Board of Retirement Meeting

San Joaquin County Employees' Retirement Association

Agenda Item 4.04-01

July 14, 2017

SUBJECT: 2017-2018 Real Estate Implementation Plan

SUBMITTED FOR: _X_ CONSENT ___ ACTION ___ INFORMATION

RECOMMENDATION

The Real Estate Committee unanimously recommends that the Board approve the 2017-2018 Proposed Real Estate Implementation Plan, authorizing new commitments to private real estate investments not to exceed $90 million in aggregate through December 31, 2018.

PURPOSE

To establish the Board's plan for making real estate investments, which will guide the Real Estate Committee's actions under its authority as delegated by the Board.

DISCUSSION

At its June 9, 2017, the Real Estate Committee reviewed and discussed the Real Estate Implementation Plan proposed by Courtland Partners. The Committee unanimously recommends that the Board adopt the proposed plan for 2017-2018.

ATTACHMENT(S)

Memo from Real Estate Committee prepared by Courtland Partners
Summary of 2017-2018 Proposed Real Estate Implementation Plan
Proposed 2017-2018 Real Estate Implementation Plan
Presentation to Real Estate Committee on Strategy and Proposed Implementation Plan

Nancy Cal

NANCY CALKINS
Chief Investment Officer

COURTLAND PARTNERS, LTD.
INSTITUTIONAL REAL ASSET ADVISOR

MEMORANDUM

To: SJCERA Board of Retirement (the "Board")

From: Real Estate Committee (the "Committee") of the Board of Retirement by Courtland Partners, Ltd. ("Courtland")

Subject: 2017 and 2018 Real Estate Implementation Plan (the "Plan")

Date: June 14, 2017

As a part of its annual strategic review of the SJCERA real estate portfolio, Courtland presented the Plan to the Committee at its meeting on June 9, 2017. Current market conditions, SJCERA portfolio needs, and current investment opportunities were all taken into consideration during the creation of the Plan. The Plan recommends that the Board allocate up to $90 million in new commitments for its real estate portfolio in 2017 and 2018 based upon the following strategic objectives:

- Consider committing up to $90 million in the Value-Added sector in order to take advantage of attractive opportunities in this sector.
- Consider committing up to $30 million in the Opportunistic sector in order to take advantage of any unique opportunities in this sector that may arise through 2018.

In total, no more that $90 million will be committed in 2017 and 2018. The Plan has been designed to enable flexibility in the potential allocations that may be made during this time period. The Plan recognizes that while the underlying fundamentals for real estate are generally solid that the state of the capital markets should be thoroughly considered prior to making any new commitments. Therefore, any investment that is recommended to the Committee and/or the Board will take into account current market conditions and the manager's risk mitigation strategy. There will also be an emphasis on investments that produce high current income in the Value-Added sector.

The Committee has reviewed the Plan and hereby recommends that the Board adopt it.

Summary of 2017 and 2018 Real Estate Proposed Implementation Plan

❑ Real Estate Portfolio Update as of 4Q16

- *Total value of $313.3 million (12.5% vs. 10.0% Policy)*
- *In accordance with the 2016 Plan, $30 million committed to Opportunistic strategies in 2016*
- *Approximately $47 million of unfunded commitments likely to be called (including $30 million to GAP VIII)*

❑ Current Market Conditions

- *Underlying real estate fundamentals remain generally positive*
- *Returns have reverted to historical norms; income focus remains important*
- *Cap rates unlikely to compress further; however, real estate remains "in demand" from investors*

❑ 2017 and 2018 Proposed Implementation Plan

- *Maintain target allocation of 40% Core, 40% Value and 20% Opportunistic*
- *Allocate up to $90 mil. in Value and $30 mil. in Opportunistic, but no more than $90 mil. combined*
- *Seek investments that provide current income or the potential to generate current income*
- *Continue to monitor Real Estate Securities, domestic and international; consider potential modifications*

San Joaquin County Employees' Retirement Association ("SJCERA")

2017-2018 Proposed Real Estate Implementation Plan

June 2017

I. SUMMARY

Courtland recommends that SJCERA consider the addition of up to three real estate managers/funds. The main objective for 2017-2018 is for SJCERA to consider allocating to diversified value-added investments which Courtland believes will create a sound and prudently managed portfolio. These new investments will help to keep SJCERA moving towards its long-term targets. New value-added investments will be focused on continuing to improve the current income for the portfolio while capitalizing on some opportunities for upside.

Courtland regularly monitors investment opportunities and may present opportunities to SJCERA throughout 2017 and 2018 for consideration. Contingent upon the approval of the Implementation Plan as well as the timing of the potential investment opportunities, Courtland may recommend scheduling Real Estate Committee meeting(s) to interview several firms as needed.

II. PURPOSE AND OBJECTIVES

This document sets forth the 2017-2018 Real Estate Implementation Plan (the "Implementation Plan") for the San Joaquin County Employees' Retirement Association ("SJCERA") with respect to its real estate investment portfolio (the "Portfolio"). This Implementation Plan presents real estate investment planning and procedures for the remainder of calendar year 2017 and calendar year 2018 within the guidelines set forth in the SJCERA Real Estate Investment Policy (the "Policy").

The Implementation Plan is the investment plan for the Policy, which outlines the long-term objectives and policies for the investment in and management of the asset class of real estate. The Implementation Plan shall be reviewed regularly and revised, if necessary, to incorporate changes in the real estate portfolio, real estate markets, and capital markets.

The performance target for the Portfolio is a 6% real rate of return, net of investment management fees (9% nominal rate of return, net of investment management fees assuming inflation of 3%). SJCERA's investments in leveraged or higher risk investments will have a target return in excess of the 6% real rate of return. Investment specific return expectations will be determined on a case-by-case basis.

In order to achieve the long term investment objectives, SJCERA has determined that decisions regarding the real estate portfolio shall be guided by the objectives of: (i) maximizing current income; (ii) achieving a total return competitive with other asset classes; and (iii) maintaining a broad diversification of assets by property type, location and investment type, manager and other attributes. Risk shall be controlled by the establishment and active monitoring of diversification strategies.

III. MARKET CONDITIONS

The economy grew at a 1.9% annualized rate in the three months ended December 2016. This is 50 basis points above the 10-year average growth rate and 160 basis points below the third quarter 2016 GDP growth of 3.5%. 443,000 new jobs were added during the fourth quarter, compared to 716,000 in the third quarter 2016 and 493,000 in the second quarter 2016. The unemployment rate fell to 4.7% for December, slightly up from 4.6% at the end of November. Rates on the 10-year U.S. Treasury increased 85 basis points from September 30th to 2.45%. The Atlanta Fed's GDPNow model projects a 0.6% annualized real growth rate of the U.S. economy for first quarter 2017 as of April 2017.

Fourth quarter transaction volume according to Real Capital Analytics was $122.7 billion across the five main property types. The past four quarters have seen similar transaction volume after a record-high volume of transactions ($152.6 billion) in fourth quarter 2015. Apartment transactions are the only property types with transaction volume up at 4% over the past year. Office decreased by 6%, retail decreased by 17%, industrial decreased by 26%, and hotel decreased by 30%.

Overall U.S. transaction volumes on a rolling four-quarter basis are down 10% at $441 billion compared to a year ago. The $490 billion in transaction volume in 2015 is the highest trailing twelve month transaction volume since 2007 when transaction volume was $515 billion.

Industrial properties had the largest total 1-year return at 12.3% while office had the lowest 1-year return at 6.2%. However, over the previous 10 years the returns on all asset types were within 2% of each other. The overall NCREIF Property Index ("NPI") cap rate is at its all time low as is the cap rate on Office, Industrial, and Retail properties. Apartment cap rates are only slightly off their all time lows. The NPI annualized cap rate moved down slightly in fourth quarter 2016 to 4.56% from 4.64% in third quarter 2016. Relative to the 10-Year U.S. Treasury yields of 2.45%, the cap rate spread decreased to 2.11%.

The fourth quarter NPI net operating income (NOI) growth was at 4.7%, which is 1.2% above the ten-year average growth rate of 3.5%. Industrial NOI growth of 7.2% led the property types with Industrial significantly above its 10 year average.

Both the NPI and Industrial ended the fourth quarter at the lowest vacancy in the past 10 years. Vacancy is flat to declining quarter over quarter for all property types except Apartment, which saw vacancy move up from 6.69% in third quarter 2016 to 7.18% in fourth quarter 2016.

Commercial mortgage debt availability has tightened a bit as banks utilize more stringent underwriting standards and the market embraces regulatory changes. CMBS issuance of $76 billion in 2016 shows a downward trend compared to $101 billion of 2015 issuance. However, debt generally remains available through a variety of sources including banks and insurance companies.

Low supply growth for Retail and Office property types has been a major differentiator in the current recovery. Apartment and Industrial deliveries were robust in 2015 and 2016. However, these deliveries have yet to put significant upward pressure on vacancy as vacancy for both continues to be low by historical standards. Industrial reached its all time low in fourth quarter 2016 despite significant new product coming to market. Certain markets are seeing new supply of Apartments put downward pressure on NOI growth, with the most notable being New York City. But outside of New York City, most markets are still experiencing strong positive NOI growth. The Industrial market continues to grow NOI significantly despite significant new deliveries. The Apartment market appears to have hit an inflection point as the rate of NOI growth is slowing after growing very rapidly for the past seven years although the trailing twelve month NOI growth rate of 4.8% is still strong growth.

Apartments

Apartment annual returns as of fourth quarter 2016 averaged 7.3% according to NPI. For the 12 months ended December 2016, returns were the highest in Portland (+12.4%), Oakland (+12.2%), and Denver (+11.0%). Houston (-3.8%), San Francisco (+3.6%), and Washington, DC (+5.0%), had the lowest annual total returns.

Apartments have been the beneficiary of strong NOI growth since 2010, averaging 7.73% per year which was well above the previous nine year average of 2.72%. As a result of this strong NOI growth, new supply has been coming to market at a historically rapid pace hitting a record of 2.0% of existing inventory in 2015 with 2016 slightly off the 2015 mark.

The result of new supply hitting the market will have an effect on the rents apartment owners can charge and in turn the NOI generated by apartments. NOI growth was 4.7% in 2016 compared to 10.3% in 2015 and 9.8% in 2014 so the rate of NOI growth is slowing. What remains to be seen is at what growth rate NOI growth will bottom. Construction lending for apartments has tightened a bit as the market anticipates new product being delivered to the market. The positive sign for future NOI growth is that new supply is expected to slow after expected deliveries over the remainder of 2017 and the first half of 2018 work its way through the system.

Industrial

Industrial annual returns as of fourth quarter 2016 averaged 12.3% according to NPI. For the 12 months ended December 2016, returns were the highest in San Jose (+21.0%), Oakland (+18.8%), and Seattle (+17.5%). Baltimore (+6.5%), Washington, DC, (+6.7%), and Houston (+7.0%) had the lowest annual total returns.

NOI growth has been strong in comparison to its historical trend since 2011. There was -0.63% annualized NOI growth in NPI tracked industrial properties between 2000 and 2010. NOI has grown annually at 4.77% since 2010, which is well above the historical trend. This rapid pace of NOI growth does not appear to be abating.

Office

New office supply is generally minimal aside from a few high-growth and technology markets including Dallas, Houston, and Phoenix. San Francisco, New York, and West Los Angeles remain healthy, although there are concerns of a broader tech sector slowdown. Uncertainty exists in energy markets such as Houston, where a shadow space market also exists. Nationally, fourth quarter occupancy was 88.8% and was up 87 basis points year over year.

Office annual returns as of fourth quarter 2016 averaged 6.2% according to NPI. For the twelve months ended December 2016, returns were the highest in Portland (+13.0%), Oakland (+10.5%), and Cambridge (+10.3%). Houston (-3.2%), Washington D.C. (+4.1%), and Denver (+4.6%) had the lowest annual total returns.

NOI growth has been quite strong since 2012. Notably, the drawdown in NOI that was experienced in the early 2000s was less severe than the drawdown during the GFC. The asset price drawdown during the GFC was largely attributable to the very large expansion in cap rates which offset the large cap rate compression prior to the GFC.

Retail

Higher quality retail centers continue to perform well, particularly those that offer an experience not easily replicated through internet shopping. Minimal supply growth benefits the sector. Tenant sales growth has been volatile as internet shopping pressures are mounting. Retail bankruptcies have significantly increased which has had the effect of Retail having the lowest NOI growth rate of all asset types at 2.6% year over year.

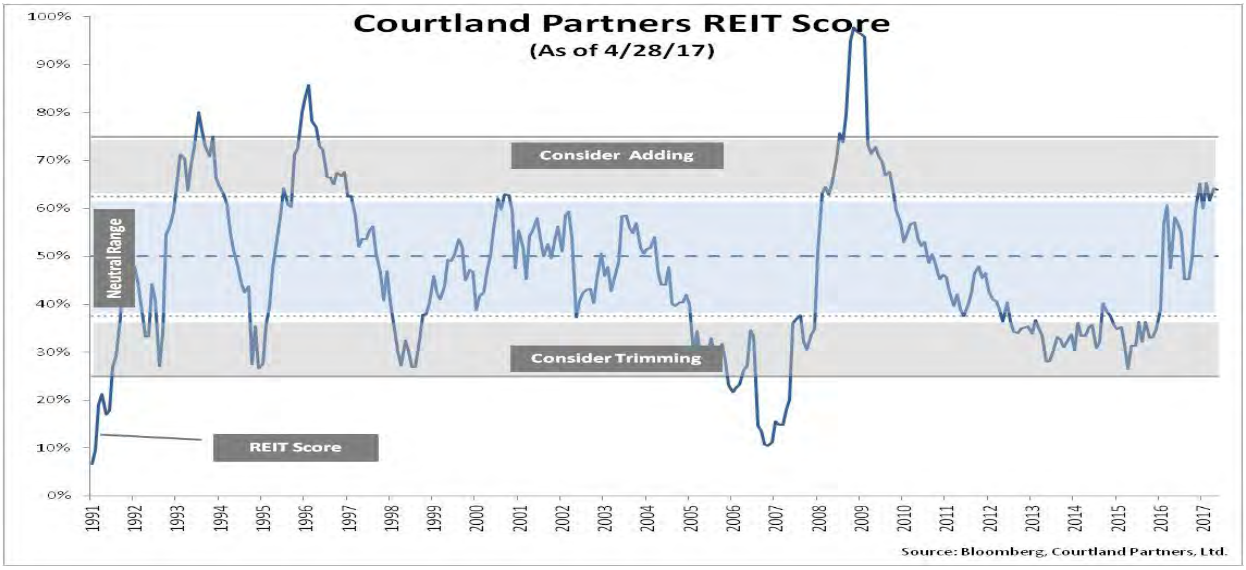
Orlando and Phoenix led the retail markets with total annual returns of 14.8% and 12.3%, respectively. This compares to 9.0% for the aggregate retail NPI. Oakland and New York were the laggards with returns of 6.3% and 6.6%, respectively. According to NPI, all retail subtypes saw positive returns for the year ending fourth quarter 2016. Super-Regional Centers performed best at 10.3%.

Retail NOI was barely affected by the recession in the early 2000s and had a modest drawdown during the GFC. It has grown at a 4.2% annualized rate since 2010 which is higher than its 3.1% growth rate since 2000.

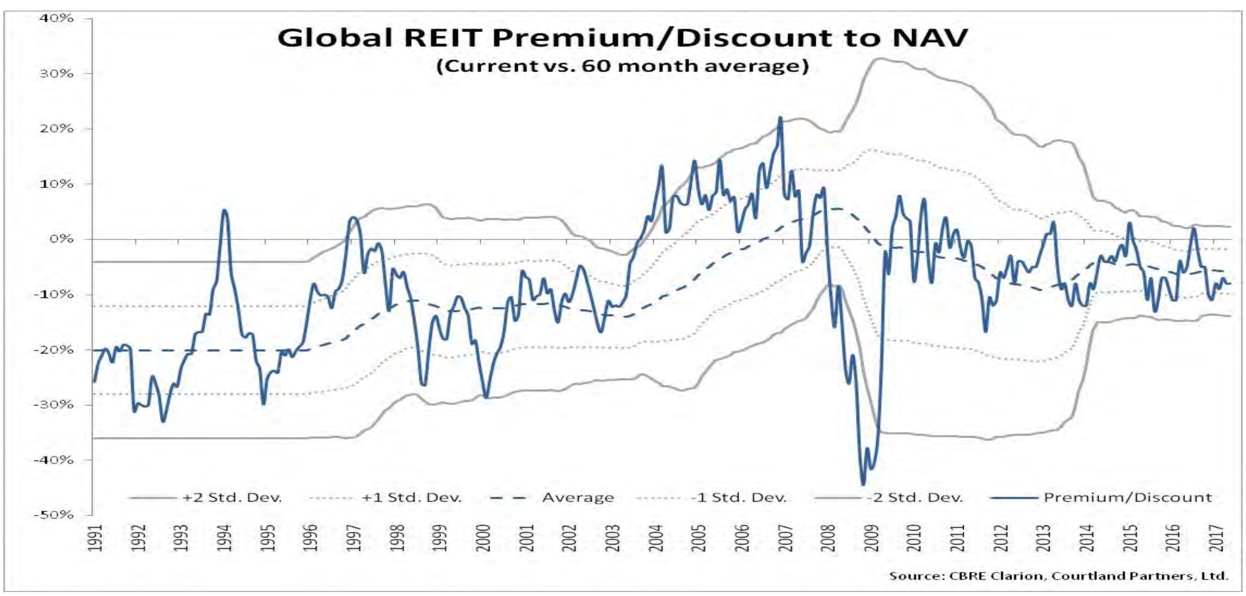
Housing

U.S. housing starts were at an annualized rate of 1.275 million in December 2016. While housing starts have greatly recovered from the annualized rate of approximately 0.5 million during the GFC, they are still significantly lower than they were prior to the GFC when they topped out at almost twice the current rate. The Case-Shiller 20 city composite home price index was at 195.47 in January 2017 and grew 5.7% since January 2016. House prices have been steadily rising since 2012 and are 5.4% below the all time peak of 206.65 reached in March 2006.

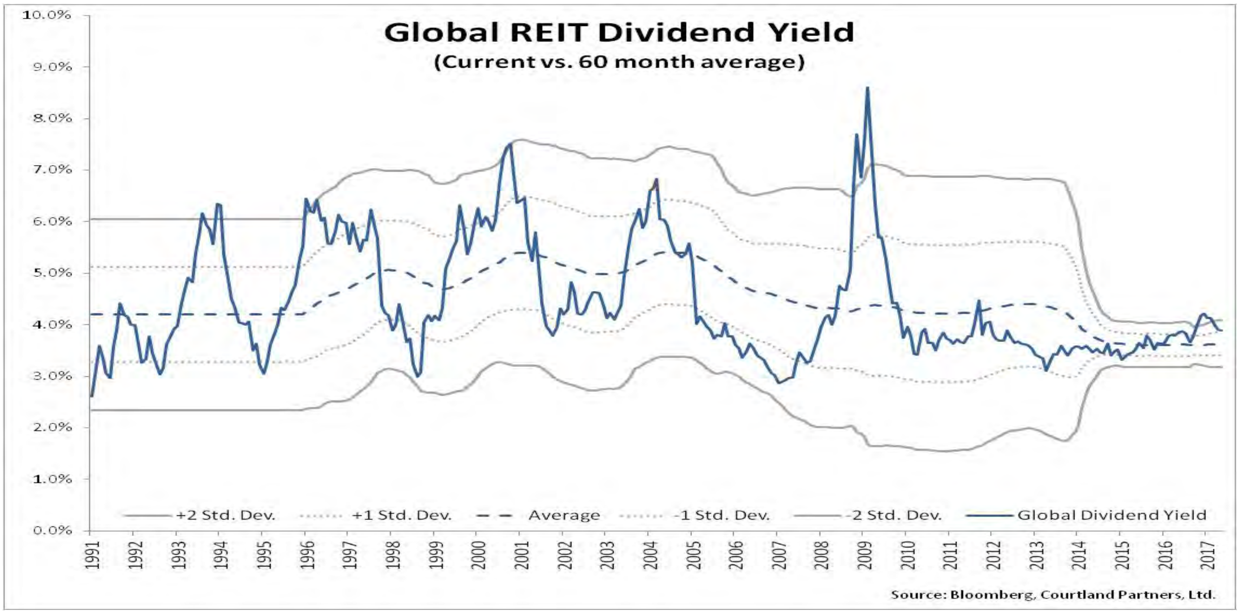
Courtland Partners REIT Score. The Courtland Partners REIT Score currently resides right around in the "Consider Adding" range. SJCERA has maintained its allocation over the past few years. For the existing domestic and international REIT allocations, additional trimming or adding should be considered in 2017 and 2018 based upon the REIT Score and other portfolio considerations.



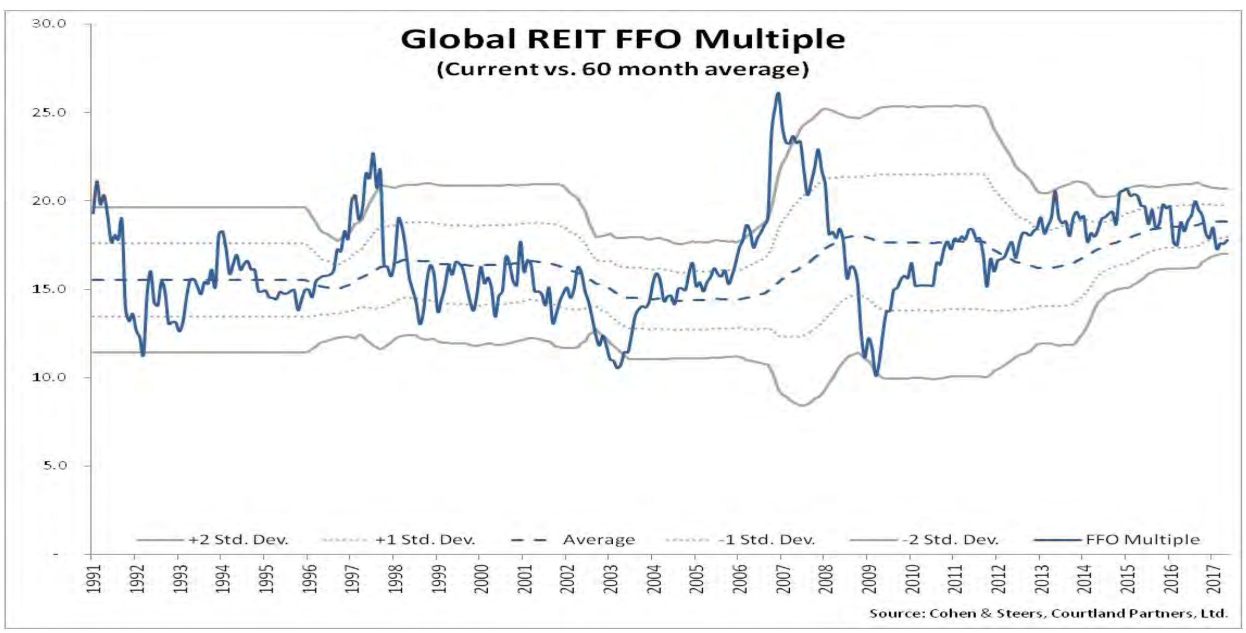
Global Premium/Discount to NAV. Global REITs are currently trading around an 8% discount to NAV on average. The discount to NAV has increased from 5% one year ago. The current reading is slightly below the 60 months average. Per this metric, it is fair to say that from an NAV basis, global REITs are trading close to fair value. However, if the NAV begins to trade at a premium, this would indicate that global REITs have become expensive on an NAV basis, suggesting a pull-back in REIT pricing may be imminent.



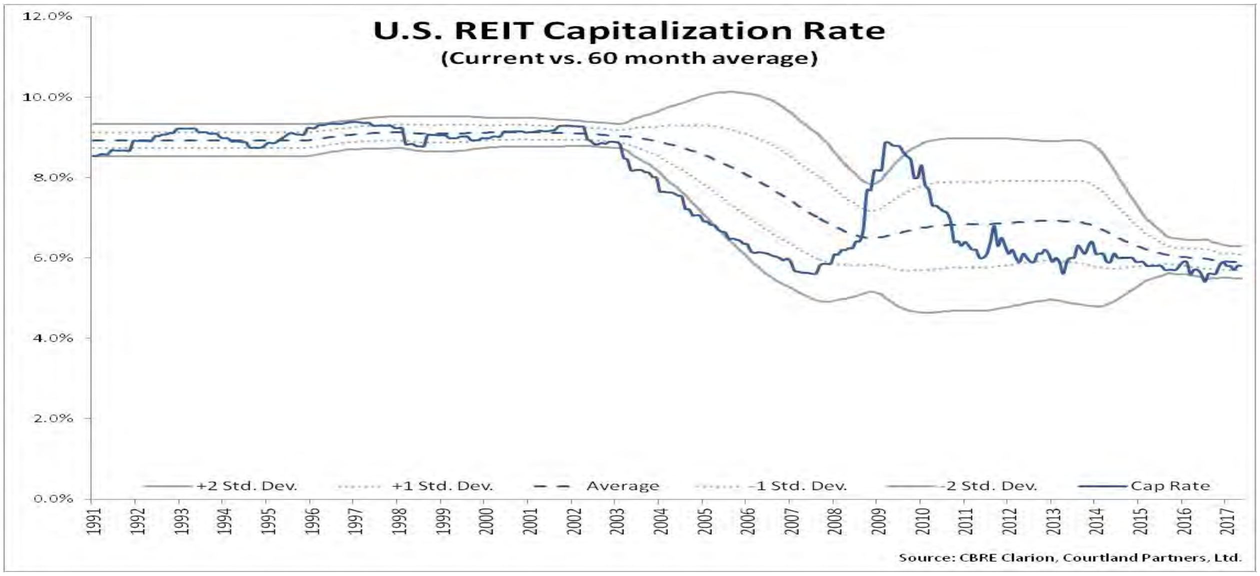
Global Dividend Yield. The FTSE EPRA/NAREIT Developed Index average dividend yield is currently 3.9%, which is slightly above the long-term average. It is important to compare where the REIT dividend yield is relative to the yields of fixed income alternatives. The 3.9% current dividend yield when compared to the 2.3% 10-Year U.S. Treasury yield offers a spread of 160 basis points. This current spread continues to remain above the historical long-term average spread of approximately 100 basis points. Historically, a "buy" signal for the REIT sector appears to occur when the REIT dividend spread to 10-Year U.S. Treasury is in excess of 150 basis points.



Global FFO Multiple. Based on current 12-month trailing funds from operations (FFO), global REITs are trading at a multiple 17.8 times trailing FFO. This FFO level has fallen from 18.3 one year ago. Historically, on average global REITs trade at a multiple of 18 times FFO.



U.S. REIT Implied Cap Rate. The U.S. REIT implied capitalization rate is currently 5.8%, or priced at approximately a 350 basis points premium to the 10-Year U.S. Treasury rate of 2.3%. Cap rates have increased slightly from the 5.7% level of a year ago. Like the dividend yield, it is important to compare where the REIT implied cap rate is relative to the yields of fixed income alternatives. The 350 basis points spread between REIT implied cap rates and the 10-Year U.S. Treasury is above the long-term historical average spread of approximately 300 basis points. Historically, a "buy" signal for the U.S. REIT sector appears to occur when the implied cap rate premium to the 10-Year U.S. Treasury is in excess of 400 basis points.



IV. 2017-2018 STRATEGIC OBJECTIVES

The financial model prepared by Courtland projects contributions/distributions for SJCERA's Portfolio through the end of 2020. The model shows that the core allocation will increase from its current 48% exposure to 61% primarily due to the recent $45 million allocation to RREEF America REIT II ("RAR II"). Significant distributions were received in 2016 and these are expected to continue over the next few years as 2007-2009 vintage funds continue to wind down. The opportunistic sector, in particular, is expected to provide significant distributions. However, the 2016 allocation to Greenfield Acquisition Partners VIII ("GAP VIII") is expected to keep the opportunistic sector relatively close to its long-term target of 20%. The value sector received major distributions in 2016 as three funds sold out of their remaining assets. In addition, there has not been a new allocation made to the value sector since 2014. Therefore, the value allocation is projected to decline to 22% compared to its 40% long-term target. In order to continue to develop an income-oriented portfolio while also keeping the Portfolio relatively in-line with its long-term core, value, and opportunistic targets, Courtland recommends accomplishing the following objectives in 2017-2018:

1. **SJCERA's real estate allocation is currently 12.5% and is over 15% when including unfunded commitments that are expected to be funded. The target allocation to real estate is currently 10%.** It is worth noting that there is a tactical range of +/- 1% from the real estate target, which provides for flexibility within the Portfolio. Based upon the projections of the portfolio model without including any new commitments, the SJCERA real estate allocation is expected to remain at or above its 10% target for 2017 and 2018. Assuming no new investment commitments are made, the Portfolio is expected to have allocations of 11% (2017), 10% (2018), 10% (2019), and 9% (2020).

   Even though the Portfolio's overallocation to real estate is expected to persist throughout 2017, Courtland believes that SJCERA should consider allocating to new investment opportunities in 2017 and 2018 based upon current market conditions, attractive opportunities in various segments of the marketplace, and capital anticipated to be distributed back in coming years. In addition, new commitments would help maintain vintage year diversification into the future as well as to help keep the Portfolio around its target allocation on a longer-term basis.

SJCERA approved a 40% core, 40% value, 20% opportunistic long-term target for the Portfolio in 2012. The Portfolio has made meaningful progress towards these goals over the past few years. Courtland continues to believe that this is the most effective way to achieve SJCERA's long-term, inflation-adjusted objective of a 6% net return while meeting its objectives.

Given the results of the financial model, while factoring in SJCERA's limit on equity investment in private real estate of no more than 2.5% of the value of the entire retirement fund during any one calendar year, Courtland would recommend that SJCERA consider up to $90 million of potential new commitments in 2017 and 2018 combined. Below sets forth what Courtland believes to be the best course of action for 2017 and 2018 (and potentially beyond) to achieve SJCERA's long-term real estate objectives.

2. **Core Investments: No new allocations.** SJCERA's commitment activity over the past few years has made a notable impact on the Portfolio's core exposure. The Portfolio's long-term core allocation is now projected to be approximately 61% by 2020 (it is currently approximately 48%). As a result, the Portfolio will have sufficient core exposure for the foreseeable future.

The Invesco U.S. Real Estate Securities Separate Account (the "Account") has been a part of the core allocation for many years. The Account has served as a proxy for traditional core real estate. However, SJCERA now has sufficient core exposure and will be above its long-term target to the sector. In addition to the usual montioring of the REIT metrics for potential modifications, Courtland may recommend redeeming shares to redeploy elsewhere in the Portfolio (or even in other non-real estate investments) given the new foundation of core funds that exists.

3. **Value Investments: Consider committing up to $90 million to value funds deemed to be opportunities that will help the Portfolio achieve its long-term objectives.** Courtland continues to see opportunities in the value space that will generate a large component of their return from current income. The Portfolio is projected to be 22% allocated to the value sector by 2020, which is below the 40% long-term target. We believe that there are attractive opportunities in this space and we would like to consider opportunities here in 2017-2018. Almanac, Angelo Gordon, and Colony are all expected to be back in the market over the next 18 months with their next fund offerings.

4. Opportunistic Investments: Consider committing up to $30 million to opportunistic funds if any opportunities are deemed to be unique opportunities with top-tier managers. SJCERA's current exposure to opportunistic is 24%. The Portfolio is expected to continue to receive significant distributions in this space over the next few years. However, SJCERA's 2016 commitment of $30 million to GAP VIII has largely filled the need to add to the opportunistic bucket. The Portfolio is projected to have opportunistic exposure of 17% by 2020, which is close to the 20% long-term target.

However, Courtland continues to see some attractive opportunities with managers in this sector. Therefore, we would recommend at least maintaining some flexibility in order to consider the prospect of adding one additional fund here over the next 18 months. In addition, this is a potential area to add some international exposure to the Portfolio.

5. **Property Type Considerations: There is no need to focus on a sector-specific product to fill a gap in the Portfolio.** Retail, which currently has the lowest exposure at 10%, is projected to increase to 14% by 2020. According to the financial model, the Portfolio is expected to have industrial exposure of 35% by 2020, which is high relative to industry benchmarks. Courtland continues to believe that the underlying conditions in industrial are favorable; therefore, this is overweight is acceptable. However, we would not recommend adding an industrial-only product to the Portfolio. In addition, the Portfolio currently has hotel exposure of 11%, which is high relative to industry benchmarks. However, the hotel exposure is expected to be only 2% by 2020. Courtland recommends considering these factors while making new allocation decisions.

6. Public Securities: The Portfolio's current exposure to public securities is 19%. This exposure is projected to increase to 23% according to the portfolio model assuming no new 2017-2018 allocations are made to public securities. It is important to note that the public securities allocations are held steady, while the private equity investments decrease in exposure due to the expected distributions over the coming years. As new private equity allocations are made, the public securities exposure as a percentage of the real estate portfolio should decline. The Policy calls for REITs to be between 0-30% of the allocation, therefore there is significant flexibility to tactically react to the market.

Courtland continues to recommend a regular review of current market conditions to take a tactical approach to the public securities allocation and may recommend modifications during the course of 2017-2018. To this end, Courtland has established a process with Staff and the Real Estate Committee for taking action in this area when conditions warrant. As previously described in the core section, Courtland may recommend redeeming shares within the Account to redeploy elsewhere in the Portfolio (or even in other non-real estate investments).

The Account is actively managed while the non-U.S. account is passively managed. Courtland may revisit pursuing a passive strategy for domestic securities.

7. International Investments: The Portfolio currently has 9% international exposure, primarily from the International public securities allocation. The model assumes that the BlackRock Index Fund remains within the Portfolio through 2020. Without any new allocations and holding this value steady per the financial modeling process, the Portfolio's international exposure is expected to remain around 10%. Any additional private equity allocations that do not include an international component would reduce the international exposure in the Portfolio.

International investments may consist of value or opportunistic strategies. The Policy allows for up to 20% of the Portfolio to be international. Courtland recommends that SJCERA remain open to the consideration of funds with international exposure in 2017-2018. There remain areas of distress and opportunity internationally. However, there is not a pressing need to add an international strategy given the current exposure level.

A potential consideration, subject to market and other portfolio conditions, for increasing the Portfolio's international exposure would be to reallocate some of the Invesco Account into the BlackRock Index Fund. This would be a relatively efficient way to increase international exposure without making a significant long-term commitment to the sector. In addition, it would reduce the Portfolio's core exposure while increasing its value exposure.

In summary, Courtland recommends that SJCERA consider making allocations to up to three real estate managers/funds primarily in the value sector with the possibility of an allocation to one opportunistic fund should an attractive opportunity present itself. New allocations may total up to $90 million. The main objective for 2017-2018 is for SJCERA to consider allocating to diversified investments which will maintain a sound and prudently managed portfolio. New value investments will be focused on continuing to improve the current income for the Portfolio. Any opportunistic investments will be focused on capitalizing on opportunities with top tier managers.

Courtland regularly monitors investment opportunities and may present funds to SJCERA throughout 2017 and 2018 for consideration. Contingent upon the approval of the Implementation Plan as well as the timing of the potential investment opportunities, Courtland may recommend scheduling Real Estate Committee meeting(s) to interview several firms as needed.