



MEMORANDUM

To: Members of the Investment Committee
California Public Employees' Retirement System


Date: December 14, 2009

From: Pension Consulting Alliance, Inc. (PCA)

RE: Real Estate Performance through September 30, 2009

PCA has received and reviewed Wilshire's Third Quarter 2009 Executive Summary of CalPERS' Investment Performance as it relates to the Real Estate Portfolio. The following items should be considered in your assessment of Real Estate's performance:

- In an illiquid asset class populated with ten-year partnerships, longer term results are more significant than those of a shorter duration. Over the trailing ten-year period and since inception (Q2-1982), CalPERS total real estate performance before fees has underperformed the policy benchmark of NCREIF. In addition, on an after fee basis, the total real estate portfolio is underperforming the inflation-adjusted real target return of 5% for the trailing ten-year period and since inception time horizon with 1.9% and 4.2% returns, respectively. **This has been primarily driven by the recent, vintage 2006-2007 investments' poor performance in the real estate portfolio and, therefore, the short-term results continue to warrant close scrutiny.**
- The total Real Estate Portfolio produced a -30.1% return during the quarter and a -48.7% return over the trailing year. Net returns for the total Real Estate Portfolio have underperformed the benchmark in all time periods. Ten-year net returns were 4.4% versus 8.9% for the benchmark, once again driven by 2006-2007 investments.
- The Core Portfolio underperformed the Special Real Estate Portfolio, the total Real Estate Portfolio and the policy benchmark over the quarter and the trailing year. The Core Portfolio's recent relative underperformance was largely attributable to June 30, 2009 appraisals of all Core properties which captured the impact of eroding fundamentals on income and appreciation, leverage levels, and capital market valuation declines.
- The performance in the real estate portfolio has been deteriorated by four primary factors. First, capital markets have had significant impact on real estate property valuations. Second, the macro-economy continues to go through a downturn which has had an impact on rents. The final two factors are related to the exposure in the CalPERS real estate portfolio to non-stabilized assets with higher amounts of leverage.



These final two factors have exacerbated the recent underperformance to the benchmark as non-stabilized assets provide less income to insulate valuation declines and increased leverage magnifies returns in upward and downward market cycles.

- Substantially all of the separate account real estate assets were independently appraised as of June 30, 2009, which when combined with updated manager-reported values for the commingled funds, resulted in a total Real Estate Portfolio value of \$13.4 billion, which represents a decline of \$4.2 billion or 24% from the previous quarter (March 31, 2009), and an \$8.6 billion or 39% decline from a year ago (June 30, 2008). Other factors negatively impacting returns included a relatively large proportion of non-stabilized and non-income producing properties and high levels of leverage utilized in CalPERS real estate portfolio relative to the benchmark.
- PCA expects the fundamentals, and therefore the performance, of the Real Estate portfolio to continue to deteriorate over the next 12 months and potentially longer. Persistently weak economic conditions, the absence of a functioning commercial mortgage origination/re-financing market and negative leverage are likely to erode income streams and total returns.
- Value declines in the real estate portfolio combined with stronger performance by US and global equity markets brought the real estate asset class to 6.9% of the total portfolio, below the target allocation of 10.0%.
- The partnership review process initiated by Staff to evaluate the risks and merits of individual investments and investment managers is well underway. Information gathered through this review process has yielded important lessons learned and is proving very valuable to the restructuring of the portfolio. Furthermore, a number of managers have been or are in the process of being terminated as their performance and judgment proved to be well below expectations.
- Staff continues to implement a deleveraging plan that addresses loan-to-value (LTV) considerations, new policy limits, and existing, prospective and potential covenant breaches and defaults. These efforts are expected to stabilize the portfolio and relieve Staff from the intense asset-level management responsibilities required by the distressed debt situations that pervade the portfolio.
- The combination of the significant underweight to real estate and distressed market conditions indicate that 2010 may be an excellent time to begin looking at new acquisitions that are consistent with CalPERS' new investment policy.