

## PUBLIC AGENDA ITEM - #19c

### 19c. Review and Consideration of Proposed Real Estate Policies and Procedures

August 25, 2009

#### BACKGROUND:

The investment policies of the Employees Retirement System of Texas (“System” or “ERS”) are determined by its Board of Trustees (“Board”). Staff is charged with preparing and presenting to the Board for its review and approval the Real Estate Policies and Procedures.

At the August 19, 2008 joint meeting of the Board and the Investment Advisory Committee (IAC), an asset allocation was adopted that included investing eight percent of system assets in real estate. At that time, approximately two percent of system 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.

At the May 19, 2009 joint meeting of the Board and IAC, the Board hired RV Kuhns & Associates as its real estate consultant. The consultant was hired to assist and advise the Trustees, the IAC, and ERS staff with implementing the real estate investment program. One of the first tasks RV Kuhn’s was charged with was assisting in development of policies and procedures for the ERS real estate program.

The proposed Real Estate Policies and Procedures document provides a framework, or manual, for investing in real estate. It encompasses the permissible investment structures, performance measurement criteria, benchmarking, objectives, diversification requirements, reporting requirements, leverage limitations, manager evaluation criteria and responsibilities of the various parties. It also includes a proposed Annual Tactical Plan which is intended to be a planning document that outlines steps to be taken over the next 12 months to further the real estate portfolio objectives. The proposed Annual Tactical Plan will be presented separately for consideration by the IAC and Board, under number 19-d of the posted meeting agenda.

ERS’ real estate portfolio investments shall be made in a manner consistent with the whole portfolio approach, as provided in the Texas Trust Code and the exclusive benefit requirements of the Texas Constitution. The selection and management of real estate portfolio assets will be guided to maintain prudent diversification of assets, to maximize management responsibility, and to preserve the System’s investment capital. The diversification objective is required to manage overall market risk and the specific risks inherent in any single investment or single manager.

#### **Key points of the Real Estate Policies and Procedures:**

- Similar to Private Equity, private real estate investments will be approved by an internal investment committee. The investment committee will be comprised of the Executive Director and ERS investment professionals.

- In evaluating the performance of the real estate program, the FTSE EPRA/NAREIT index will be used for the public equity real estate portfolio and the NCREIF Fund Index-Open Diversified Core Equity (“NCREIF-ODCE”) for the private real estate portfolio.
- The current investment policy for the overall plan stated that Public Real Estate will be 2% and Private Real Estate will be 6% combining to give the 8% total Real Estate asset allocation. These weightings have been further refined in the Real Estate Policies and Procedures to include +/-10% bands around each. The plan’s investment policy is currently under revision.
- There are no changes in how the listed securities portfolio is managed with the exception of over/under weighting it relative to the overall real estate allocation (target weight is 25% of real estate with +/- 10% bands).
- Infrastructure is an emerging investment area. It is ERS staff’s belief that it will continue to grow and has diversification benefits. For the time being, infrastructure will be managed by both the private equity and real estate teams depending on the underlying characteristics of a fund. While there is no formal allocation to infrastructure, the Real Estate Policies and Procedures allow for up to 10% of real estate assets to be invested in this area.
- There are seven diversification elements guiding the construction of the real estate portfolio to reduce risk, one of which includes limitations on risk/return strategies.

Risk/return mixture is a function of the System’s risk tolerance and return expectations. A target allocation has been set for each of the five categories with a +/- 10% band around each. This allows flexibility due to the illiquid nature of a majority of the investments and for the potential to over or underweight a category based on valuations or fundamental issues. With the exception of the publicly traded securities, most of the investments are inherently difficult to rebalance in a timely manner.

The five categories are core, value-added, opportunistic, global publicly traded securities, and infrastructure. Please note that core, value-added and opportunistic refer to private real estate.

Based on the target weights, the expected return of the real estate portfolio is 10.2%. Utilizing the policy weighted ranges (+/- 10% bands) the lowest and highest expected returns would range between 9.1% and 11.2%, respectively. This range of weights provides flexibility to take advantage of market mispricing within an acceptable level of risk.

- Geographic limitations are another diversification element to help reduce risk in the portfolio. The policies contain several layers to address geographic diversification for the private real estate portfolio.

The first layer is a limitation between domestic at 70% of the private equity portfolio and international at 30% with a +/- 15% band around each. It should be noted that the approximate global weight of institutional quality real estate is 35% US and 65% international. ERS’ portfolio will have a home country bias due to several factors including tax and transactional costs that reduce the risk/return appeal of investing overseas. However, international investing offers compelling growth prospects and diversification benefits.

Within domestic private real estate, there is a further restriction based on regional locations compared to the NCREIF Property Index (“NPI”). NPI has four regions as listed in the following table and the policy includes a +/- 10% band around each region’s weight.

<b>Domestic Regional Limitations</b>		
	<b>Policy Target Weight</b>	<b>NPI Index Weight As of March 31, 2009</b>
West	NPI +/- 10%	36%
Midwest	NPI +/- 10%	10%
South	NPI +/- 10%	21%
East	NPI +/- 10%	33%

International private real estate will be further diversified by country type and geographic region. Country type relates to whether a market is considered developed, e.g., United Kingdom, Japan, Australia or emerging, e.g. Brazil, China, India, Mexico as defined by the MSCI/Barra Indices. The ranges are as follows:

Developed Countries: 80% to 100%

Emerging Countries: 0% to 20%

Geographic limitations within international private real estate are:

Asia: 20% - 50%

Americas: 0% - 30%

Europe: 20% - 50%

Other International: 0% - 20%

Based on the policy limitations, emerging markets cannot be more than 7.7% of the real estate portfolio (Max Private Real Estate of 85%\*Max International 45%\* Max Emerging Markets 20% = 7.7%).

- A third diversification factor is property type. Property type weights will be compared to the NPI property type diversification parameters and are shown below:

<b>Property Type Limitations</b>		
	<b>Policy Target Weight</b>	<b>NPI Index Weight As of March 31, 2009</b>
Office	NPI +/- 10%	37%
Mutli-Family	NPI +/- 10%	24%
Retail	NPI +/- 10%	21%
Industrial	NPI +/- 10%	16%
Hotel	NPI +/- 10%	2%
Other	Up to 30%	0%
Infrastructure	Up to 10%	0%

- There are other risk mitigation elements to the policies such as investment manager exposure (no more than 10%), vintage year diversification, etc.

STAFF RECOMMENDATION:

Staff recommends the adoption of the proposed ERS Real Estate Policies and Procedures as presented in Exhibit A.

ATTACHMENT – 1

Exhibit A – ERS Real Estate Policies and Procedures

PROPOSED ACTION - #19c

19c. Review and Consideration of Proposed Real Estate Policies and Procedures

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The ERS staff recommends the following motion to the Investment Advisory Committee:

I move that the Investment Advisory Committee recommend that the Board of Trustees of the Employees Retirement System of Texas approve the ERS Real Estate Policies and Procedures as presented in Exhibit A.

Contingent upon adoption of the above motion by the Investment Advisory Committee, staff recommends the following motion to the Board of Trustees:

I move that the Board of Trustees of the Employees Retirement System of Texas approve the ERS Real Estate Policies and Procedures as presented in Exhibit A.