	All transactions	All transactions

The old policy under section (H) in Real Estate Policy is as follows:

The rejection and approval decision for low, moderate, and high risk direct ownership properties, co-investments, commingled funds, and secondary interests is delegated to staff with the stipulation that all investments are subject to the appropriate due diligence, as defined in the Real Estate Procedures.

The approval of major capital decisions including the decision to acquire, finance, refinance, renovate, expand, or sell is delegated to staff considering the following stipulations:

1) Due diligence process shall be consistent and appropriate as defined in the investment Real Estate Procedures.
2) Maximum amount of the commitment should not exceed $100 million.
3) A final recommendation report will be presented to the Investment Committee as soon as practical after the transaction is completed.
4) Direct real estate assets and commingled fund strategies located in the United States.

Staff can delegate the above authority to CalSTRS' real estate managers for the implementation of the low risk investment strategies.

The new policy recommendation to replace section (H) of the old policy (See Attachment 3) is as follows:

The approval and rejection decision for real estate investments is delegated to Staff with the following stipulations:

1) Staff had discretion up to and including $100 million for an initial allocation to a new firm with the ability to allocate up to, and including, an additional $400 million for follow-on investments with the same firm. Thereafter, incremental allocations may be approved by Staff subject to the Investment Committee's review, if so requested.
2) For firms that the Investment Committee has either selected through a request for proposal process, or approved as described above, Staff has authority to approve individual transactions up to, and including, $500 million. Transactions include all major capital decisions including acquisitions, renovations and dispositions.

All real estate investments are subject to appropriate due diligence as defined in CalSTRS Real Estate Guidelines. Dollar limitations are based on equity amounts made by CalSTRS.

Conclusion

Staff and PCA believe they have developed an efficient set of policies that will enable CalSTRS to address the challenges of investing in real estate in the future. These changes in policy will permit needed investment flexibility, while maintaining our high standards of prudent due diligence. Therefore, we recommend approval of the proposed policy language. Should the Investment Committee approve the proposed revisions to the Real Estate Policy, a resolution is provided as Attachment 4.

Staff and PCA are available for discussion on this item.

Date prepared: June 16, 2004

By:

FOR

Mike DiRé
Director - Real Estate

Review & Concur:

Christopher J. Ailman
Chief Investment Officer

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Real Estate – Investment Policy – Revision ITEM NUMBER: 7

ATTACHMENT(S): 0

ACTION: ____ DATE OF MEETING: November 5, 2003

INFORMATION: X PRESENTER(S): Mike DiRé and Nori Gerardo Lietz

Policy: This is the core policy document that governs the entire real estate investment portfolio.

Executive Summary: Staff identified a review and update of the real estate policy as a goal in the Real Estate Annual Business Plan for 2003-2004. Staff asked PCA to assist with the policy review. Staff, and PCA together, are bringing this item to discuss issues with the Investment Committee prior to drafting an updated policy, which will be presented at the December meeting.

Background & Discussion: Over the last three years, at the Board's direction, staff has implemented the strategy to diversify by moving the real estate portfolio from a primarily low risk, "core-like" portfolio, to one with up to 25% in both moderate and high risk investment strategies. To accomplish this, the real estate investment policy has been modified several times. These changes, in total, have caused the policy to be an ineffective working document as conflicting statements and ambiguities have arisen from piecing together the multiple revisions, as opposed to taking a comprehensive review. Staff and PCA have spent considerable time reviewing the current policy document, taking into account:

(i) the role of real estate in CalSTRS' overall portfolio
(ii) the current real estate market conditions
(iii) the current real estate strategy

Staff and PCA are proposing a rewrite of the policy document to accomplish the following:

- To accurately reflect the role of real estate and the interplay of component parts;
- To better integrate an assessment of market conditions in the overall allocation of capital to various investment strategies;
- To simplify the overall investment structure; and
- To simplify and streamline the investment decision making process.

Overall, our intent is to present a comprehensive set of investment policy revisions at the December meeting. This will allow the Investment Committee and staff to have a workable policy document that reflects both the overall goals of the Investment Committee and gives staff the flexibility to implement these objectives.

This memo is structured as follows:

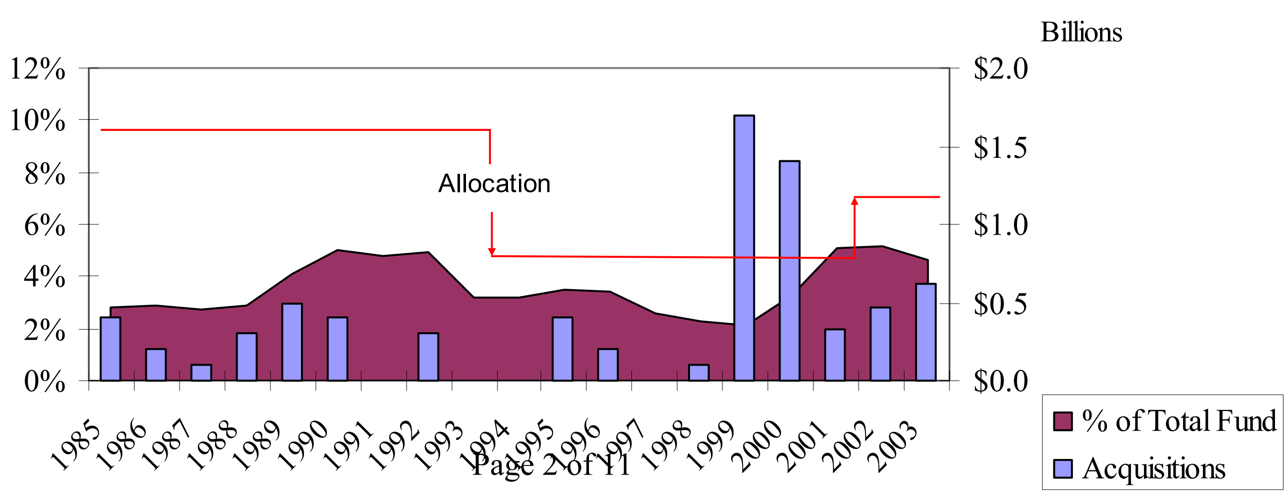
A. History of CalSTRS Real Estate Investing and Policy
    a. Investment History
    b. Policy Evolution and History
B. Changing Times
C. Portfolio Composition and Structure
D. Proposed Policy Change
    a. Proposed Portfolio Structure
    b. Environmental Standards
    c. Discretionary Authority
E. Conclusion

A. History of CalSTRS Real Estate Investing and Policy

a. Investment History: The chart below shows CalSTRS' real estate investment history. Investment tracking has had a light switch effect, with periods of activity in 1985 – 1991; 1995 – 1996; and 1999 – 2003. The former 5% allocation target was reached in early 2001. The allocation target was raised to 7% in 2002, dropping us back below the target. The addition of approximately $925 million in leverage proceeds caused a further drop below the allocation target.

*Note: the chart does not include commitments to opportunity funds of approximately $1 billion.

Real Estate as a % of Total Fund



b. Policy Evolution and History: When CalSTRS began investing in real estate in 1985, the policy was to invest in only core real estate. Since then, the Investment Committee has approved various changes in strategy and scope for the real estate portfolio that included investments in higher risk and return strategies. These include the following highlighted additions:

1985 → Original policy for real estate investments "core-only" strategy.
1997 → Added commingled funds and securitized investments as approved strategies.
1998 → Incorporated into strategies an urban focus for the applicable portions of the portfolio.
1998 → Commenced the low, moderate, and high component strategies.
2000 → Added joint ventures and debt instruments as approved structures.
2001 → Added overriding leverage policy and international investments.
2003 → Discussed changes to the environmental standards.

The above sampling of policy and strategy changes reflects the evolution of the marketplace and CalSTRS' growing knowledge and response through its policies; however, the policy changes were cobbled onto an existing policy that was established for a simple, core real estate program. In hindsight, these changes, although individually thoughtful, have in total made the policy document cumbersome to work with in the current market environment.

Over time, we have had a number of issues crop up as a result of the current policy. Some examples may illustrate our point. For example, how should staff categorize an investment under the policy? Should it be based upon the initial risk profile or should it be moved from one risk category to another as the investment's characteristics change?

In theory, staff can classify these assets at the outset of the investment by using pre-established criteria. In practice, many assets do not fit neatly into one category or another. Assume we have an existing, fully leased apartment building with 55% leverage. This core asset moves from the core portfolio into the moderate category by the simple addition of debt. Additionally, over time assets naturally move from one category to another as investments are managed through their life cycle. An office development project could begin as a high risk investment; however, after the development is completed and the building is fully leased, it could then be considered a low risk core asset.

Staff and PCA concur that the current policy structure could lead to illogical consequences. The current policy requires allocations to low (50%), moderate (25%), and high risk (25%) investment strategies irrespective of taking into account then-prevailing market conditions. This could lead to a rigid, ill-timed portfolio strategy. Additionally, the policy, while silent on the point, has been interpreted to mean that the categorization of an investment occurs at the inception of the investment and the categorization never changes, even though the character of the investment might.

Staff and PCA are working closely to redraft the investment policy to be more flexible. The revisions will likely eliminate the specific allocations to each of the risk factors in favor of guidelines that permit investments in each of the categories based upon the risk-adjusted returns of the opportunities relative to the core/low risk alternative. The guidelines will be permissible allocations as opposed to mandated target allocations.

We will also likely recommend that the portfolio be evaluated annually on the basis of what the original expectations were and what then-current expectations are for individual investments. A spectrum of risk and return will be compiled for each investment and for the portfolio and presented to the Investment Committee annually.

B. Changing Times: The real estate market has changed significantly over time and CalSTRS must continue to respond to these changes to remain a successful investor. The changes are external and internal, as discussed in the following section.

External Changes – The Real Estate Market

Current Market Environment

- There is an abundance of capital for real estate today (both debt and equity).
- The market has matured with the development of several, now widely accepted, new investment vehicles.
- Pricing is at an all-time high in many segments for reasons unrelated to fundamentals.
- Consequently, the market is extremely competitive.
- Competing in this market environment is tough, even for large investors like CalSTRS.
    - To compete successfully an investor needs: (i) flexibility; and (ii) certainty of closing (which means discretion for the buyer's agent).

Allocations to real estate are up for both domestic and foreign funds. In addition, private individuals have also increased their allocation to real estate investments. All are seeking premium yields relative to fixed income and lower volatility than equities. The net result is that capital allocated to real estate has exponentially increased and a number of different professionally managed vehicles are vying for product.

The velocity of transactions has increased almost exponentially over the past ten years. To compete effectively as a buyer, all investors must now compete; not just with price, but with the ability to show the seller a certainty of closing quickly. Buyers, who historically could have demanded environmentally clean, leverage-free, fully-warranted transactions and take six months to close, are now asked to take assets in "As Is" condition and close in 30 days.

Sellers prefer to deal with pension funds that give discretion to managers (i.e., no staff or board approval needed) or have streamlined approval processes. In addition, sellers often demand to use their own contracts and ask for non-refundable deposits in case the buyer fails to close for any reason.

These and other factors have pushed the current real estate market into a multifaceted, highly competitive environment. Staff has reacted to these changes by obtaining pre-approval for transactions, at the staff and Investment Committee level, on significant assets with sellers that are sensitive to approval processes and speed. To keep our thorough due diligence processes in place, this increases CalSTRS' time and costs on the front end of the transaction prior to knowing the outcome of the bid process. It also takes more Investment Committee time on assets that may or may not eventually close.

Going forward, the staff will propose additional modifications to the policies to further streamline the investment decision making process to make CalSTRS even more competitive in the market.

<u>Internal Changes – CalSTRS – Investment Committee and Staff:</u> The Investment Committee's decision to shift the real estate portfolio from a primarily core portfolio to one with up to 50% in higher returning strategies occurred in 1998, staff has implemented this decision over the last four years. This strategic change, coupled with the change in market conditions, has necessitated a change in both the approach and staffing of CalSTRS' real estate division.

Approach

Initially, CalSTRS invested in core, low risk assets with heavy emphasis on the four major property types (office, industrial, retail, and multifamily) and assets located in major markets. This strategy served CalSTRS well during times where it was a "buyer's market". The Investment Committee reviewed and approved each and every buy and sell decision for each property in the portfolio. This process proved to be very taxing of time, and ultimately found to be unworkable and unprofitable by the Committee.

In 1998, decision-making as to purchase and sale decisions was delegated to the advisors, fund managers, and joint venture partners, subject to defined limitations. Staff was able to do this prudently by giving various levels of discretion; from broad - with opportunity funds - to limited "discretion in a box" - with advisors and joint venture partners. Additionally, staff was delegated the discretion to approve discrete investments and new investment opportunities up to $100 million.

Today, the Investment Committee still spends considerable time reviewing and approving discrete investment transactions (over $100 million in the real estate asset class), which are complicated and time consuming. This is a function of the increased size of CalSTRS investment portfolio and the increased size of individual transactions. Staff and PCA will recommend the Investment Committee consider as part of the policy revisions that the amount of delegated discretion to the real estate staff be commensurate with other asset classes. This will free up Investment Committee time to focus on policy matters, such as the approval of new strategic initiatives within the asset class. Examples might include consideration of a housing program, senior housing, etc.

Personnel

CalSTRS is fortunate in that the staff has deep real estate experience, with an average portfolio manager's institutional real estate experience level of approximately 15 years. The portfolio managers have a combination of private, and public service, direct asset manager experience. While small in size, the staff is efficiently organized by product type to maximize each member's specialization and knowledge of specific product types. This facilitates our staff's effectiveness in both choosing potential partners and making informed and timely decisions on asset-specific transactions. This is an important aspect in forming lasting relationships with top tier firms in the market. These firms want to know that they will have access to capital, but equally important that they have good partners who are knowledgeable about the opportunities as they arise.

Staff has successfully implemented joint venture relationships with focused management groups such as Fairfield, Waterton, and GID in the apartment sector; and Dermody Partners in the industrial sector. With all these groups, the management of the relationship is a key factor for both parties. Thus far, the restructuring of the internal staff along more specialized product types and manager-specific relationships appears to be working well.

C. **Portfolio Composition and Structure:** The primary role of the CalSTRS real estate portfolio is to provide improved diversification to the overall investment portfolio. Secondary objectives are to generate an enhanced yield to the actuarial rate assumption and to provide stable cash flows. In regard to these objectives, a preponderance of CalSTRS' real estate portfolio is dedicated to a core strategy.

Core Investments

Generally speaking, a core portfolio is expected to produce market-level returns over time with a commensurate level of risk. The investor should expect performance to mirror the composite NCREIF Property Index on a "net-of-fee" basis. Income is expected to make up the majority of the total return for a core portfolio.

To mitigate risk, a core portfolio should be well-diversified by property type and geography. Usually, investments in a core portfolio are limited to office, retail, industrial, and apartment properties. A core portfolio may also include limited investment in "other" property types such as hotels, which are often classified as "enhanced" portfolio investments because they are generally management intensive. Minimal amounts of entitled land may also be included in the "other" property type, as well as land held for development.

Typically, core portfolio properties exhibit "institutional" qualities. They are well-located within their local and regional markets and of high-quality design and construction. In general, a core portfolio represents well-occupied properties; though a limited portion may be invested in properties undergoing redevelopment, new construction, or significant re-leasing at any time. Leverage may be used in the core portfolio on a limited basis to enhance investment returns; however, sufficient consideration should be given to the impact of debt financing on the risk and return characteristics of the leveraged investments, as well as the total core portfolio.

Tactical Investments

From time to time, one needs to consider alternative investment strategies within real estate; if (i) they can be underwritten to produce a superior return relative to core real estate; and (ii) one can quantify the risk associated with the strategy. The categories of value-added and opportunistic investments can add alpha, but should be done on a <u>tactical</u> basis. One must underwrite the fundamentals of the market and the specific investment thesis of the particular opportunity to determine if it will add alpha to the real estate portfolio. These alternative strategies are considered to be "arrows in the quiver" to supplement the core real estate portfolio returns.

Current Portfolio Structure

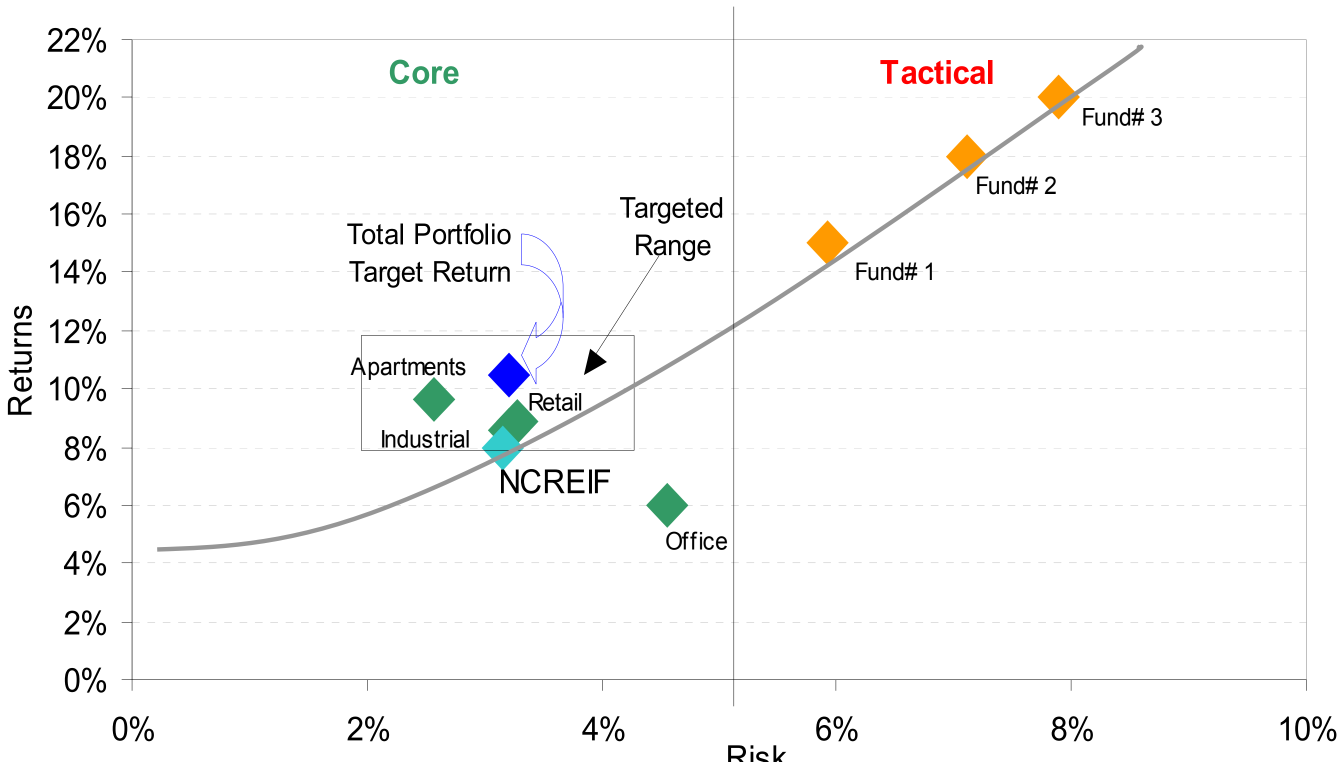
As mentioned previously, CalSTRS' real estate portfolio is presently divided into three discreet risk categories (low, moderate, and high); each having specific hurdles, allocation ranges, and investment parameters. It is important to note that each category is assigned a strategic role within the real estate portfolio irrespective of market conditions. This structure was well suited for a portfolio that was primarily concentrated in low risk, directly owned investments supplemented by a few high risk opportunities.

There are times when it makes economic sense to invest in value-added and opportunistic strategies and times when it does not. Staff does not believe these investment strategies should necessarily have strategic allocations. Instead, these percentages should represent caps on the strategies versus target allocations.

In reality, real estate investments are spread across a risk/return continuum. As with any investment, the various risks need to be identified and quantified. First, there is the "market risk" associated with real estate asset class, which is the NCREIF Index. In addition to market risk, there are risks associated with specific investment strategies. These have to be broken down into their constituent parts and specific risk premia assigned to each component. For example, the risks associated with a value-added real estate investment (one in which a manager is rehabilitating or renovating an existing office building with existing tenants) are completely different than those associated with a speculative development that is highly leveraged. One must take the approach of assigning specific excess return expectations for each component of the strategy (a return premia assigned to the leverage, a return premia assigned to the development aspect, a return premia assigned for the lease-up, etc.) and comparing them to the market risk attributed to the asset class.

At the portfolio level, the specific risks with each investment need to be aggregated to present a composite risk/return profile for the composite real estate portfolio. The following table illustrates how each investment could fall on a risk/return continuum and where the composite portfolio profile might be.

<u>Risk vs. Return</u>



Source: Pension Consulting Alliance, Inc. and CalSTRS Real Estate staff.

D. Proposed Policy Changes:

a. Proposed Portfolio Structure:

Anticipated CalSTRS policy changes will seek to clarify the role of core, as well as tactical, higher risk investing. Emphasis will be placed on how each investment, both existing and proposed, contributes to the overall portfolio target return. Therefore, as displayed in the chart above, we are proposing that instead of three rigid categories with specific targets, we should shift to a blended portfolio with a target risk and return level.

It is anticipated that core investments will comprise a majority of the portfolio as they provide stable cash flow. The remaining investments will be prudently diversified across the risk/return curve. Careful portfolio construction will ensure that the portfolio is not bar belled at the core (low) and tactical (high) ends of the spectrum.

Viewing and actively managing the real estate portfolio in this manner does not alter the current real estate strategy. Incorporating the risk/return concepts into the policy will provide clarification and understanding for making appropriate, ongoing investment decisions, and provide a better format for the Board's real estate consultant and staff to analyze the portfolio.

b. Environmental Standards

As discussed in the May 2003 meeting, CalSTRS has, and will continue to have, some level of environmental exposure in our real estate portfolio. While we always seek to minimize or eliminate exposures that come from past or current operations of dry cleaners, gas stations, or industrial uses, the nature of real estate investing dictates that there will invariably be some exposure from time to time. As CalSTRS moves to increase investments in developments or redevelopments in urban markets, where the sites had various past uses, our potential exposure to environmental issues will increase.

There are two concepts to consider. One is the environmental exposure. The second is the risk that exposure creates. CalSTRS has environmental exposure; however, the environmental risk that CalSTRS accepts by purchasing or owning these assets can be mitigated through various measures. The goal of the environmental policy will be to mitigate our environmental risk through careful evaluation and planning, when faced with environmental exposures. The Board gave staff and the consultant feedback to incorporate into policy language. We will fold the new policy in this area into the proposed policy at the December meeting.

c. Discretionary Authority

As discussed earlier, the discretionary authority levels for real estate investments will address a number of the concerns listed previously. Discretionary authority levels have not been adjusted in this area since 1998 and, therefore, have not kept up with changes in other disciplines or changes in the market in general. As mentioned above, revisions to this aspect of the policy will be proposed to the Investment Committee along the lines that have been approved in other asset classes.

Current Discretionary Authority - CalSTRS Staff

	Fixed Income	U.S. Equities	Alternative Investments	Real Estate
IC approval required for transactions above	$1 Billion	$1Billion	$400 Million[1] for "add on"	$100 Million[3] for all transactions
			$100 Million[2] for "new relationships"	
CIO approval required for transactions above	$750 million	$500 Million	All transactions	All transactions

1. Add on investments with existing partners
2. New relationships
3. All Real Estate transactions

E. Conclusion: As indicated previously, this is an information agenda item intended to give the Investment Committee an opportunity to provide input and to discuss proposed modifications to the current real estate policy. With the Investment Committee's input, staff and PCA will prepare an updated and revised real estate policy document for review and approval at the December meeting.

As stated in the memo, the proposed changes will include:

- Changes to the portfolio structure that will eliminate the target allocations to moderate and high risk investment strategies. Instead, these will be permissible investment strategies subject to percentage limitations of the composite portfolio.
- The return/risk profile of the real estate portfolio will be presented to the Investment Committee annually. This presentation will include an expected risk/return profile and a proforma profile.
- New environmental guidelines will also be presented to streamline the investment decision making process. CalSTRS legal counsel will be actively involved in creating this language.
- Changes to the investment discretion guidelines will be presented to bring the real estate portfolio in line with other asset classes. This change will free up Investment Committee time on strategic initiatives as opposed to transaction reviews.

Attachment: 2
Investment Committee – Item 5
July 7, 2004

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Real Estate – Real Estate Policy – Revised ITEM NUMBER: 7

ATTACHMENT(S): 2

ACTION: X DATE OF MEETING: December 3, 2003

INFORMATION: _____ PRESENTER(S): Mike DiRé and Nori Gerardo Lietz

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Policy: This is the core policy document that governs the entire real estate investment portfolio.

Executive Summary: At the November 2003 Investment Committee meeting, staff and PCA presented a plan to revise the current policy, add language for assets with environmental exposure, and propose changes to the discretionary levels. At the direction of the Investment Committee, staff was instructed to accomplish the above in stages including an opportunity for the Investment Committee to discuss the discretion in more detail.

Due to the amount of changes that need to be accomplished, we are recommending addressing the issues in the following manner:

1. December Meeting:
    a. Review and approve proposed policy language.
    b. Discuss proposed discretionary levels.
2. February/March Meetings:
    a. Review and approve proposed changes to discretionary levels.
    b. Review and approve proposed language for environmentally impaired assets.

For this meeting, staff and PCA are submitting an updated Real Estate Policy for the Investment Committee's review and approval (Attachment 1). This document incorporates modifications outlined at the November Investment Committee Meeting regarding portfolio classifications, and provides additional detail and clarification as to the overall management of the portfolio. It does not include any changes to the current discretionary levels.

At the request of the Investment Committee, staff and PCA were asked to bring forward a more detailed series of recommendations regarding modifying the current discretionary levels. This is outlined below.

Background & Discussion:

Discretionary Guidelines

The current discretionary guidelines for real estate and the other asset classes are depicted in Table 1.

Table 1 - Discretionary Guidelines – Current

	Fixed Income	U.S. Equities	Alternative Investments	Real Estate
IC approval required for transactions above	$1 Billion	$1 Billion	$400 Million for "add on"	$100 Million for all transactions
			$100 Million for "new relationships"	
CIO approval required for transactions above	$750 Million	$500 Million	All transactions	All transactions

The real estate discretion issue arises in three contexts for CalSTRS:

(i) Investment decisions regarding the purchase/sale of individual buildings in the core separate accounts in amounts over $100 million;
(ii) Investment decisions regarding a commitment to a commingled fund; and
(iii) Investment decisions regarding commitments to joint ventures, typically on a programmatic basis; meaning that the commitment is typically to an operating partner to invest in a single property type and/or geographic region in which the firm has unique expertise, and the firm coinvests capital in the program.

The investment decisions with regard to (i) (above) are differentiated from (ii) and (iii) in that these investments will be predominantly core assets under a pre-approved strategy with existing fiduciary managers. These decisions often are subject to tight investment time frames. Higher risk or tactical strategies would fall under (ii) and (iii) and would often include a new relationship and/or strategy. Commingled funds and programmatic joint ventures are not typically as time sensitive and therefore can be inserted more effectively into the board meeting time frames.

Table 2, below, shows the approvals the Investment Committee has made in each of the categories over the past 5 years.

Table 2 - Discretionary Guidelines – IC Approvals

Transaction	Year	Property/Fund	Amount
Purchase Asset	1999	Lincoln Plaza (office building)	$113 Million
Purchase Assets (2)	1999	Lincoln Place (2 office buildings)	$161 Million
Purchase Portfolio	1999	University of Chicago Portfolio	$246 Million
Sell Asset	1999	The Parks (regional shopping mall)	$150 Million
Fund Investment	2000	CIM CA Urban RE Fund	Lesser of $125 Million or 25% of fund
Fund Investment	2000	William E Simon & Sons Realty Partners	Lesser of $125 Million or 25% of fund
Purchase Asset	2000	685 Third Ave (NY office building)	$205 Million
Fund Investment	2001	Lone Star Fund IV	$200 Million
Fund Investment	2001	Morgan Stanley RE Fund	$200 Million
Purchase Portfolio	2001	Pacific Northwest Group A	$147 Million
Fund and Joint Venture	2002	Canyon Johnson Urban Fund	$15 Million in JV, $50 Million In Fund
Fund Investment	2002	Fortress Investment II	$150 Million
Joint Venture Investment	2002	Dermody Industrial Portfolio (90%)	$285.3 Million
Joint Venture Investment	2002	AIMCO (national student housing)	$150 Million
Purchase Portfolio	2002	EOP East Bay Industrial Portfolio	$280 Million
Sell Asset	2002	685 Third Ave (NY office building)	$245 Million
Sell Asset	2002	Oaks Mall	$152.5 Million
Fund Investment	2003	CIM Group	$200 Million
Funds (2) Investment	2003	Pending transaction	n/a
Joint Venture Investment	2003	Fairfield Residential	$125 Million
Sell Assets (2)	2003	Pending transaction	n/a
		Total	**$3,324.8 Million**

Below is an analysis of the merits of the Investment Committee's involvement in each category of investments.

1. Individual Building Approvals

CalSTRS has a competitive advantage by having the ability (expertise through staff and fiduciary relationships) and wherewithal (large amounts of capital) to analyze and close large transactions. The Board review process reduces CalSTRS' competitive advantages with certain sellers who only want to transact with managers who have complete discretion. These sellers want certainty of execution and often feel that the time associated with returning to a board, as well as the potential for the board to countermand the manager's investment decision, makes the bid less attractive. It is common for sellers to discount or ignore bids from buyers with such contingencies. Clearly, as Table 2 illustrates, the Investment Committee has been involved in a number of individual investment decisions regarding the purchase and sale of buildings over $100 million. PCA questions whether this is an effective investment policy, and whether this is an effective use of the Investment Committee's time.

As mentioned above, these approvals arise in the context of the core separate accounts in which the manager has a clear fiduciary duty to CalSTRS and has been delegated investment discretion over all other aspects of managing their portfolio, but for the fact of buying or selling buildings over $100 million. Additionally, managers are also compensated with incentive fee contracts. Theoretically, since a significant component of their compensation is tied to performance, the interests of CalSTRS and the managers are aligned in the individual investment decisions they make. Furthermore, staff closely monitors these relationships.

Historically, the Investment Committee has approved all transaction recommendations brought before them. To the extent that the Investment Committee declines to approve the recommended transactions from the manager, the Investment Committee is assuming a level of fiduciary responsibility for the investment decision. This can complicate the question of accountability for performance, should the decision ultimately be determined to be sub-optimal for CalSTRS. We are not recommending unfettered discretion for all of CalSTRS' managers to buy any asset of any size; however, staff and PCA believe that as the real estate portfolio's size continues to grow, so grows the likelihood that there will be more transactions over $100 million appearing before the Investment Committee for approval. We recommend that the concept of materiality be adopted in the approval process; meaning that transactions with the potential of having a material impact on the portfolio are brought to the Investment Committee for approval.

Staff and PCA both recommend that any individual transaction (either purchase or sale) representing over 10% of the equity value of the real estate portfolio be brought to the Investment Committee for approval. Presently, that would mean the transaction would have to be in excess of $460 million. Additionally, staff and PCA recommend that a policy be adopted that the Investment Committee is informed of any proposed transaction (either buy or sell) over $100 million at the earliest possible date, pursuant to a written report in the closed session activity status reports.

Adopting this recommendation will leave in place the same level of due diligence, with a secondary approval by the CIO. In addition, as mentioned above, the Investment Committee will be kept informed of all large transactions on a timely basis.

2. Commingled Fund Approvals

Again, as shown in Table 1, the real estate staff has investment discretion up to $100 million for commitments in commingled funds, subject to the CIO's approval. There is no separate discretionary authority for follow-on investments, as there is in the private equity program.

Both staff and PCA recommend that there should be commensurate discretionary authority provisions for real estate, as there are in private equity, since the issues are very similar. However, staff and PCA also recommend that follow-on investments should still have some aggregate cap on the size of the relationship with the firm. By this, we mean that staff should not have the authority to continue allocating capital to a firm over time even though each individual allocation falls within policy if the aggregate size of the relationship grows to become material to the portfolio's performance. If the aggregate size of the relationship exceeds $500 million, staff should inform the Investment Committee and ask if the Investment Committee wants to assume the investment discretion for any incremental capital allocations.

3. Programmatic Joint Ventures

This area is slightly more complicated in that there are two separate investment decisions that have to be made. The first investment decision is the investment strategy for the joint venture program and how it fits within the context of CalSTRS' overall real estate program. The second investment decision is the allocation of capital to individual managers. In these programs, CalSTRS is typically the sole investor with an operating partner who coinvests capital in the joint venture. Normally, the joint venture also has a very focused investment strategy, such as investments in an individual property type and/or region.

In PCA's opinion, it is an appropriate investment policy for the Investment Committee to retain the discretion over approving the investment strategies for these programmatic joint ventures, particularly in the non-traditional areas of real estate. This is also the case because CalSTRS is typically the sole institutional investor in these arrangements.

The following example may illustrate this concept. If staff were to determine through their market research that they wanted to pursue a housing program, staff should present the facts to the Investment Committee for their consideration and approval of the particular investment strategy. This process could be part of the semi-annual review of the real estate portfolio. Staff would present a potential capital allocation to the program they want to implement that the Investment Committee would approve. Staff could then have the discretion to select and structure relationships with individual firms to implement the approved strategy, subject to the same restrictions as those that apply to the commingled funds, as described above.

Table 3 summarizes the proposed revisions to the policies for allocated staff discretion.

	Individual Building Transactions (Separate Accounts)	**Commingled Funds**	**Programmatic Joint Ventures**
IC approval required	Investments representing 10% or more of the Total Invested Equity of the Real Estate Portfolio, presently $460 Million	$100 Million for "new relationships" $400 Million for "add on" commitments; subject to notification at $500 Million aggregate level	New Strategies and new relationships with capital allocation; subject to $500 Million aggregate manager allocation
CIO approval required	Investments greater than $50 Million	All transactions	All transactions
Real Estate Director	All transactions	All transactions	All transactions

Conclusion and Recommendation: Staff and PCA believe they have developed an efficient set of policies that will enable CalSTRS to address the challenges of investing in real estate in the future; and therefore, are recommending approval of the proposed policy language. Should the Investment Committee approve the proposed revisions to the Real Estate Policy, a resolution is provided as Attachment 2.

Staff and PCA are available for discussion on this item.

SUBJECT: Real Estate – Real Estate Policy – Revised

Date prepared: November 20, 2003

By:

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Mike DiRé
Director of Real Estate

Review & Concur:

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Christopher J. Ailman
Chief Investment Officer

CALSTRS

HOW WILL YOU SPEND YOUR FUTURE?

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

REAL ESTATE
Policies

INVESTMENT BRANCH
FEBRUARY 2004

California State Teachers' Retirement System
Investment Policy for Real Estate

Executive Summary

In accordance with the Investment Policy and Management Plan ("Plan"), the California State Teachers' Retirement System ("CalSTRS") has established an allocation for investment real estate, an illiquid equity-related asset. The primary objective for investment real estate is to improve diversification of the overall investment portfolio. The investment real estate portfolio will also have secondary objectives 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, to provide a stable cash flow to the investment portfolio, and to provide a hedge against inflation.

The real estate investment portfolio of CalSTRS is to be invested, managed, and sold in a prudent manner for the sole benefit of CalSTRS' participants and beneficiaries, in accordance with the Teachers' Retirement Law and other applicable statutes. No investment vehicle or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended from time to time, will be authorized for the real estate portfolio.

CalSTRS' Investment Committee ("Board") has established the asset allocation and strategic objectives for the real estate portfolio. The design of the Investment Policy for Real Estate ("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. The internal investment officers and independent fiduciaries operate under the direction of the Chief Investment Officer ("CIO"). The external Real Estate Consultant ("Consultant") reports directly to the Board.

Policies approved by the CalSTRS Board cannot be altered without explicit direction from said Board.

Investment Objectives

The strategic objectives of the real estate portfolio are as follows:

A. To provide improved diversification to the overall CalSTRS investment portfolio;

B. To generate an enhanced yield to the actuarial rate assumption and provide stable cash flows; and

C. To provide a hedge against inflation.

Performance Objectives

The real estate portfolio shall be managed over the long-term to accomplish the following:

A. Exceed a minimum net-of-fees real Internal Rate of Return ("IRR") of 5%;

B. Exceed, on a net-of-fees basis, the National Council of Real Estate Investment Fiduciaries ("NCREIF") Property Index while maintaining an appropriate level of diversification to mitigate risk; and

C. Meet or exceed the actuarial assumed rate of return for the real estate asset class.

Benchmark

The real estate portfolio's net-of-fees performance shall be benchmarked against the total rate of return of the NCREIF Property Index. Additional criteria will be applied to the performance of individual managers, investments having a focus on a particular property sector or geographic location, and for investments having higher risk categories. As appropriate, customized benchmarks will be used to measure performance of investments within the real estate portfolio.

Strategic Asset Allocation

The asset allocation target and range for the real estate portfolio shall comply with the guidelines set forth in the Plan. Adjustments from actual to target allocation shall be implemented within a time frame consistent with the provisions set forth in the Plan.

Portfolio Sub-Classifications

A. Strategic Objectives

The real estate portfolio shall be divided into two segments: 1) Core; and 2) Tactical. The strategic objective of the Core Portfolio is to produce stable current income and market level returns commensurate with a low to moderate level of risk. The Tactical Portfolio is expected to enhance the performance of the real estate portfolio and to provide additional diversification. Assignment of an investment to a particular portfolio shall be based on the investment's risk and return characteristics.

B. Allocation

Allocations to the Core and Tactical Portfolios shall be made to maximize the total return to CalSTRS while mitigating risk. The Core Portfolio shall comprise 50 – 90% of the target allocation to the real estate portfolio. The remaining 10 – 50% of the target allocation for the real estate portfolio shall comprise the Tactical Portfolio. The allocation ranges for the Core and Tactical Portfolios may be adjusted for risk management purposes.

From time to time, the actual allocation to the Core and Tactical Portfolios may not fall within 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 Tactical Portfolio mature, their characteristics may migrate towards a more Core-like profile. Staff and the Consultant shall monitor the portfolio for these instances when changes in the classification of investments (from Tactical to Core) are warranted. Any recommendation for reclassification by the Consultant will be brought before the Investment Committee for approval.

C. Core Portfolio

1. Characteristics

The Core Portfolio shall be well-diversified by property type and geography to reduce risk. Generally, investments shall be limited to traditional property types including office, retail, industrial, and apartment properties. Typical Core Portfolio properties shall exhibit "institutional" qualities. They shall be well-located within their local and regional markets and of high-quality design and construction. Generally, the Core Portfolio shall be well-occupied, though a limited portion may be invested in properties undergoing re-development, new construction, or significant re-leasing at the time.

2. Target Return and Benchmark

The Core Portfolio has a long-term targeted minimum real net-of-fees IRR of 5%, and is expected to produce market level returns over time with a commensurate level of risk. Hence, its performance is expected to mirror the composite NCREIF Property Index on a net-of-fees basis.

3. Diversification

Property Type

To reduce risk, the Core Portfolio shall be well-diversified by property type. Allocation ranges for the four basic property types to be included in the Core Portfolio are as follows:

Property Type	Allocation Range
Apartment	10% - 30%
Office	30% - 50%
Retail	15% - 35%
Industrial	15% - 35%
Land	0% - 5%

In limited instances, land may be acquired in connection with the purchase of improved property. It is contemplated that the acquisition of land shall be incidental to the investment characteristics of the improved property. The land may be contiguous with the improved property, or in the immediate area or subdivision of the property. The land may be held if an expansion of the existing property or new development is anticipated. In any event, direct ownership of land should not comprise more than 5% of the Core Portfolio.

If feasible, multi-use properties shall be allocated between the property type categories listed above based on the gross fair market value attributed to each use.

Geographic

To reduce risk, investments in the Core Portfolio shall be located in the United States. Based on the geographic classification system used in the NCREIF Property Index, the Core Portfolio will be divided into four regions with allocation ranges as follows:

Property Type	Allocation Range
East	10% - 30%
Midwest	5% - 25%
South	15% - 35%
West	30% - 50%

A listing of states by region is included in Appendix 2.

While there are no specific guidelines for diversification based on exposure to geographies having similar economic profiles and/or industry concentrations, the real estate portfolio shall be prudently diversified and monitored in this aspect.

From time to time, the actual allocations to the various property and geographic sectors may not fall within the ranges prescribed by this policy. In these instances, adjustments from the actual to the policy allocation ranges shall be implemented over a reasonable period (normally a one to three-year period). Ample consideration shall be given to preserving investment returns to CalSTRS.

4. Use of Leverage

Limited use of leverage is permissible in the Core Portfolio to enhance investment returns. Sufficient consideration shall be given to the impact of debt financing risk and return characteristics of the leverage investments, and the Core Portfolio, in total. Leverage within the Core Portfolio will have a targeted guideline of no greater than 40%, based on the aggregate gross fair market value of the funded investments in the Core Portfolio.

D. Tactical Portfolio

1. Characteristics

The Tactical Portfolio shall generally consist of investments with expected returns in excess of the Core Portfolio, and above-market risk along with specifically targeted strategies and investments with generally acceptable returns. These investments are often found in "niche" opportunities (i.e. urban redevelopment, hotels, parking, and so forth) or exist because of inefficiencies in the real estate or capital markets. Additionally, the Tactical Portfolio may contain investments in special purpose properties (i.e. public storage) or efforts to increase property value through significant re-leasing, repositioning, redevelopment, or development, as well as higher levels of debt. Tactical investments may include both traditional and non-traditional property types. Investment strategies for the Tactical Portfolio shall be considered opportunistic, based on prevailing market conditions at the time of investment. The real estate policy shall be modified time to time to take advantage of new investment opportunities as they arise.

2. Target Return and Benchmark

The Tactical Portfolio is expected to enhance performance of the real estate portfolio. It may offer limited current income, and returns are often largely dependent on future appreciation.

The Tactical Portfolio has a targeted minimum real net-of-fees IRR of 9%. Within the Tactical Portfolio, expected returns may vary considerably based on differences in investment strategies and structures, and the level of risk associated with each strategy, among other factors.

The Tactical Portfolio is expected to outpace the NCREIF Property Index by 300 basis points, on a net-of-fees basis.

3. Diversification

Non-U.S. investments (primarily developed markets) are permitted for the Tactical Portfolio given appropriate review of the experience and strength of potential investment management organizations, and the real estate and capital markets, practices, and laws of countries selected, among other factors.

The Tactical Portfolio shall not have property type or geographic location allocation range limitations.

4. Use of Leverage

Some investment strategies may employ moderate to high levels of leverage to augment investment performance. Leverage within the Tactical Portfolio shall have a targeted guideline of no greater than 75%, based on the aggregate gross fair market value of the funded investments in the Tactical Portfolio.

Investment Policy Guidelines

A. Portfolio Leverage

CalSTRS shall employ leverage in the real estate portfolio in order to enhance investment returns. Such leverage may exist at the portfolio, manager, or investment level. Since leverage also increases the volatility of the real estate portfolio, careful consideration will be given to the impact of leverage on 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 negotiated or arranged wherever possible.

Leverage at the aggregate real estate portfolio level shall be limited to 50%. To preserve the character of the asset class with CalSTRS' composite investment portfolio, the aggregate asset class shall not be overleveraged. This shall be measured quarterly by comparing the principal amount of debt secured by real estate investments in the real estate portfolio quarterly to the aggregate gross fair market value of the real estate portfolio. To the extent that leverage in any portfolio exceeds the maximum, CalSTRS shall make reasonable efforts to reduce the leverage ratio to below the maximum allowable, within a reasonable time frame.

B. Investment Life Cycle

The basic phases of a property's life cycle include predevelopment, development, initial leasing, operating, and redevelopment; as defined in Appendix 1. In general, properties in the earlier stages of their respective life cycles and redevelopments possess greater risks and thus should offer the real estate portfolio incrementally higher expected returns. To reduce risk, the real estate portfolio shall be appropriately diversified accordingly to life cycle, with the Core Portfolio having a majority of investments in operating properties that are substantially leased. The Tactical Portfolio may contain a higher concentration of investments undergoing development or redevelopment.

C. Alignment of Interests

Preferred investments for CalSTRS will be those that exhibit the highest degree of management accountability and the greatest alignment of interests. As a matter of policy, CalSTRS will seek, but is not limited to, dedicated management teams that co-invest or have substantial ownership interest in the investment entity, controlling positions with provisions for liquidity, and disclosure, as well as the mitigation of conflicts of interest.

D. Liquidity

Real estate investments shall be structured to include clearly defined redemption or termination provisions that offer investors some liquidity. In addition, whenever possible, investments shall include features that enhance liquidity to investors such as (i) shorter investment time horizons and holding periods; (ii) provisions for interim liquidation of investments; (iii) multiple exit strategies; (iv) alignment of interests between management and investors, as well as management accountability; and (v) a readily tradable market for investor holdings.

E. Environmental Liability

Subject to the following provisions and restrictions, 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.

CalSTRS will not make investments in real estate with environmental conditions in the Core Portfolio unless: (i) the dollar value of the environmental risk can be quantified; (ii) the cost of remediation can be quantified; (iii) the environmental liability can be mitigated with measures already in place or to be implemented by the investment manager to effectively mitigate the risks to CalSTRS and result in an appropriate risk-adjusted rate of return; (iv) any such potential environmental liability is limited to the particular real estate investment; and (v) the real estate investment does not expose the entire CalSTRS portfolio to any potential liability. All environmental risks will be appropriately mitigated by factors that may include, but are not limited to, specific remediation planning, environmental insurance, indemnifications by creditworthy sellers, agreements with regulatory authorities, and the legal structure of ownership.For investments held in separate accounts, the appropriate level of environmental risks to be assumed and the appropriate mitigation approaches shall be detailed in CalSTRS Real Estate Guidelines. Environmental guidelines for investments in Commingled Funds and Joint Ventures will be addressed in the legal documents that control the activities and responsibilities of the Managing or General Partner of that investment opportunity.

F. Eligible Ownership Vehicles

For CalSTRS to meet its objectives in the real estate asset class, CalSTRS 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. For this reason, the following ownership vehicles are allowable:

Separate Accounts

CalSTRS may enter into discretionary separate account relationships with real estate investment managers, subject to pre-approved investment guidelines, whenever possible, and/or clearly defined investment strategies. This delineation is known in the real estate industry as "discretion in a box", which means the manager shall have the authority and discretion to execute a particular investment strategy only so long as each and every investment falls within the preapproved guidelines for the portfolio. The CIO must approve any deviations from the approved guidelines. For this reason, investments shall be structured to facilitate alignment of interests between management and CalSTRS, management accountability, investment monitoring, and ultimately - liquidity.

In these separate accounts, CalSTRS shall have sole ownership of the asset(s) or may co-own the asset(s) with other institutional investors. CalSTRS will reserve the right to remove the real estate manager of any separate account, with or without cause, in a timely manner.

Joint Ventures

CalSTRS may invest with operating partners to execute defined investment strategies in which the operating partners have unique expertise. In these joint ventures, the operating partner shall also co-invest capital in the venture in an amount that is material to the partner. CalSTRS staff shall strive to incorporate similar governance provisions into the joint venture agreements as are obtained in CalSTRS' separate account relationships.

Commingled Funds

To enable greater diversification and to reduce risk, investments in the real estate portfolio shall be made in participation with other institutional investors. Real estate investments may be made in commingled vehicles including, but not limited to (i) closed-ended funds such as group trusts, private REITs, limited liability companies, and limited partnerships; and (ii) open-ended funds (primarily bank and insurance company commingled accounts). Investments in closed-ended commingled vehicles shall have clearly articulated and viable exit strategies through which assets can be disposed of or liquidated upon termination of the investment and on an interim basis. The term of these investments shall also be limited to no more than seven to ten years and shall provide for a winding-up and orderly liquidation within this time period. Investment agreements for closed-ended commingled vehicles shall include flexible provisions for removal of management by investors and interim liquidation of investor holdings.

Open-ended commingled fund investments shall include flexible redemption provisions, though such provisions often do not provide investors with liquidity at times when it is most needed; therefore, it is critically important that such investments be made with the most proactive of managers. In addition, to the extent possible, investments in closed and open-ended commingled fund vehicles shall include an opportunity for investors to participate on advisory boards.

To ensure adequate diversification and to reduce risk, no more than 10% of CalSTRS' real estate portfolio shall be allocated to any one individual commingled fund in which CalSTRS does not exercise control over its capital. For the purpose of this document, "control over its capital" refers to the ability to time the exit from an investment vehicle or the termination of the manager of such vehicle.

G. 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.

H. Discretionary Authority
~~**(This section has not been modified, as yet, pending discussions with the Investment Committee)**~~

~~The rejection and approval decision for low, moderate, and high risk direct ownership properties, co-investments, commingled funds, and secondary interests is delegated to staff with the stipulation that all investments are subject to the appropriate due diligence, as defined in the Real Estate Procedures.~~

~~The approval of major capital decisions including the decision to acquire, finance, refinance, renovate, expand, or sell is delegated to staff considering the following stipulations:~~

~~1 Due diligence process shall be consistent and appropriate as defined in the investment Real Estate Procedures.~~

~~2 Maximum amount of the commitment should not exceed $100 million.~~

~~3 A final recommendation report will be presented to the Investment Committee as soon as practical after the transaction is completed.~~

~~4 Direct real estate assets and commingled fund strategies located in the United States.~~

~~Staff can delegate the above authority to CalSTRS' real estate managers for the implementation of the low risk investment strategies.~~

REPLACE WITH

The approval and rejection decision for real estate investments is delegated to Staff with the following stipulations:

1) Staff had discretion up to and including $100 million for an initial allocation to a new firm with the ability to allocate up to, and including, an additional $400 million for follow-on investments with the same firm. Thereafter, incremental allocations may be approved by Staff subject to the Investment Committee's review, if so requested.
2) For firms that the Investment Committee has either selected through a request for proposal process, or approved as described above, Staff has authority to approve individual transactions up to, and including, $500 million. Transactions include all major capital decisions including acquisitions, renovations and dispositions.

All real estate investments are subject to appropriate due diligence as defined in CalSTRS Real Estate Guidelines. Dollar limitations are based on equity amounts made by CalSTRS.

I. Investment Manager Diversification

To reduce risk, the real estate portfolio shall be diversified by investment manager organization. No single manager organization shall manage more than 40% of the gross fair market value of funded investments in the real estate portfolio.

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.

On a quarterly basis, a performance measurement report for the real estate portfolio shall be prepared by the Consultant, or other designated contracting entity. The performance measurement report shall evaluate CalSTRS' portfolio diversification and investment performance. At the request of the Investment Committee, the Consultant shall present the results no more than semi-annually.

CalSTRS staff shall endeavor to ensure that investment valuations and returns that are prepared by investment managers and included in the performance report are calculated in accordance with guidelines established by NCREIF, the Association for Investment Management and Research ("AIMR"), the Pension Real Estate Association ("PREA"), and the National Association of Real Estate Investment Managers ("NAREIM"); as included in the most recent editions of the Real Estate Information Standards and the NCREIF Market Value Accounting Policy Manual.

To the extent that managers do not report on CalSTRS investments in a manner consistent with the real estate portfolio's guidelines, CalSTRS staff shall work with these managers to obtain the most appropriate information. CalSTRS' managers shall be notified at the inception of their contracts that their failure or inability to provide accurate and timely financial reporting, including performance results computed in a manner consistent with AIMR guidelines, may constitute grounds for termination.

Guidelines for Selection, Monitoring, Evaluation, and Termination of Managers

The selection of real estate investments shall be guided by the "prudent expert" standard, embracing the prudent decision-making process typically employed by experts in the areas of real estate acquisition, development, operation, disposition, and portfolio management.

Selection of Investment Management Organizations

CalSTRS seeks to retain investment management organizations that possess superior capabilities in the selection and management of real estate assets. With this objective in mind, prospective investment management organizations shall be evaluated for selection based on criteria including, but not limited to (i) the suitability of the organization's investment, relative to CalSTRS' investment guidelines and objectives; (ii) the quality, stability, integrity, and experience of the management team; (iii) the ability and willingness of the organization to dedicate sufficient resources and personnel to optimally manage CalSTRS' investments; (iv) the reasonableness of investment terms and conditions, including provisions to align interests of management and CalSTRS; (v) the appropriateness of management controls and reporting systems, among other factors; and (vi) commitment to responsible contracting policies, workplace diversity, and community involvement.

Monitoring, Evaluation, and Termination of Investment Management Organizations

CalSTRS' investment management organizations shall be monitored and evaluated continuously, based on their performance relative to stated objectives and benchmarks, and relative to the performance of firms managing similar investments in the marketplace. In addition, investment management organizations shall be monitored for compliance with investment guidelines, policies, and procedures of the Fund, and other contractual provisions. Manager performance should be evaluated over meaningful time intervals to ensure that performance is indicative of management's efforts. The performance of the Core Portfolio investments should be evaluated on a three-year trailing performance basis, while the performance of the Tactical Portfolio investments should be evaluated on a three to five-year trailing performance basis.

Consideration shall also be given to the financial strength of the investment management organization, the level of client service given to CalSTRS, as well as changes within the managing organization such as the continuity of personnel assigned to CalSTRS' investments, among other items. CalSTRS shall seek to liquidate investments with management organizations found to be deficient relative to CalSTRS' investment standards.

Annual Business Plan

The real estate portfolio will be managed according to an annual business plan whose main business components will encompass an analysis of the investment environment, a review of the investment strategy, a review of the diversification ranges, a review of the portfolio projected versus actual returns, and a resource allocation budget.

Policy Monitoring and Modification

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

The guidelines contained herein shall be reviewed periodically to determine if modifications are necessary or desirable. Any changes shall be subject to the approval of the Investment Committee.

Appendix I

GLOSSARY

APPRAISAL – An estimate or opinion of market value.

APPRECIATION – The percentage change in the market value of a property or portfolio over the period of analysis.

ASSET MANAGEMENT – The various disciplines involved with managing real property assets from the time of investment through the time of disposition. Proper asset management plans and policies include requirements for operating and capital budgets; property management; leasing; physical property analysis; operational and financial reporting; appraisal; audits; accounting policies; and asset disposition plans (hold/sell analyses).

BENCHMARK – An index derived from database information that allows for comparative performance evaluation within an asset class.

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.

DISCRETION – The level of authority given to an investment manager over the investment and management of a client's capital once that capital is allocated to the investment manager.

DIRECT INVESTMENT – An investment in which CalSTRS has a direct ownership interest in a property or group of properties.

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.

FIDUCIARY – A person in whom CalSTRS reposes, and the person accepts, a special trust and confidence involving the exercise of professional expertise and discretion.

GROUND LEASE – A lease of land only, not including any improvements on the property.

INCOME – The component of return derived from property or portfolio operations during the period of analysis.

INTERNAL RATE OF RETURN (IRR) – The actual (or projected) dollar-weighted holding period return produced by an asset, calculated with consideration for all items of cash in and cash out.

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 OPERATING INCOME (NOI) – Rental and other income of a property, less operating expenses, but before the deduction of capital expenditures and debt service.

NON-TRADITIONAL PROPERTY TYPE – Non-conventional property types such as timber, hotels, senior housing, single family housing, natural resources, land, mini-storage, etc.

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.

PROPERTY MANAGEMENT – The various functions that are performed at the property level in order to assure timely collection of rents, payment of expenses, and supervision of on-site activities.

REAL RATE OF RETURN – Yield to the investor after adjusting for inflation (typically determined by the Consumer Price Index).

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

TRADITIONAL PROPERTY TYPE – Conventional property types such as office, multi-family residential, industrial, and retail real estate; included within the NCREIF Index.

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

California State Teachers' Retirement System
Investment Policy for Real Estate

Appendix 2

Distribution of States by NCREIF Regions and Sub-regions

West Region	Midwest Region	East Region	South Region
Mountain *Arizona* *Colorado* *Idaho* *Montana* *Nevada* *New Mexico* *Utah* *Wyoming*	**East North Central** *Illinois* *Indiana* *Michigan* *Ohio* *Wisconsin*	**Northeast** *Connecticut* *Maine* *Massachusetts* *New Hampshire* *New Jersey* *New York* *Pennsylvania* *Rhode Island* *Vermont*	**Southeast** *Alabama* *Florida* *Georgia* *Mississippi* *Tennessee*
Pacific *Alaska* *California* *Hawaii* *Oregon* *Washington*	**West North Central** *Iowa* *Kansas* *Minnesota* *Missouri* *Nebraska* *North Dakota* *South Dakota*	**MidEast** *Delaware* *District of Columbia* *Kentucky* *Maryland* *North Carolina* *South Carolina* *Virginia* *West Virginia*	**Southwest** *Arkansas* *Louisiana* *Oklahoma* *Texas*

**PROPOSED
RESOLUTION OF THE
TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE**

SUBJECT: Revised Real Estate Policy – Discretion *(Policy)*

Resolution Number ________________________

WHEREAS, the Investment Committee of the California Sate Teachers' Retirement Board is responsible for recommendations to the Board, investment policy and overall investment strategy for the management of the Teachers' Retirement Fund, a multi-billion dollar public pension plan; and

WHEREAS, the Investment Committee is charged with developing the Fund's Investment Policies and Management Plan including the policies for individual asset classes such as real estate; and

WHEREAS, the Investment Committee has reviewed the written material and oral presentation from staff; Therefore, be it

RESOLVED, that the Investment Committee approves the revised Real Estate Investment Policy.

Adopted by:
Investment Committee
on July 7, 2004

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Jack Ehnes
Chief Executive Officer