



June 14, 2004

AGENDA ITEM 5A

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Delegation Authority Clarification - Opportunistic Program
- II. PROGRAM:** Non Core Real Estate Portfolio
- III. RECOMMENDATION:** Information Only
- IV. ANALYSIS:**

At the May 17, 2004, closed session of the Investment Committee meeting, Legal Staff raised questions about the delegation of authority for the Opportunistic Real Estate program. The Investment Committee requested a follow-up agenda item to clarify the matter. Staff seeks to clarify the delegation of authority and the various chain of approvals regarding the Opportunistic Real Estate program.

Staff believes it was the intent of the Investment Committee to grant delegation of authority to the Senior Investment Officer and Chief Investment Officer based on the history below to approve new real estate related transactions deemed opportunistic prior to full approval of the Statement of Investment Policy for Opportunistic Real Estate. The delegated authority is conditioned upon Pension Consulting Alliance's (PCA)'s concurrence and also subject to satisfactory negotiation of terms and conditions. Additionally, all investments within the Opportunistic Real Estate sector must not be in violation of other investment policies, i.e. meet requirements of the Statement of Investment Policy for International Real Estate (as applicable) and the corresponding Permissible Equity Markets List.

On May 13, 2002, Staff presented item 4B – Real Estate Opportunistic Real Estate Investment Policy, Attachment A. From the Investment Committee,

Minutes of the Meeting, Open Session, dated May 13, 2002 the following action was taken:

“Michael McCook, Senior Investment Officer, Bryan Bailey, Portfolio Manager and Bob Langhi, Investment Officer, presented the item. Nori Gerardo-Lietz, PCA/E&YKL, was available to answer questions from the Committee.

Dr. Connell MOVED, SECONDED, and CARRIED to approve:

1. A \$500 million allocation, subject to availability, for opportunistic investments in the Specialized (Non Core) Portfolio.
2. The allocation will be derived primarily from existing non-core sources including increasing leverage on non-core assets and partial sales of existing non-core portfolios.
3. Investments would be subject to staff and third party review, satisfactory due diligence, and negotiation of appropriate terms and conditions.

The Committee also directed staff to bring back the delegation of authority for the Senior Investment Officer for consideration of the opportunistic investments.”

In response to the Investment Committee’s request to clarify the delegation of authority for Opportunistic investments, Staff presented item 5B – Real Estate Investment Delegation of Authority – Opportunistic Program on June 17, 2002, Attachment B. From the Investment Committee, Minutes of the Meeting, Open Session, dated June 17, 2002, the following action was taken:

“Michael McCook, Senior Investment Officer, and Bob Langhi, Investment Officer, presented the item.

On MOTION by Mr. Eliopoulos, SECONDED and CARRIED, to approve:

1. Senior Investment Officer discretion for investments up to \$100 million.
2. Chief Investment Officer approval required for investments over \$100 million up to \$200 million.
3. Investment Committee approval required for investments over \$200 million.

The Committee requested that regular activity reports be provided that would include allocation to new partners as well as non-allocation to existing partners.”

Over and above the initial delegation of authority granted to Staff on May 13, 2002 and June 17, 2002, Staff presented an additional item to the Investment Committee on April 19, 2004, Attachment C. The April 2004 agenda item reiterated the basis upon which Staff had previously been granted delegation of authority and specifically gained approval for continued investment in the

opportunistic sector with an additional allocation of \$500 million. This action was taken with the understanding that as interim measure to ensure compliance, investment activity would continue while the Statement of Investment Policy for Opportunistic Real Estate was formalized. From the Investment Committee, Minutes of the Meeting, Open Session, dated April 19, 2004, the following action was taken:

“The Committee approved an additional allocation of \$500 million for Opportunistic Real Estate Investments. Investments would be subject to PCA review, satisfactory due diligence and negotiation of appropriate terms and conditions.”

It was based upon the delegation of authority granted to the Senior Investment Officer – Real Estate by the Investment Committee on June 17, 2002, that Staff began negotiations with Capri Capital regarding the opportunistic investment which was presented to the closed session of the Investment Committee.

In May 2002, the Opportunistic Program was considered to have a limited window of opportunity and therefore a specific one time allocation of \$500 million was requested. Since then, continued opportunities have surfaced and continue to surface within the Opportunistic sector.

Therefore, Senior Management and Staff began the process of analyzing whether or not Opportunistic Real Estate Investments should have a formalized allocation within the Real Estate Portfolio. Various analyses were undertaken to define the opportunity set within opportunistic real estate investments. It was concluded that opportunities continue to exist within the sector and therefore, a formalized policy should be developed in order to have a defined percentage allocation of total Real Estate.


Staff and PCA began to develop a formalized policy to govern Opportunistic Real Estate Investments. Accordingly, the first reading for the Statement of Investment Policy for Opportunistic Real Estate will be presented to the Policy Sub-Committee for their review and comment on June 11, 2004. Staff is cognizant of the Investment Committee’s desire to ensure that appropriate controls are in place to effectively govern and monitor proposed investments within the Opportunistic Real Estate sector. Staff will work closely with the Policy Sub-Committee to ensure that the Investment Committee has appropriate input and guidance in the development of the new Investment Policy.

V. STRATEGIC PLAN:

This item is consistent with the Strategic Plan, Goal IV, to assure that sufficient funds are available, first, to pay benefits, and, second, to maximize and stabilize employer contributions.

VI. RESULTS/COSTS:

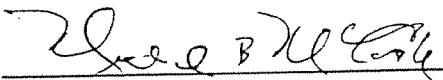
The above item clarifies the delegation of authority for the Senior Investment Officer – Real Estate and shall provide the Real Estate Unit with a clear mandate on the continued implementation of the Opportunistic Real Estate program. Opportunistic Real Estate Investments within the existing Non Core Portfolio allow further diversification of the real estate portfolio



Julie Rost
Investment Officer



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Senior Portfolio Manager



Michael McCook
Senior Investment Officer



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May 13, 2002

AGENDA ITEM 4b

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Opportunistic Real Estate Investment
- II. PROGRAM:** Specialized (Non-Core) Real Estate Portfolio
- III. RECOMMENDATION:**
 - 1) Approval of \$500 million allocation earmarked for opportunistic investments.
 - 2) This allocation will be funded primarily from the Specialized (Non-Core) allocation provided appropriate investments can be found.
 - 3) SIO discretion would be allowed for investments up to \$100 million, with CIO approval required over \$100 million.
 - 4) Investments would be subject to staff and third party review, satisfactory due diligence, and negotiation of appropriate terms and conditions.

IV. ANALYSIS:

Background

Over the past several years, CalPERS Real Estate staff has been approached with "opportunity fund" investments from large institutional investors including La Salle, Merrill Lynch, Morgan Stanley, Fortress Group, Eastdill, Prudential, Goldman Sachs, and Blackstone. Because the authority to take advantage of opportunistic investments does not exist, CalPERS was not able to react to these investments. Staff believes, and PCA/EYKL concurs, the investment climate is currently favorable for reviewing proposals, which may be on a separate account

or commingled fund basis. Staff seeks the flexibility to react quickly to certain opportunities.

For example, during the past several months CalPERS was presented the following opportunities:

- Hines, an experienced developer and successful CalPERS core partner, presented an international fund primarily for office development in Europe projecting after fee returns in the mid to high teens.
- A CMBS fund manager presented a co-mingled fund opportunity to invest in unrated tranches of CMBS securities projecting after fee returns in the 20% to 30% range.
- An international manager presented a fund covering all sectors of real estate development in Europe, Asia, and Latin America, projecting after fee returns of 20% with a 10% preferred return.

The opportunistic investment strategy is permitted within the Specialized Equity Real Estate Policy approved November 13, 2001. These opportunistic investments will be located both within the United States and internationally. International investments will comply with CalPERS' Permissible Country List as it applies to the External Equity Managers and will comply with the International Equity Real Estate policy approved November 13, 2000. Additionally, international investments will only be undertaken with companies who have dedicated staff in the country of investment. Although returns will vary by investment, the expected minimum return must be above 13% unleveraged after fee. Any international investment will have a premium return expectation to offset its currency risk. Partner co-investment will be required and the investments will be primarily structured either as separate accounts or co-mingled funds, although direct investments or other alternatives may be considered. The allocation will be derived primarily from existing non-core sources including increasing leverage on non-core assets and partial sales of existing non-core portfolios. The primary objective of this program is to achieve risk adjusted returns superior to those in CalPERS' Core portfolio.

Recommendations

- 1) The Investment Committee allocate \$500 million, subject to availability, for opportunistic investments in the Specialized (Non-Core) Portfolio. The allocation will be derived primarily from existing non-core sources including increasing leverage on non-core assets and partial sales of existing non-core portfolios.
- 2) SIO discretion will be allowed for investments up to \$100 million, which is consistent with other minimum SIO approval levels.

- 3) CIO approval will be required for investments over \$100 million.
- 4) In addition to staff, a third party will review all potential investments.

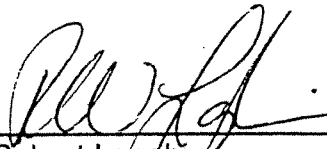
See attachment 1 for a discussion provided by PCA/EYKL and Hines of some potential Opportunistic Real Estate Investments.

V. STRATEGIC PLAN:


This item is consistent with the Strategic Plan, Goal IV, to assure that sufficient funds are available, first, to pay benefits and, second, to minimize and stabilize employer contributions.

VI. RESULTS/COSTS:

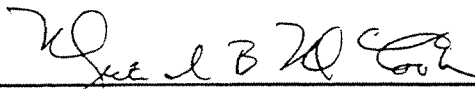
The recommendation allocates \$500 million from the existing Specialized (Non-Core) Portfolio allocation and allows further diversification of the real estate portfolio with the expectation of achieving returns in excess of Core Portfolio returns.



Robert Langhi
Investment Officer - Real Estate



Bryan Bailey
Portfolio Manager - Real Estate



Michael B. McCook
Senior Investment Officer - Real Estate



Mark Anson
Chief Investment Officer

Opportunistic Investments

In the past six months United States real estate markets and certain markets abroad have entered into an apparent market correction period. The potential magnitude or the duration of the correction is currently unclear. Anecdotal evidence suggests the bid/asked spread for sales transactions is widening and transaction volume has dramatically slowed. One manager describes the current market as in a state of "paralysis"¹, suggesting pricing may be poised for a downturn in order to achieve market clearing prices.

The NCREIF Property Index reported a decline in value, albeit small (0.5%), for the quarter ending September 30, 2001. This represents the first depreciation return reported in five years. The year-end numbers exhibited a similar pattern with a depreciation return of (1.2%) for the trailing one year period. Historically, the NCREIF Index lags the market when it moves upward or downward due to the appraisal process and the fact that not all index assets are appraised annually.

During times of uncertainty and "choppy" pricing, investment opportunities exist for those with capital and the ability to move quickly. These "windows of opportunity" open and close quickly, and as described below, one may have already shut. CalPERS wants to be positioned to move quickly to take advantage of a perceived buyers market occurring in next 12 months.

As discussed below, the profile of the potential investments vary and each has different risk and return attributes. While the risks and returns will vary depending upon the nature of the specific opportunity, this Fund will seek net returns in the 13% to 18% range. This return profile contrasts with expected unleveraged Core portfolio returns in the 8% to 9% range over the next year.

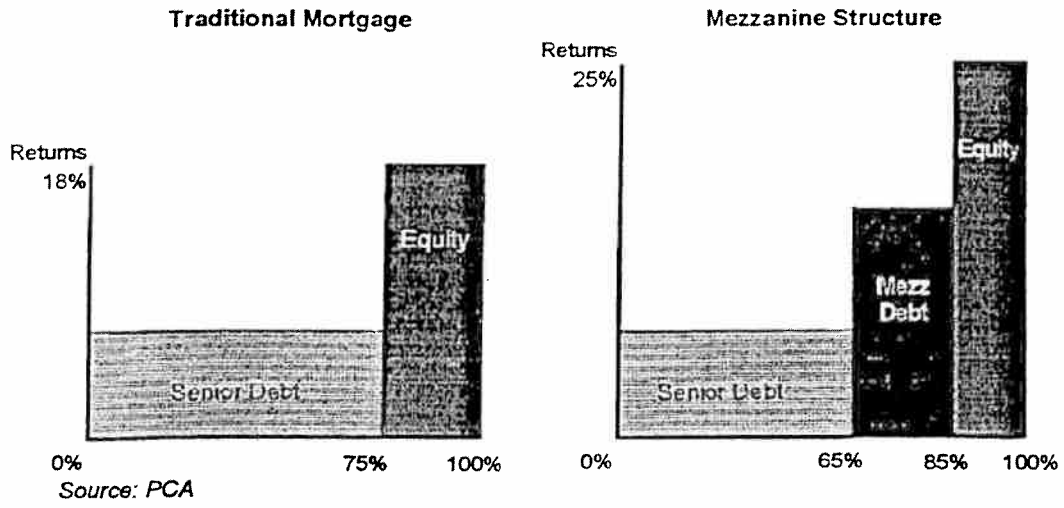
The types of investment strategies under consideration are:

Mezzanine Debt

There is unquestionably an opportunity to achieve equity returns in the mezzanine sector today. While the term "mezzanine debt" is used to define a number of investment strategies, for this strategy, Staff defines it as taking a debt position in the capital structure of a building that is equivalent to a "second mortgage" position. There is usually a substantial subordinate equity cushion in the range of 15% to 25% below the mezzanine position. Table 1 depicts where the mezzanine position falls within the capital structure of a building.

¹ Directions, Lend Lease Real Estate Investments, First Quarter 2002.

Table 1

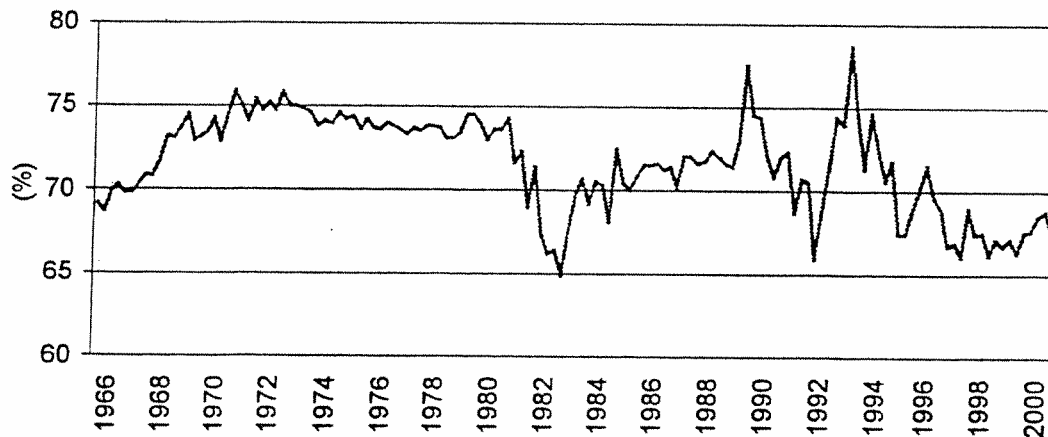


The demand side for owners requiring mezzanine capital is expected to be very strong over the next few years. There are a number of potential sources who will issue this debt: conventional borrowers with five year bullet loans coming due; opportunity funds who cannot achieve their hurdle returns by selling into today's market, yet need to make some cash distributions to their investors; and buyers of assets who do not have sufficient equity to qualify for a conventional loan, which will be originated in the 60% to 65% loan to value range.

Loans are presently being underwritten very conservatively. Tables 2 and 3 illustrate the trend lines for underwriting standards in terms of loan to value and debt service coverage ratios. These underwriting guidelines are one of the market factors creating the opportunity for mezzanine investors.

Table 2

Loan to Value Ratio

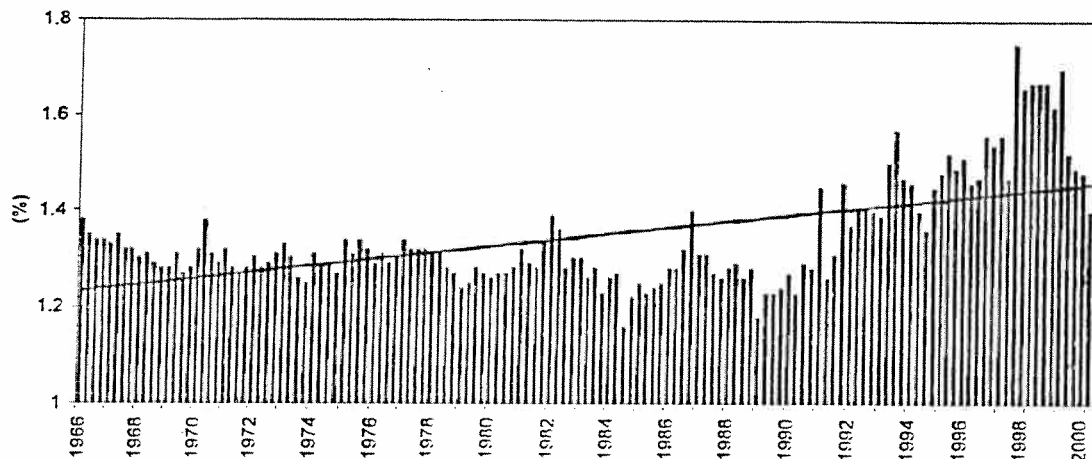


Source: Prudential Real Estate Investors

Table 3

Source: Prudential Real Estate Investors

Debt Service Coverage Ratio

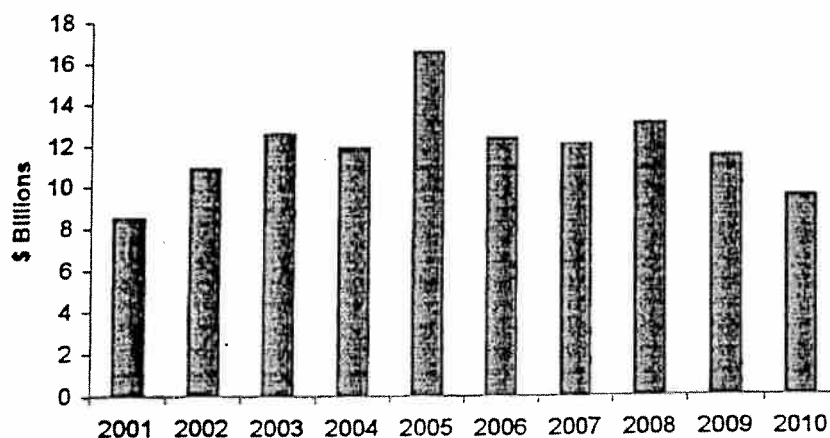


There is a capital gap between what a borrower can obtain from conventional financing and the equity they must put up as collateral. Given that asset values may be declining, it will be difficult for many borrowers to produce the 35% to 40% equity (depending on the property type) required to reissue these loans. Thus, mezzanine loans will afford these borrowers the ability to refinance the debt without losing their equity in the project.

Table 4 illustrates the potential volume of whole loans that will mature over the next few years. This is the new supply of refinancings that must occur, which will also fuel the demand for mezzanine financings.

Table 4

Projected Amount of Loan Maturities By Year



Source: ACLJ

Estimates vary, but it is believed the outstanding balance of commercial mortgages was approximately \$1.6 trillion at year end 2000. Mezzanine debt accounted for approximately \$60 billion of that amount.² The potential size of the mezzanine market is estimated to be in the range of \$400 billion with the annual capacity of the mezzanine financing market to fall in the \$10 billion to \$14 billion range.³

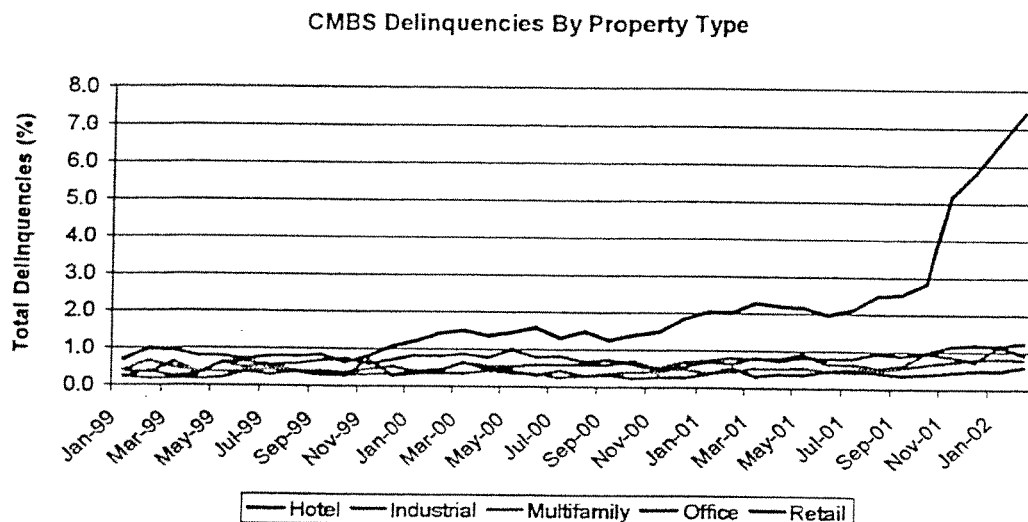
From a supply side, the market has been slow to recognize the opportunity. Mezzanine specific funds have found it difficult to raise capital, largely because the investment structure is not well understood by many equity orientated real estate investors. Thus, those investors who move more quickly will achieve superior yield on these mezzanine loans. Conservatively underwritten

² Federal Reserve Board, Apollo Real Estate Capital.

³ Tim Ballard and Scott Muldavin, "Does Mezzanine Real Estate Investing Make Sense Today?", Real Estate Finance, Summer 2000, p.41.

mezzanine loans generate yields in the range of 13% to 15%. Mezzanine loans on "out of favor" property types, such as hotels, have higher yields.

Table 5



Source: Deutsche Bank

Hotel Sector.

Of all property sectors, hotels suffered most from the September 11th attacks. PCA conducted a March 2002 seminar with industry experts addressing hotel opportunities since September 11th. One surprising conclusion was the equity market in hotels has recovered much more quickly than we originally thought. According to Steve Bollenbach, President of Hilton Hotels, if the fourth quarter 2001 is excluded, their firm wide operations have essentially recovered to first quarter 2001 results.

Eastdil, a group specializing in hotel sales, indicated hotel values may have fallen 10% to 25% since their 1999/2000 peaks, but they expect the equity market to stabilize if the economic recovery takes hold. It is possible that the window of opportunity has passed for acquiring equity interests in hotels. PCA is presently determining whether the risk adjusted returns for equity investments in hotels would meet the 13% to 18% return thresholds discussed above.

The hotel seminar revealed the debt market has yet to exhibit the same recovery. Hotel loan delinquencies have risen sharply since September 11th, as reflected in Table 5 above and Table 6 below.

Table 6

CMBS Hotel Delinquency Rates

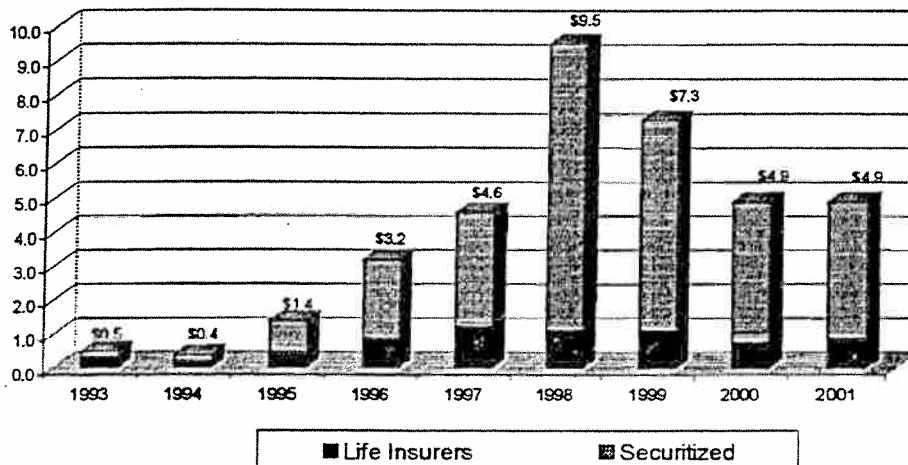
	<u>Delinquency Rate</u>
1999 December	0.7%
2000 June	1.2%
2000 December	1.6%
2001 June	2.7%
2001 December	5.6%

Source: S & P, Eastdil

Additionally, there will be significant volume of five and ten-year bullet loans coming due over the course of the next 24 months as shown in the table below.

Table 7

Hotel Loan Originations 1993-2001
(\$ In Billions)

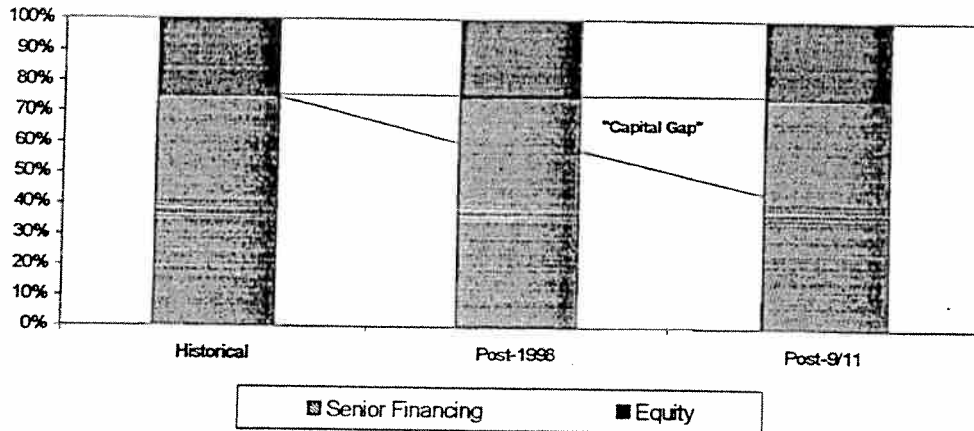


Source: ACIL, TREPP, EASTDIL

Lenders have become very conservative in underwriting these loans. Loan to value ratios for the senior debt is generally not available above 45% to 50%. Many borrowers will be unable to refinance on the same terms. They will either have to seek equity partners, mezzanine debt, or some other restructuring to avoid losing the hotel. CalPERS, as a capital source, can receive attractive equity returns as part of these restructurings. The opportunity in the hotel capital structure is illustrated below.

Table 8

**Opportunity:
Illiquidity Is Widening the "Capital Gap"**



Source: Lowe Enterprises, Inc.

Return expectations for hotel mezzanine investments are in the high teens. PCA is exploring whether a hotel specific strategy makes more sense than a more broadly defined mezzanine investment strategy. A broadly defined mezzanine strategy would likely include hotel mezzanine investments.

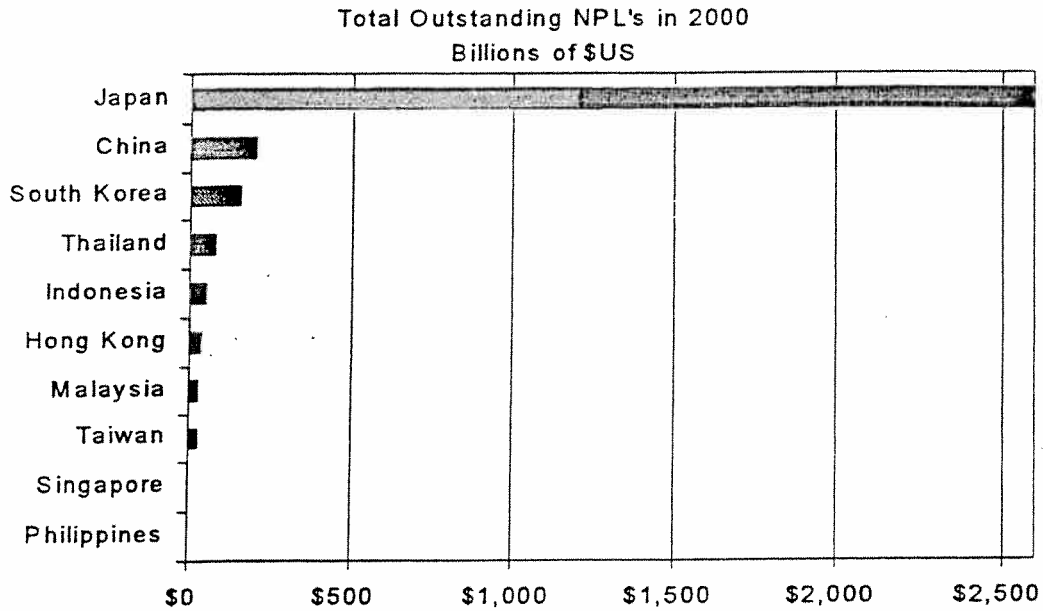
International Investments

Japan

The Japanese economy remains in shambles. All the discussion by Japanese banking officials regarding structural change has led to no meaningful reforms. The banks have been liquidating problem loans and assets at a snail's pace. The banking crisis prompted one economist at the recent PREA conference to state that there is a 100% probability of Japan's economic collapse. While few hold the same view, unquestionably Japan's economic problems associated with its financial institutions and corporations are profound and are significantly larger than publicly reported. Industry experts estimate the size of the potential market to greatly exceed the issues the United States experienced in the S & L crisis in the early 1990's and could approximate 150 trillion yen.

The sheer magnitude of Japan's problems and the amount of capital required to fix them creates a compelling investment opportunity. The investment opportunities fall in a variety of categories. These include corporations attempting to shed real estate assets they acquired in the 1980's, financial institutions selling problem loan portfolios and assets, and restructuring of corporate Japan by transferring or selling real estate assets off their books. Table 9 illustrates the potential volume of transactions in the non-performing loan category alone.

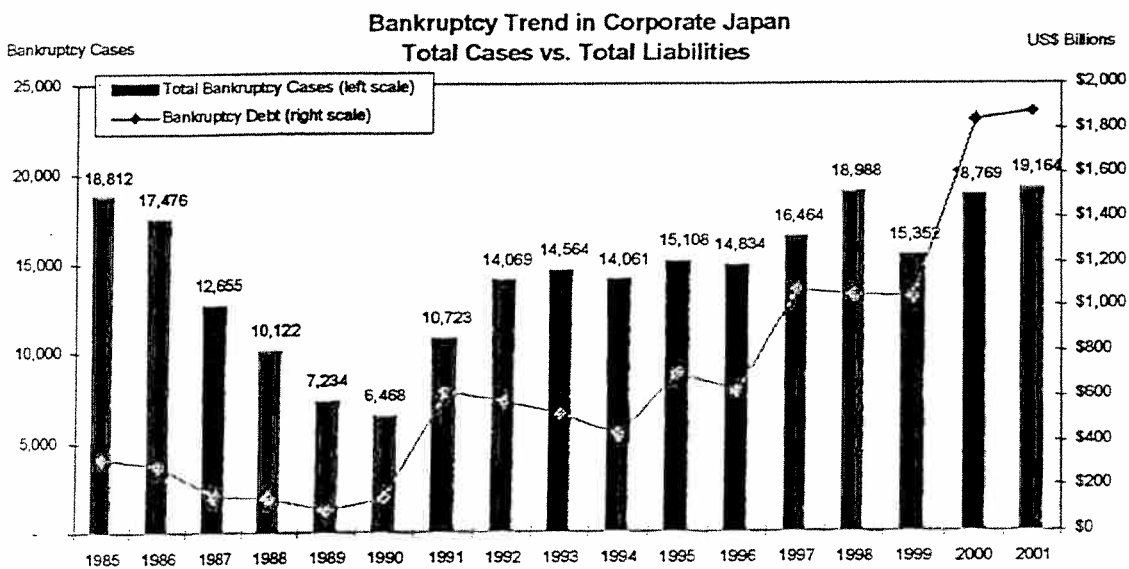
Table 9



Source: Ernst & Young

Additionally, corporate bankruptcies have dramatically increased in the past few years, as shown in Table 10 and are likely to continue in the foreseeable future. These restructurings will provide investment opportunities for investors with capital and with access to corporate Japan.

Table 10



Source: Teikoku Databank, Mikuni & Co. Ltd., Tokyo Shoko Research

Complicating matters is the fact that only a few firms have been successful in penetrating these institutions. Significant cultural issues exist in overcoming the Japanese reticence to realize losses and thus gain access to deal flow. The transactions that have been completed are done quietly. However, those few firms who have been able to tap into the problem financial institutions and garner their trust have generated returns in the 25% to 30% range as illustrated in Table 11 below.

Table 11

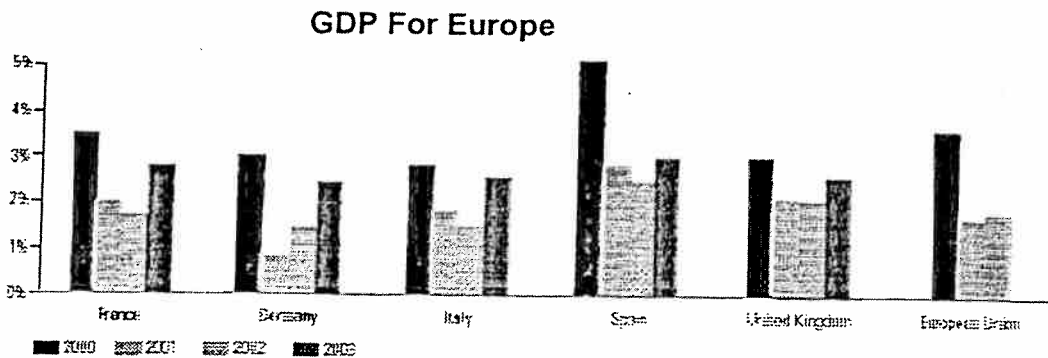
Opportunistic International Real Estate Funds			
FUND	INCEPTION	SIZE	PROJECTED GROSS IRR
LoneStar I	1996	\$396 M	18%
MSREF III	1997	\$1.4 B	25%
LoneStar II	1998	\$1.2 B	31%
Deutsche Bank	1998	\$4.9 B	30%
LoneStar III	2000	\$2.3 B	25%
SREI	2000	\$1.0 B	32%

* Projected returns are gross of advisory fees and partnership expenses

Europe

Continental Europe and the UK, like the US, have experienced a slowing of GDP growth. However, the rate of slowing has not been as dramatic as in the US. Forecasted GDP growth remains positive through 2003 as shown in Table 12. For the near term, a positive economic environment should continue to drive the demand for real estate space.

Table 12

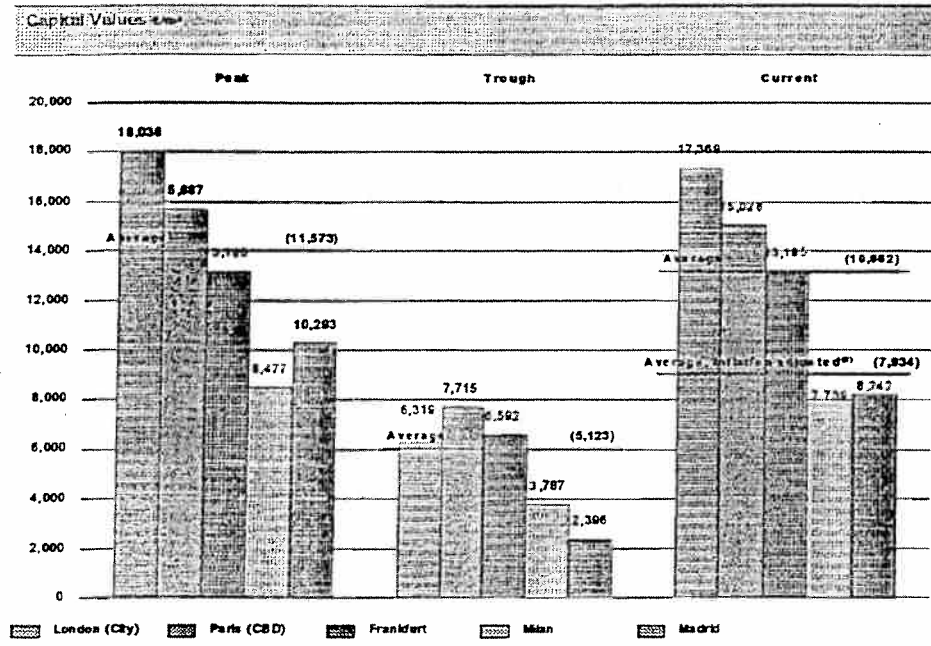


Over the past few years the European property markets have enjoyed a resurgence analogous to that of investors in United States real estate. However, it appears European markets generally lag the United States recovery. Capital values, while increased, remain below their

peak values as illustrated in Table 13. Investors appear to have some continued upside based upon historical experience.

Table 13

Peak Trough Analysis

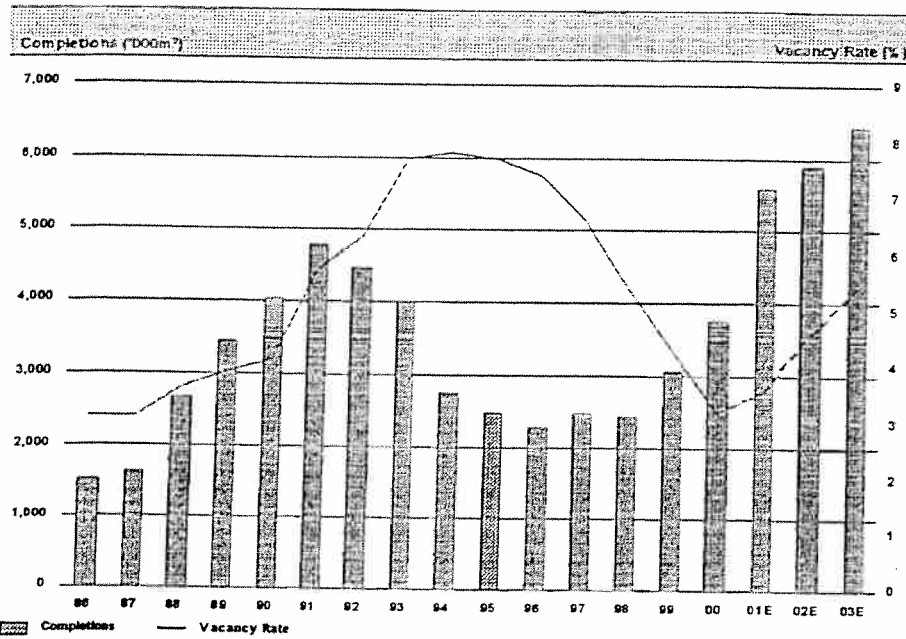


Source: Morgan Stanley Equity Research (8-Oct-01); CB Richard Ellis Q3 2001
 Note: Data for the period January 1990 to date with an assumed average inflation rate of 3% over ten years

Since many markets lack a supply of high quality, efficient space, the pricing recovery has fueled new development. Over the past ten years there was a sharp drop in new supply and the pent up demand is driving new construction projects on line now or expected to come on line in the next two years. Table 14 illustrates the future office completions anticipated through 2003 as well as the projected vacancy rates for the same time period.

Table 14

Future Office Completions

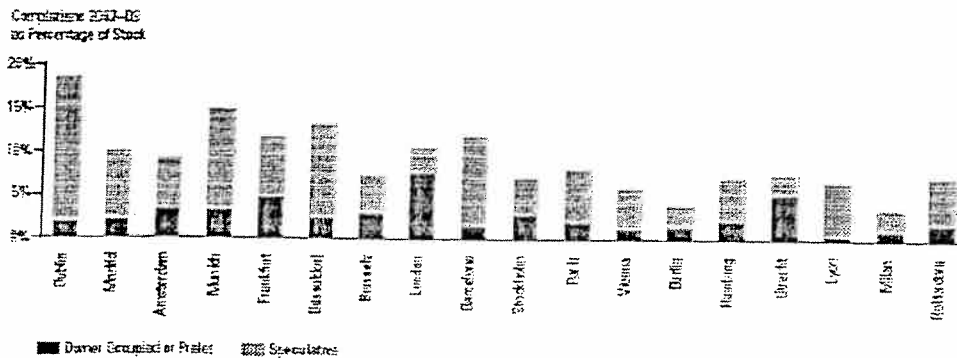


Source: Jones Lang LaSalle European Research, 30th of June 2001

Interestingly, much of the new supply is from owner/users. This new supply is essentially preleased and will have no impact upon future vacancy rates. Much of the new supply in this category has been in the build-to-suit category for European companies seeking a different office environment with more functional buildings.

Table 15

European Office Pipeline: 2002-2003



Source: Jones Lang LaSalle, LaSalle Investment Management

The European community has been operating at almost full capacity at a 3% vacancy rate. While vacancy rates are expected to rise, the overall projected level of approximately 6% suggests a fairly robust office market environment. The projected vacancy levels suggest that supply and demand will be in relative balance over the near term.

Much of the existing building space in European central cities is old and inefficient. As corporate Europe restructures, there is an inexorable trend for companies to efficiently reconfigure their office and production space. This reconfiguring is causing companies to seek more efficient buildings.

Europe offers opportunistic investments in office, industrial, retail, residential, hotels, and resorts. The current European market environment presents opportunities for acquiring existing buildings and retrofitting them to new space requirements and acquiring scarce well-located land sites for new development. There are also select opportunities for new, build-to-suit developments for owner/users, which can be attractive in markets with high barriers to entry (lack of available sites and complex entitlement processes) or where the potential owner/user has good credit and is locked into taking the building. Trends currently in place indicate that the prospects for new office developed or redeveloped now for delivery after 2003 could be very positive. Even though Jones Lang LaSalle currently projects increasing vacancies in office through 2003 as the result of the generally weaker economic conditions prevailing in Europe, the reduction in deliveries of new office buildings that will result from abandoned projects during this slowdown together with the increased demand for space as the economy improves should reverse this trend, causing vacancy rates to begin falling again from 2004 through 2007. This trend is even more dramatic with respect to high quality, modern efficient space (ie. Class A) as in most major markets in Europe, Class A space represents only 10% - 20% of the total stock vs approximately 50% or more. Accordingly, investment in well located, high quality, efficient real estate in the short term could produce attractive yields given that it typically requires three or four years to renovate or complete a project. The returns on European office opportunities are equivalent to United States opportunities (which are presently unattractive due to the lack of demand for new space) in the unleveraged 12% to 15% range. However, most transactions are leveraged with the resulting expected returns in the 20% to 25% range.

May 13, 2002

California Public Employees' Retirement System
Investment Committee
Lincoln Plaza, 400 P Street, Room 3492
Sacramento, CA 95814

Re: Opportunistic Investment Program

Dear Members of the Investment Committee:

PCA/E&Y Kenneth Leventhal ("PCA/EYKL") concurs with the Staff's recommendations to create an opportunistic real estate program within CalPERS' Specialized Portfolio. The United States real estate markets are entering into a "choppy" environment in which there may be investment opportunities to buy assets at either distressed prices or from distressed sellers.

The NCREIF Property Index reported the first decline in value over the past five years, albeit small (0.5%), for the quarter ending September 30, 2001. The year-end numbers exhibited a similar pattern with a depreciation return of (1.2%) for the trailing one year period. Historically, the NCREIF Index lags the market when it moves upward or downward due to the appraisal process and the fact that not all index assets are appraised annually. We also agree that the bid/asked spread for sales transactions is widening and transaction volume has dramatically slowed. This suggests a potential market correction may be underway.

PCA/EYKL has also recommended international, opportunistic investments, particularly focusing upon Japan. The Japanese real estate markets are in chaos. Their situation is not unlike the United States during our own Savings and Loan crisis. Real estate investors during this time period in the United States achieved handsome returns and we believe the same potential exists presently in Japan. The key issue in Japan is finding managers who have true access to the financial institutions to obtain good deal flow.

There are also certain development opportunities in Europe in major markets that are supply constrained. As is described in the Staff's write up, much of the current inventory is physically old and inefficient in terms of modern business use. Consequently, there has been recent demand by owner/occupiers of newly developed office space.

We are also favorably recommending real estate mezzanine investment strategies for our clients. It is our view that these investments may produce a current yield in the near term that will exceed core, equity returns as measured by the NCREIF Index.

During times of uncertainty and choppy pricing, investment opportunities exist for those with capital and the ability to move quickly. CalPERS should be positioned to capitalize on these investment opportunities as they present themselves. These "windows of opportunity" open and close quickly.

Investment Committee
May 13, 2002
Page two

As is detailed in the Staff's write-up, there are a number of potential investment themes that appear initially attractive. The risk and return profile of the potential investments vary and each potential strategy requires further due diligence to ascertain its attractiveness. PCA/EYKL believes net return expectations in the 13% to 18% range are achievable and should outperform the Core portfolio in the near term.

We look forward to addressing any questions the Investment Committee may have about this potential program at the May 13th Investment Committee meeting.

Very truly yours,



Nori Gerardo Lietz
On behalf of PCA/EY Kenneth Leventhal

Cc: Mark Anson
Robert Aguallo
Mike McCook



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June 17, 2002

AGENDA ITEM 5b

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Real Estate Investment Delegation of Authority - Opportunistic Program
- II. PROGRAM:** Opportunistic Real Estate Investment Program (Specialized)
- III. RECOMMENDATION:**
 - 1) SIO discretion for investments up to \$100 million;
 - 2) CIO approval required for investments over \$100 million up to \$200 million;
 - 3) Investment Committee approval required for investments over \$200 million

IV. ANALYSIS:

At its May 13, 2002 meeting, the Investment Committee approved the Opportunistic Real Estate Investment program, subject to a review of the delegation of authority and policy for the investment strategy.

The Specialized Equity Real Estate Policy specifically outlines "opportunistic" investments, and provides policies for the investments anticipated under the Opportunistic Real Estate Investment Program (hereinafter referred to as "the Program"). All of the opportunistic investments that would be pursued under the Program would follow the respective existing real estate policy. For example, an "opportunistic" international investment that is brought to CalPERS under the Program would have to satisfy the CalPERS' Statement of Investment Policy for International Real Estate. All of the opportunistic investments, except Hotel Investments, have individual investment policies and established parameters.

Real Estate Delegation Resolution No. 95-102 (attachment A) delegates to staff the administration of programs within the Specialized Portfolio, subject to the parameters established for each program and Committee-approved policies.

Due to the unique nature of the Opportunistic Real Estate Investment Program, staff recommends limiting the SIO and CIO delegated authority as recommended in Section III.

This SIO delegation of authority is consistent with the delegation for other Investment units.

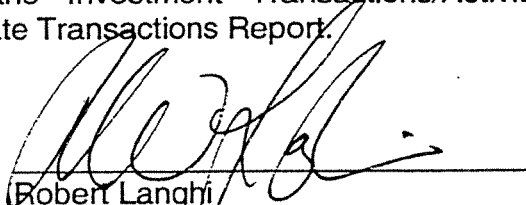
CalPERS Legal staff reviewed the agenda item and concurs with Real Estate staff that the Opportunistic Real Estate Investment program is covered under the Specialized Real Estate Policy and Delegation Resolution No. 95-102.


V. STRATEGIC PLAN:

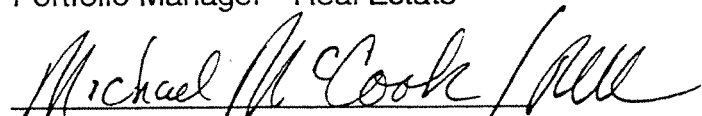
This item is consistent with the Strategic Plan, Goal IV, to assure that sufficient funds are available, first, to pay benefits and, second, to minimize and stabilize employer contributions.

VI. RESULTS/COSTS:

The recommendation establishes the Delegation of Authority for the Opportunistic Real Estate Investment Program. Staff shall report new opportunistic investments in the Investment Transactions/Activity Reports agenda item under the Real Estate Transactions Report.


Robert Langhi
Investment Officer - Real Estate


Bryan Bailey
Portfolio Manager - Real Estate


Michael B. McCook
Senior Investment Officer - Real Estate


Mark Anson
Chief Investment Officer



CalPERS
Investment Office

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April 19, 2004

AGENDA ITEM 4b

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Opportunistic Real Estate Investments – Update and Additional Allocation Request
- II. PROGRAM:** Non Core “Specialized” Real Estate Portfolio
- III. RECOMMENDATION:** Approval of an additional allocation of \$500 million for Opportunistic Real Estate Investments. Investments would be subject to PCA review, satisfactory due diligence and negotiation of appropriate terms and conditions.
- IV. ANALYSIS:**

Background

On May 13, 2002, the Investment Committee approved an allocation of \$500 million for Opportunistic Real Estate Investments. The overall strategy targets a minimum return of 13% unleveraged, after fees. Investments under consideration for inclusion in the Opportunity Fund shall be initially reviewed by Staff and further reviewed by Consultant, Pension Consulting Alliance, PCA, before commencing contract negotiation and full due diligence. SIO discretion would be for investments up to \$100 million, with CIO approval required for investments over \$100 million.

To date, a total of \$310 million has been committed to Page Mill Properties, Hampshire Partners Fund VI, Aetos Capital Asia and Secured Capital Japan Real Estate Partners I. These strategies range from distressed office assets in the Silicon Valley to niche investment opportunities in Japan. An additional \$135 million is tentatively committed for three additional opportunity funds in various stages of due diligence. Pending successful contract negotiation and completion

of due diligence, a total of \$445 million will be committed from the original allocation. Thus, \$55 million will be remaining from the original allocation and available for investment from an identified pipeline in excess of \$200 million. PCA concurs with the additional request, please see Exhibit 1. PCA will work with Staff on the proposed Policy for June.

Performance

The four funds currently committed under the Opportunistic program are in their respective funding commitment periods and therefore have not realized returns. However, Aetos Capital Asia has bought and sold one investment for a realized return of over 100% IRR and a cash multiple of 4.2X equity invested (fund level) CalPERS contributed approximately \$19,000 into the property and received \$80,000 in return in less than one year. Aetos Capital Asia currently has nine portfolios under management with a total of 6.1 million of equity invested. For those funds in the funding commitment period, on a portfolio basis, the returns are projected to be in excess of 20%; the chart below provides further detail.

Fund Total Fund \$ CalPERS Commitment \$ Major Investors	Strategy	Close Date	Projected Returns
Page Mill Properties \$275 million \$75 million Oregon Public Employees' Retirement Fund (OPERF), CalSTRS, Verizon, Oakhill Capital Management	Buying distressed high-tech Silicon Valley properties for releasing and repositioning	9/2002	Leveraged 18%+ Unleveraged 15%+
Aetos Capital Asia \$750 million \$100 million CalSTRS, AT&T, John Deere, United Nations	Repositioning and releasing various property types (office, retail and multi-family residential), limited distressed debt and real estate related investment activities in Japan	12/2002	Leveraged 20%+ Unleveraged 17%+
Hampshire Partners Fund VI \$150 million \$50 million State of North Carolina Retirement System, Notre Dame, State of Pennsylvania Retirement System	Acquire 'c' and 'b' industrial/ office properties in New York and New Jersey supply constrained markets, releasing and repositioning the assets	12/2003	Leveraged 16-19% Unleveraged 13-16%
Secured Capital Japan Real Estate \$125.5 million \$85 million Secured Capital, Pacific Life	Hard asset strategy predominantly focused on the residential (multi-family) sector with some exposure to select office and retail/mixed use properties located in Tokyo and other large cities in Japan.	3/2004	Leveraged 17-20% Unleveraged 14%-17%

Investment Opportunities

Domestic Real Estate markets continue to experience uncertainty and "choppy pricing," investment opportunities continue to arise for those with the capital and the ability to deploy the capital quickly.¹ Additionally, as noted by Pension Consulting Alliance, PCA, a formalized Strategy and Policy does not exist for Opportunistic Real Estate Investments. To that end, Staff and Senior Management of Real Estate have begun developing a formal Strategy and Policy for Opportunistic Investments. Staff will be presenting the new Opportunistic Real Estate policy to the Investment Policy Sub-Committee in June 2004. In compliance with other Real Estate Strategies and Policies, the Opportunistic Program will be formalized and as such will have an allocation of 0-15% of Total Real Estate for a maximum equity allocation of \$1.6B (based on a total real estate portfolio value of \$11.0B).

As an interim measure and to ensure compliance in the interim before review and formal approval of the new Opportunistic Policy, Staff is requesting an additional allocation of \$500 million for Opportunistic Real Estate Investments. Funds selected for the Opportunistic Real Estate allocation will continue to seek net returns in the 13% to 18% range. Targeted returns for Opportunistic Real Estate Investments should exceed Core returns by 5% to 10%.

Maximum Exposure - Opportunistic Real Estate Investments		
Original Allocation	5/2002	\$500 million
Additional Allocation - Proposed	4/2004	\$500 million
Formalized Policy Allocation - Proposed	6/2004	0-15% Total Real Estate \$1.6 billion ²

The chart above describes the allocations for Opportunistic Real Estate Investments and the total maximum exposure to the investment sub type projected as of June 2004.

Investment Thesis

The investment thesis for opportunistic real estate investing encompasses multiple property types, generally targets unique strategies that generate favorable risk adjusted returns that should exceed Core real estate investments. The investment thesis for opportunity funds and opportunistic real estate investments continues to be strong and provides ample prospects for further diversification and total return enhancement in the Real Estate Portfolio.

¹ Source: Pension Consulting Alliance (PCA) – Investment Committee Item 4B, May 13, 2002

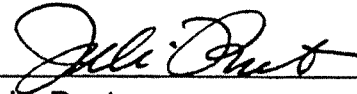
² Based on maximum 15% of Total Real Estate Portfolio valued at \$11,049,196,133 as of September 30, 2003

V. STRATEGIC PLAN:

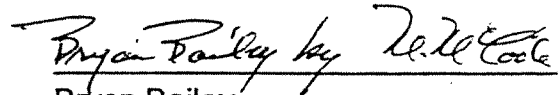
This item is consistent with the Strategic Plan, Goal IV, to assure that sufficient funds are available, first, to pay benefits, and, second, to maximize and stabilize employer contributions.

VI. RESULTS/COSTS:

The recommendation an additional allocation of \$500 million for Opportunistic Real Estate Investments within the existing Non Core Portfolio allowing further diversification of the real estate portfolio



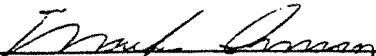
Julie Rost
Investment Officer



Bryan Bailey
Portfolio Manager



Michael McCook
Senior Investment Officer



Mark Anson
Chief Investment Officer

April 5, 2004

California Public Employees' Retirement System
Investment Committee
Lincoln Plaza, 400 P Street, Room 3492
Sacramento, CA 95814

Re: Additional Allocation Request – Opportunistic Real Estate Investments

Dear Members of the Investment Committee:

Pension Consulting Alliance ("PCA") has reviewed Staff's recommendation to allocate an additional \$500 million to Opportunistic Real Estate Investments. Based on committed and pending transactions, Staff is nearing the original \$500 million allocation approved in May 2002.

We have discussed with the Staff the need to develop a formal Investment Policy for the Opportunistic Real Estate Investments which will provide for an allocation range consistent with other non-core programs. The policy will be drafted, with our assistance, and presented to the Policy Subcommittee in June 2004. As an interim measure, Staff is requesting the additional allocation to ensure that they can continue pursuing attractive investment opportunities and remain in compliance with review and approval processes originally agreed to by the Investment Committee.

PCA continues to believe that net return expectations in the 13% to 18% range are achievable and should outperform the Core Portfolio. Accordingly, PCA concurs with the Staff's recommendation to increase the allocation for Opportunistic Real Estate Investments by \$500 million as an interim measure prior to the submittal of a proposed formal policy.

We look forward to addressing any questions the Investment Committee may have at the April 19th Investment Committee meeting.

Very truly yours,



Nori Gerardo Lietz
Managing Director

CC: Pam Alsterlind, PCA
Mark Anson, CalPERS
Mike McCook, CalPERS
Bryan Bailey, CalPERS
Julie Rost, CalPERS