PUBLIC AGENDA ITEM - #19b

19b. Review and Discussion of Real Estate Program Strategy

August 25, 2009

BACKGROUND:

At the August 19, 2008 joint meeting of the Employees Retirement System of Texas ("System" and "ERS") Board of Trustees and the Investment Advisory Committee, an asset allocation was adopted that included investing eight percent of the System's assets in real estate. At the time, approximately two percent of the System's assets were invested in real estate listed securities (Real Estate Investment Trusts or "REITs" and/or Real Estate Operating Companies or "REOCs") which were part of the public equity portfolio. With the approval of the asset allocation, Real Estate was deemed its own asset class. Consequently, the real estate public equity portfolio was "moved" to the real estate asset class.

The objectives of the System's real estate portfolio include (1) preserving the System's capital, (2) enhancing the ERS' total portfolio risk-adjusted returns, (3) further diversifying the total portfolio, (4) reducing the total portfolio's volatility, and (5) providing a hedge against inflation.

Real estate includes private equity and debt (typically in a limited partnership structure) and public equities invested both domestically and internationally. It also allows up to ten percent to be invested in infrastructure.

Update on ERS' real estate program:

The Real Estate Listed Security Portfolio is managed as an enhanced index portfolio. The overall portfolio is comprised of two sub-portfolios: domestic and international. The Barra Aegis System is utilized to monitor the portfolio's risk relative to its benchmark primarily by estimating the tracking error compared to the FTSE EPRA/NAREIT index.

The ERS real estate team attempts to enhance the portfolio's return relative to the benchmark by applying various relative value disciplines. Relative weights are assigned versus a stock's weight in the index based on expected future total return versus its peers. This is done within each country. Ideally, valuations would be compared across countries but it is very difficult to come up with a robust model at this time. Many factors complicate a cross-country relative value analysis including reporting metrics, REIT structures, tax implications, and data availability. In an attempt to further add value and diversify risk, stocks external to the benchmark may be included as long as they meet ERS investment policy guidelines.

Risk controls include a tracking error limit of 300 basis points to the FTSE EPRA/NAREIT Global Index. Consideration is also given to property and country weights to ensure the portfolio is not significantly over or under weighted to one particular area.

For private real estate investments, intensive due diligence is critical to the process. Qualitative and quantitative factors are evaluated in considering an investment.

The most significant consideration given to a prospective investment in the private real estate portfolio is the prior track record of its manager and the likelihood of that manager's success going forward. Attribution analysis is done to dissect the quantitative aspects of a manager's track record, such as: Were the returns commensurate with the risk taken? Did they execute on their strategy? How much of the return was generated by leverage?

Investment structure and strategy, manager qualifications, and advisory board participation and control rights are also an important part of the due diligence process. Does the organization have personnel turnover issues? Do they have the capacity to handle existing investments along with a new fund? Does the strategy make sense and does it fit into ERS' portfolio? Is the general partner (GP) aligned with the investors?

Another area to focus on is the fee/return structures. Fees should make sense and incentivize behavior beneficial to the limited partners. Incentive compensation should be appropriate for the investment vehicle. If the System participates as a lead investor, it should expect a reduced management fee. Acquisition, financing, and disposition fees should be avoided in most situations. If such fees are paid, preferred return hurdles should be higher, promoted interest percentages should be lower, and/or manager co-investment should be higher to compensate for this.

Investment managers should provide a clawback vehicle to address a situation in which the investment manager potentially received more than the specified incentive compensation. This can be accomplished through an incentive fee reserve or holdbacks in escrow.

Once an investment is made, monitoring becomes an essential part of the process. Attending advisory board meetings, frequent communication with management and other LP's, and reading and analyzing quarterly reports and other GP information are all important to ensure the manager is executing their strategy as promised and to identify any potential issues that arise.

This agenda item is provided for discussion purposes only.

<u>STAFF RECOMMENDATION:</u>

No action is required on this agenda item.