

San Diego City Employees' Retirement System

July 13, 2023

Real Estate Market Overview

Institutional Investment In Real Estate

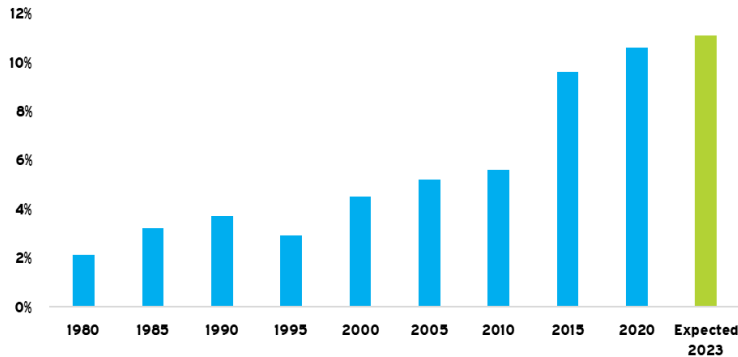
Global commercial real estate is estimated to be \$33tn, compared with Global debt securities at \$124tn and Global equities at \$110tn (Savills).

Commercial real estate is often included in an institutional investment portfolio to provide **diversification** and generate **income**. Private real estate can **reduce volatility** and serve as an **inflation hedge**.

In 1978 the National Council of Real Estate Investment Fiduciaries (NCREIF) established its Property Index to track and report real estate investment performance for institutional investors. That same year six investment management firms began contributing core real estate fund information to launch the NCREIF NFI-ODCE Index. Four of these firms continue to manage their “ODCE” funds today (Heitman, Morgan Stanley, PGIM and UBS).

Institutional investor allocations to real estate have increased steadily from approximately 2% in 1980 to nearly 11% today.

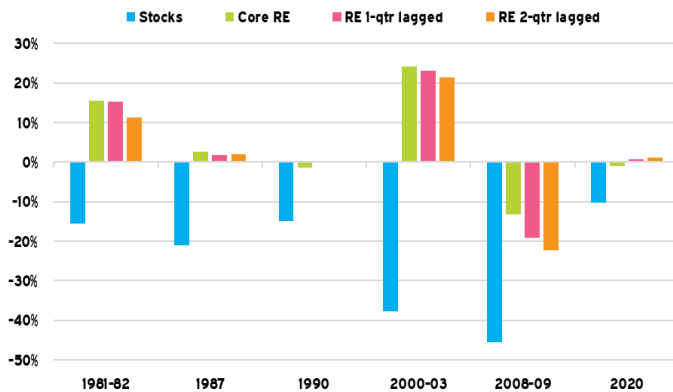
Increasing Institutional Allocations¹



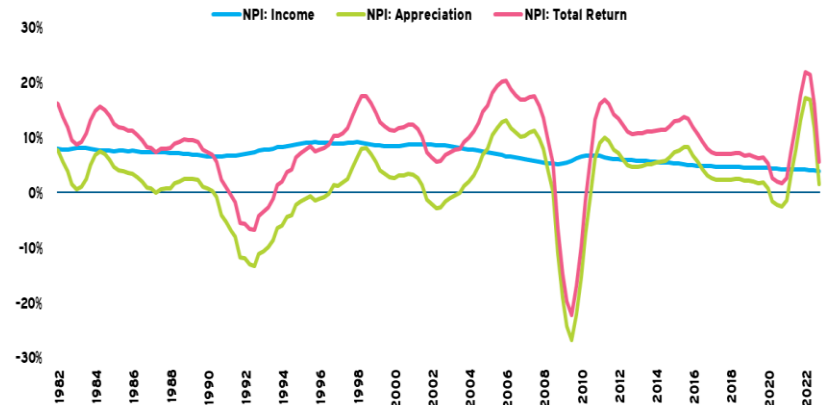
Performance Characteristics²

Historical Performance (1980-2022)			
	Core RE	Core Bonds	US Stocks
Return	8.6%	6.8%	11.6%
Standard Deviation	4.1%	5.6%	14.7%
Max Value Decline	-23.9%	-17.2%	-45.5%

Performance During Downturns³



Income Return Moderates Volatility⁴



¹ Source: Hodes Weill & Associates, 2022 Real Estate Allocations Monitor; ² Sources: NCREIF Property Index, Bloomberg Aggregate Bond Index, Russell 3000 Index; ³ NCREIF Property Index, Russell 3000 Index; ⁴ NCREIF Property Index

SDCERS Real Estate Investment History and Position

SDCERS is a long-term real estate investor has invested in the asst class since 1990.

The current allocation on a Fair Market basis is 11.7% vs. the 11% target allocation

Target portfolio exposure is 70% to Core and 30% to non-core.

SDCERS is primarily invested in the United States and in property types represented in the NFI-ODCE benchmark.

- Staff and Consultant consider supply and demand fundamentals in new allocation decisions.
- SDCERS is **underweight to the Office sector**, which is widely recognized as the sector with the most near-term demand uncertainty.
- During FY23, \$120M was committed to funds that invest in Industrial/Logistics or Multifamily properties; \$0 was committed to funds that invest in Office.

Trailing 1YR returns reflect changing market conditions:

Trailing Quarterly Returns (Net TWR)				
Period	1Q22	2Q22	3Q22	4Q22
SDCERS Return	6.8%	3.4%	0.3%	(4.0%)

Commercial Real Estate Market Observations

Since interest rates began rapidly increasing in mid-2022, U.S. real estate transaction volume has significantly declined as buyers reset pricing expectations.

- Values of public market real estate equity investments adjusted quickly and are down approximately 19% from March 2022 highs to March 2023.
- Values of private market real estate equity investments are slower to adjust because of “appraisal lag” and are down just 3.9% over the same time frame.

The increase in borrowing costs and lower available loan proceeds have negatively impacted borrowers.

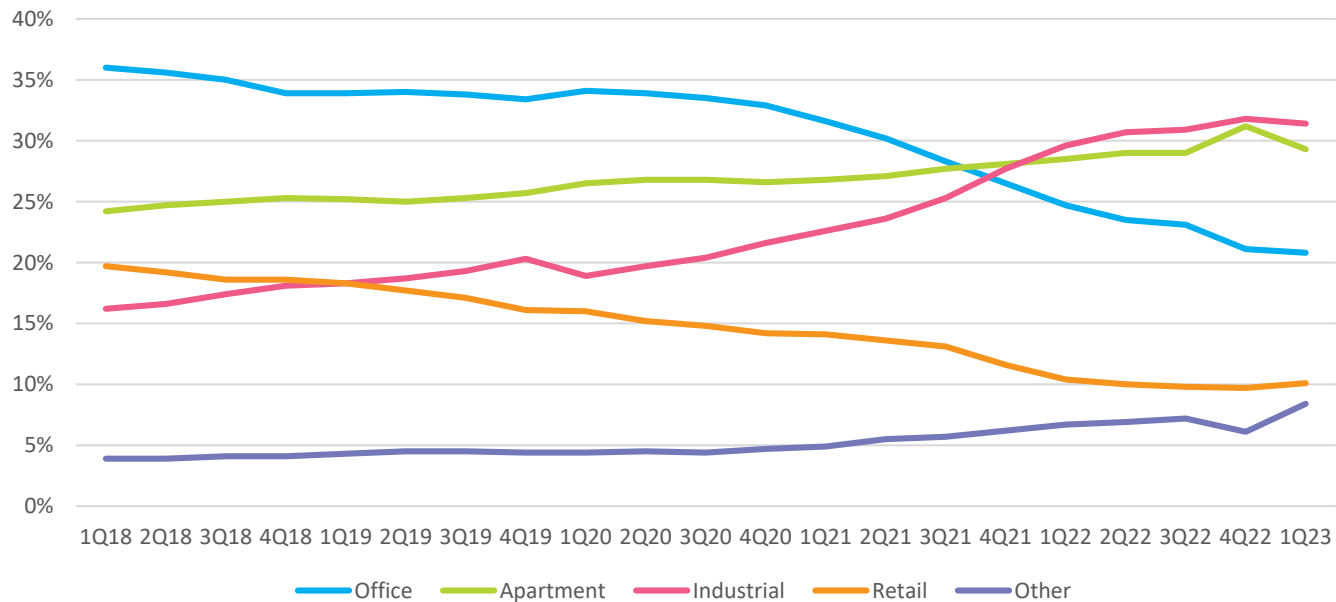
- Borrowers who used floating rate debt pay more in interest, reducing net cash flow
- Borrowers facing loan maturities and who prefer not to sell, may need additional equity or high-cost subordinate financing to supplement new loans with lower proceeds

Certain property types are more challenged than others.

- Older, commodity office faces the strongest headwinds
- Industrial/logistics, for-rent residential, and health-related real estate continue to benefit from favorable demand trends.
- Retail performance is mixed, with older regional malls continuing to suffer and community/neighborhood grocery anchored centers seeing steady tenant demand.

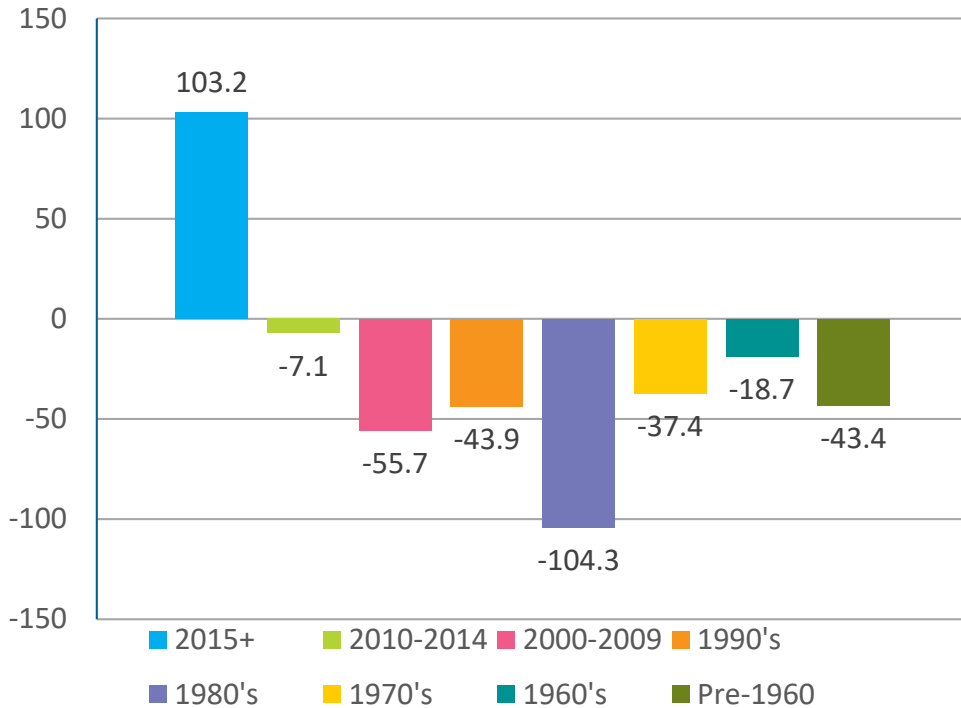
NFI ODCE Index Property Type Allocations

- COVID-19 and flexible Work From Home policies accelerated the downward trend in office allocations
- Industrial demand and rent growth has attracted more investor capital, at the expense of Retail
- Other, niche property types continue to garner increasing institutional investor interest (self storage, data centers, seniors housing, etc.)

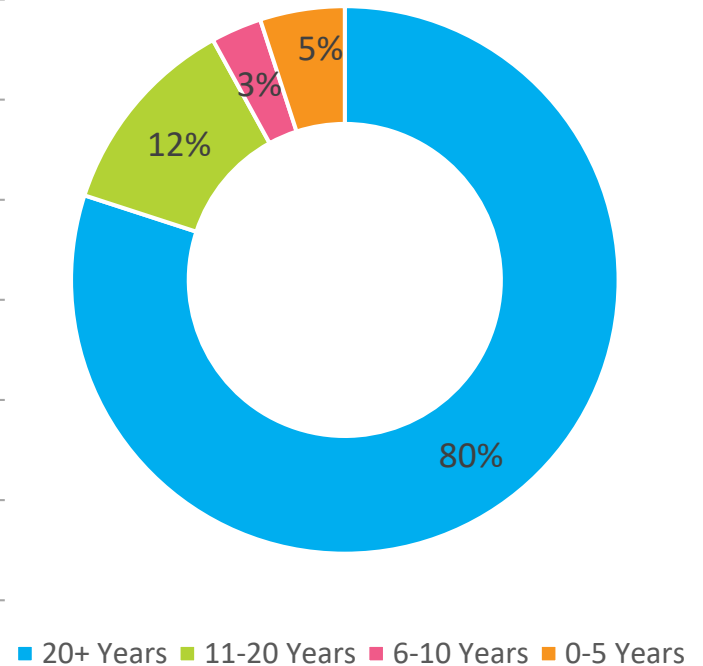


Office Leasing by Building Age

**Estimated Absorption Since March 2020
(MM Sq. Ft.)**

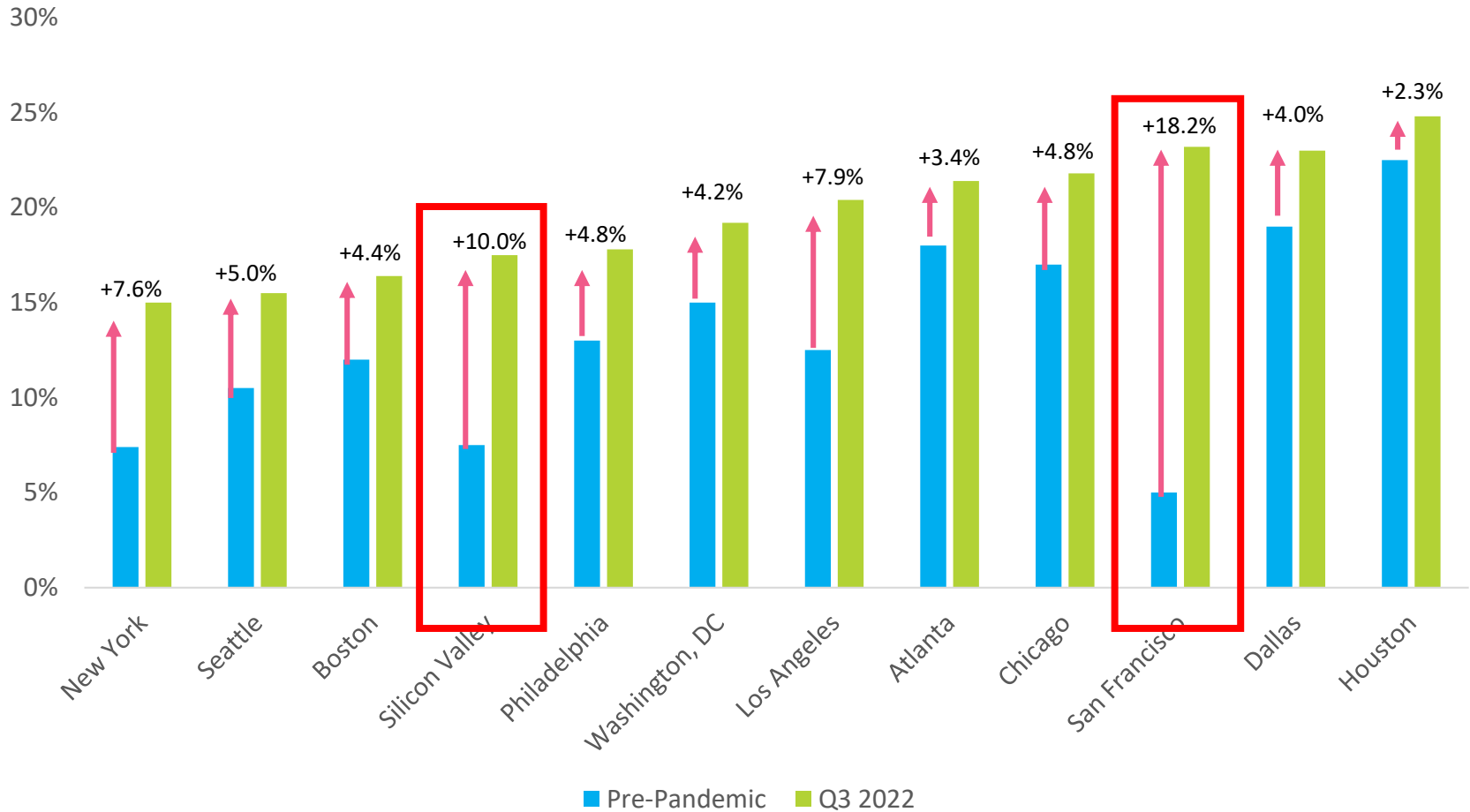


Age of U.S. Office Buildings



Source: JLL Research and CoStar

Office Vacancies on the Rise Across Top Markets



Source: JLL

Key Characteristics and Assumptions Affecting Office Owners

Characteristic	Trend	Impact
Effective Rents	Lower	Down 14% Since 1Q 2020
Vacancy	Increasing	Up from 12.9% in 1Q 2020 to 18.2% 4Q2022
Tenant Improvement Costs	Increasing	Increases Cost Basis
Leasing Commissions	Higher	Increases Cost Basis
Lease Term	Shorter	Less Predictable Cash Flow
Renewal Probability	Lower	Assumes Increasing Leasing Costs
Downtime Between Leases	Longer	Longer Periods of Lower Revenue
Financing Costs	Higher	Lower Net Cash Flow

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Fiscal Year 2024 Real Estate
Annual Investment Plan

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- B. Real Estate Program Overview
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- D. Portfolio Risk Assessment
- E. Capital Projections
- F. FY 2024 Recommendations for Approval
- G. Appendix
 - A. Investment Policy

A. Annual Investment Policy Statement Assessment

Annual Investment Policy Statement Assessment

- **Summary of Changes**
 - No changes to strategy or tactics
 - No changes to Investment Guidelines
 - Several clerical/formatting/grammatical changes
 - Consider areas of additional investment process flexibility
 - Potential delegation of investment selection subject to defined parameters
 - Maximum investment size
 - Qualified Manger
 - Favorable consultant opinion

B. Real Estate Program Overview

Real Estate Program Overview

Target Allocation and Funding Status

- **SDCERS has an 11% long term target allocation to real estate.**
 - 12/31/22 Market Value of \$1,206M
 - 12/31/22 Unfunded Commitments of \$296M

Risk Classifications

- SDCERS is slightly outside of its target ranges for Core and Non-Core but is expected to be in range as contributions to Non-Core funds are called and Core fund redemptions are paid.

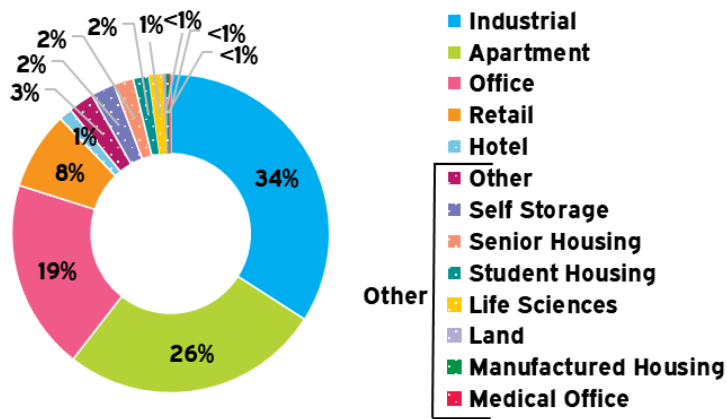
	Strategic Targets		Portfolio Composition (12/31/22)	
	Target	Tactical Range	NAV	NAV + Committed
Total Real Estate	11%	6% - 16%	11.7%	14.6%
Core Portfolio	70%	60% - 80%	81%	70%
Non-Core Portfolio	30%	20% - 40%	19%	30%

The SDCERS portfolio is in compliance with its leverage and diversification guidelines.

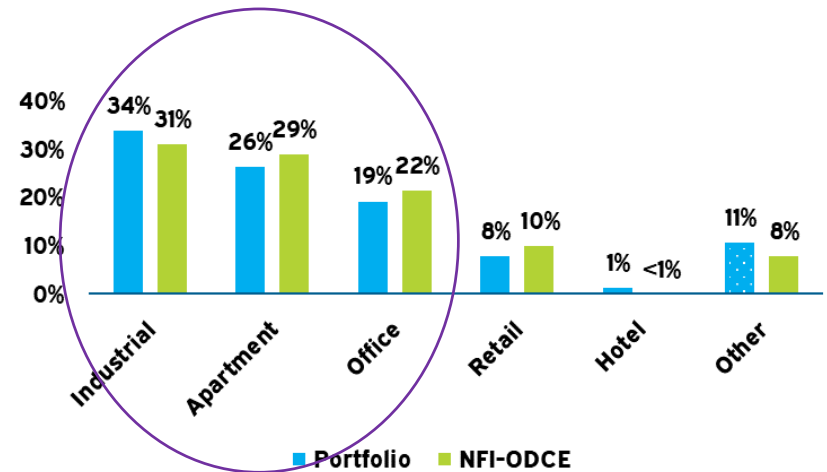
	Target	Guideline	Actual as of 12/31/22	In Compliance
Core Leverage	20% - 30%	<45%	26%	Yes
Portfolio Leverage	35% - 45%	<50%	33%	Yes
Debt Investments		<30%	11%	Yes
Single Manager		<30% (Includes Unfunded)	12% (Morgan Stanley / Mesa West)	Yes
Property Type		+/- 15% of ODCE	+/-4% (Industrial/Office/Multifamily)	Yes
Geographic Region		+/- 15% of ODCE	- 4% (West)	Yes
Non-U.S.		<15%	4%	Yes

Property Type Diversification

Real Estate Portfolio FMV



Portfolio vs. NFI-ODCE Index



Key Observations

- Broadly diversified by property type, including (Other) niche sectors
- In compliance with policy guidelines
- Favorably overweight Industrial
- Favorably underweight Office
- Unfavorably underweight Apartments

C. Update on FY 2023 Objectives

FY 2023 Annual Investment Plan Update:

- **Core Real Estate Portfolio**
 - Complete liquidation of DWS IMA
 - *Monitor entity dissolutions and escrow releases*
 - Remain in redemption queue for UBS Trumbull Property Fund
 - *In exit queue: UBS Trumbull continues to lag the benchmark (2022 4th Quartile)*
 - Consolidate Core ODCE Fund holdings from seven funds (excluding UBS) to five or six funds
 - *Submitted full redemption request from MetLife Core Property Fund*
 - Commit additional capital to Clarion LIT (\$45M) and DWS CPIF (\$25M)
 - *Clarion LIT funded, in full, in January 2023*
 - *DWS CPIF estimates capital will be called during the next few quarters*
 - Evaluate reallocating from Core Debt to Core Plus Equity
 - *Monitored performance; Core Debt funds underperformed the benchmark over the 1-YR, 3-YR and Since Inception (2018) periods*

FY 2023 Annual Investment Plan Update:

- **Non-Core Real Estate Portfolio**

- Make three to four new commitments totaling \$100M
 - \$50M - \$75M in value-add multifamily – *Committed \$50M*
 - \$25M - \$50M in diversified value-add and/or sector specific strategy – *Elected not to commit additional capital as Real Estate exposure increased from 10.3% to 11.7% during 2022, compared to the 11% target*
 - RE Portfolio increased from \$1.1B to \$1.2B; Total Plan decreased from \$11.0B to \$10.3B
- Consider re-up opportunities: compare with competing funds
 - Waterton (multifamily) and Torchlight (debt) - *\$25M committed to Waterton; Torchlight is under review*
- Evaluate co-investment opportunities – *Elected not to pursue the one available deal*
- Explore secondary market pricing for legacy fund tail-end positions – *Pricing not attractive*

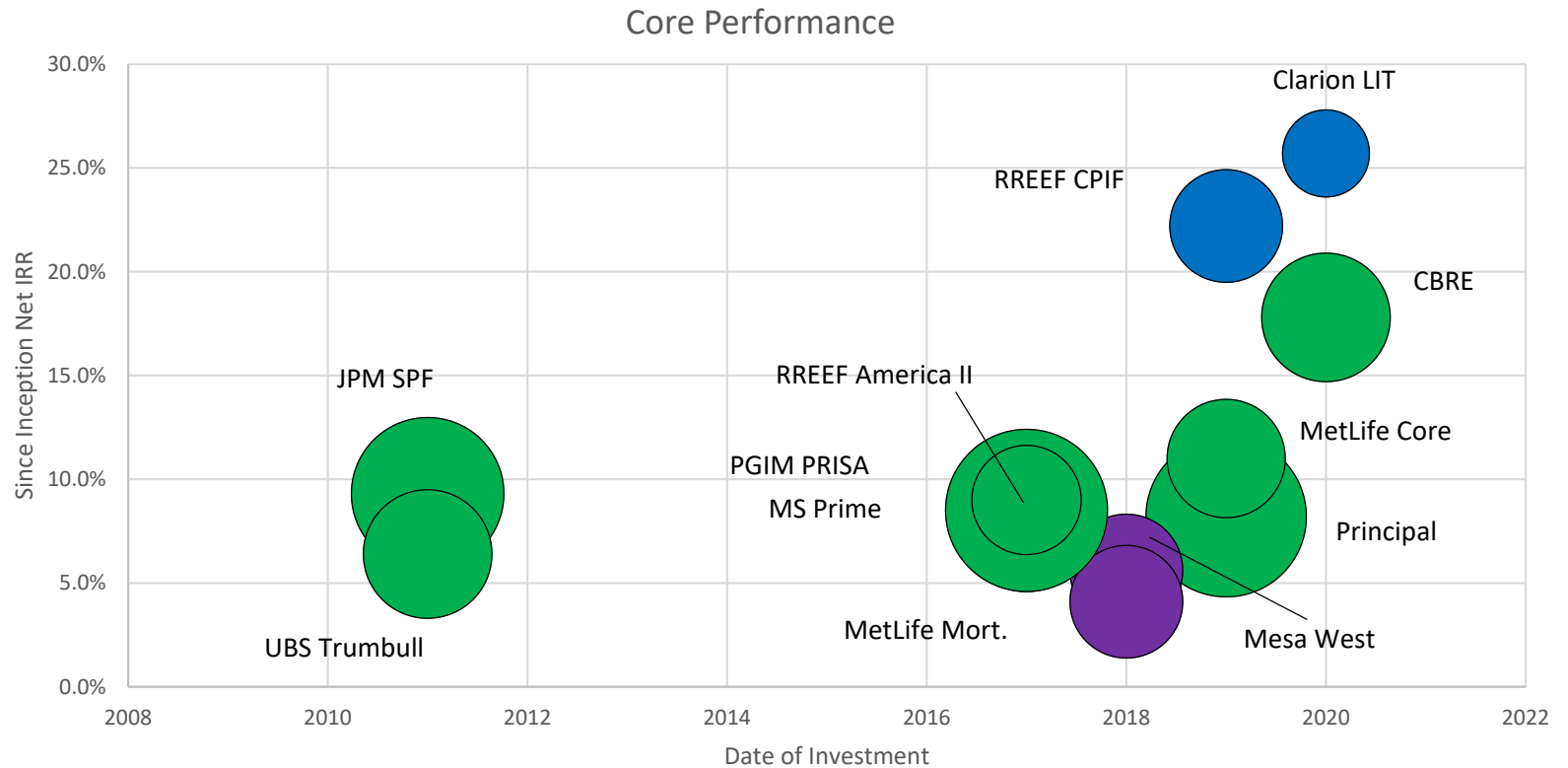
D. Portfolio Risk Assessment

Portfolio Risk Assessment Summary

- **Core / Core Plus Funds**
 - Five of eight ODCE funds are outperforming the ODCE Index the past three years
 - Both core debt funds delivered low/mid single digit returns the past three years
 - Both core plus industrial funds delivered 20%+ returns the past three years
- **Non-Core Funds**
 - Opportunistic funds have a wider return dispersion than value-add funds
 - All value-add funds are generating a positive since inception IRR
- **Funds Tracking Below 5% IRR**
 - Seven funds with current combined fair market value of \$40M, representing 3% of the total real estate portfolio
 - Two of the funds, representing half of the \$40M exposure are of a recent vintage and still investing capital

Core Portfolio Risk / Performance Snapshot¹

Core Debt ODCE Core Plus Industrial



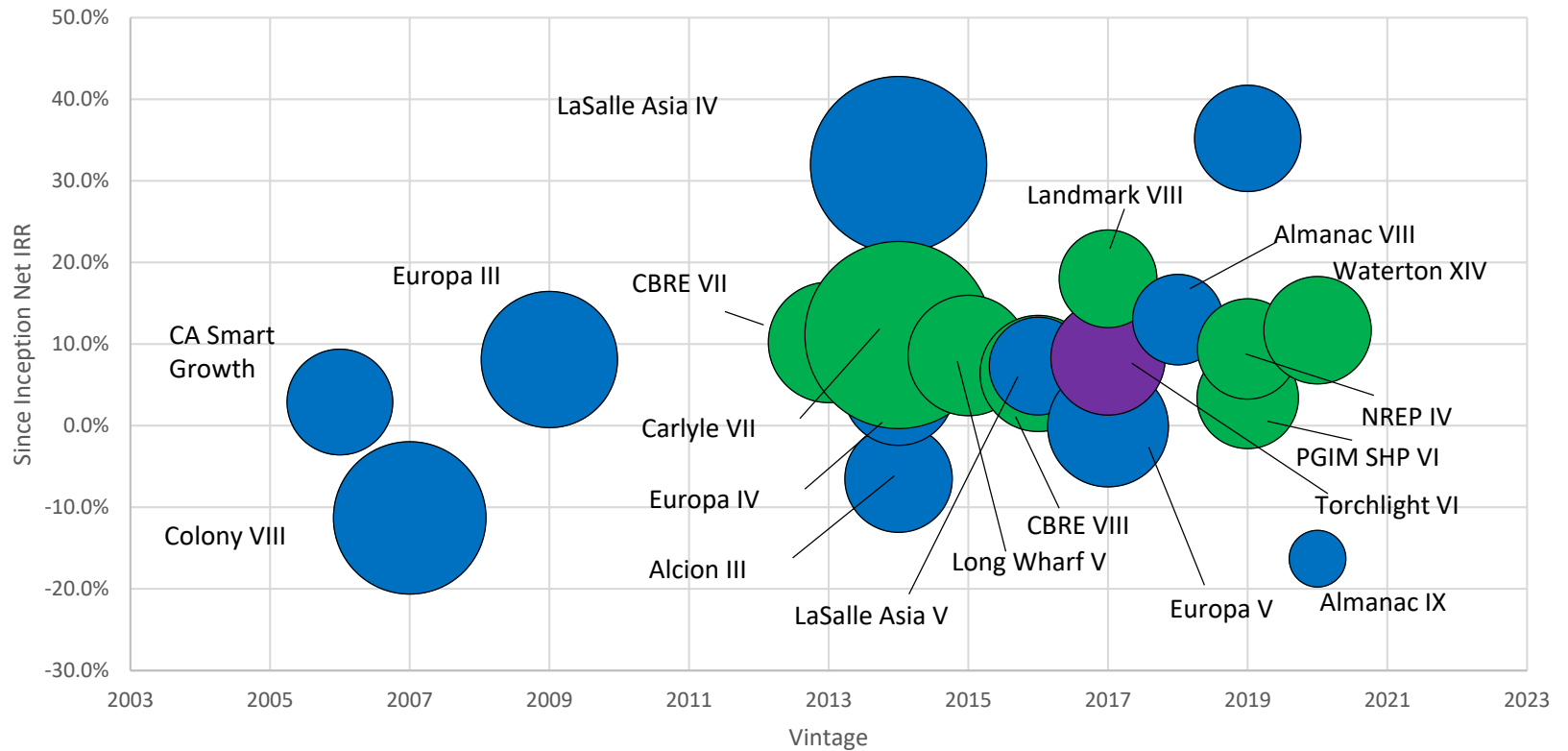
¹ Bubble size based on historical contributions

Core / Core Plus Snapshot

Fund	3YR Net TWR as of 12/31/22	Year over Year Change	Net Entry/Exit Queue as of 12/31/22	Net Entry/Exit Queue as of 12/31/21
UBS TPF	4.8%	+2.6%	Exit	Exit
JP Morgan SPF	7.7%	+0.2%	Exit	Entry
Principal	8.8%	-0.6%	Exit	Entry
<i>ODCE (Net) Value Weight</i>	9.0%	+0.8%		
PRISA	9.1%	No Change	Exit	Entry
Morgan Stanley Prime	9.3%	No Change	Exit	Entry
RREEF America II	10.5%	+0.5%	Exit	Entry
MetLife	11.3%	+0.1%	Exit	Entry
CBRE Core	13.5%	-0.7%	Exit	Entry
MetLife Core Mortgage	3.4%	-1.1%	Exit	Entry
Mesa West Lending	5.1%	-0.9%	Exit	Entry
DWS CPIF (Core Plus Industrial)	23.2%	+2.3%	Entry	Entry
Clarion LIT (Core Plus Industrial)	25.7%	+3.5%	Exit	Entry

Non-Core Portfolio Risk / Performance Snapshot – 2020 Vintage or Earlier¹

Debt Value-Add Opportunistic



¹ Bubble size based on historical contributions

Summary Table for Closed-End Funds Marked at 5% net IRR or lower

Fund	Vintage	4Q22 NAV (\$MM)	Since Inception IRR	Comment
Cal Smart Growth IV	2006	\$0.5	2.9%	Fund is in orderly liquidation; final asset is expected to be sold in 2023
Colony VIII	2008	<\$0.1	-11.3%	Invested at market peak; remaining NAV is cash
Alcion III	2014	\$8.2	-6.5%	Exposure to traditional office and Chicago apartments; Returns declined by 450 bps since last year
Europa IV	2014	\$3.5	4.4%	Exposure to U.K., Spain and Italy; Mix of residential, office and retail; Returns improved by 70 bps since last year
Europa V	2017	\$8.2	-0.1%	Returns declined by 320 bps since last year; exits expected to be challenged in the near term
PGIM SHP VI	2019	\$14.8	3.4%	Senior Housing Fund impacted by COVID-19 and J-Curve; Returns improved by 330 bps since last year
Almanac IX	2020	\$4.5	-16.3%	Primarily related to J-Curve typical of closed-end funds of a recent vintage
Total		\$39.8 / ~3% of RE Portfolio		Exposure increased by \$3.7M since last year

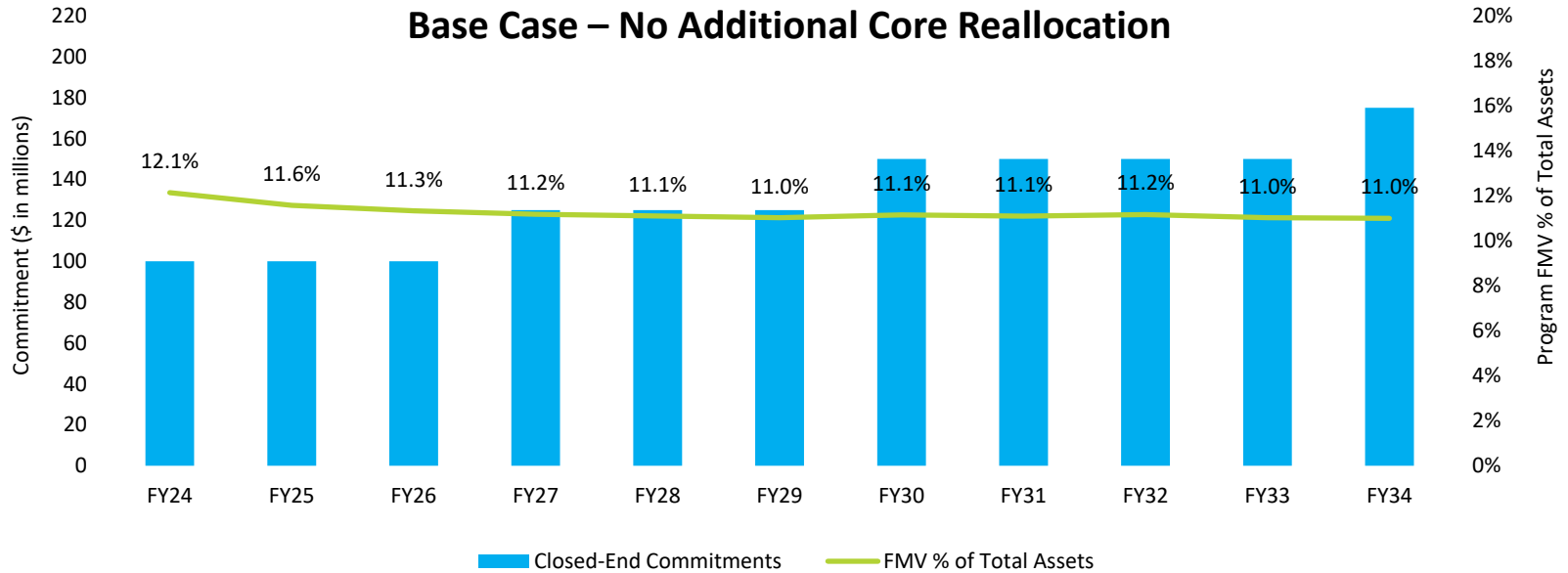
E. Capital Projections

FY 2024 Portfolio Considerations

- **Exposure Targets**
 - Manage overall exposure down from 11.7% toward 11% target
 - Manage Core/Non-Core allocation from 81 / 19 toward 70 / 30 target
- **Property Type Allocations**
 - Remain underweight Office
 - Remain overweight Industrial
 - Increase Multifamily to at least neutral weight
- **Core Portfolio Composition**
 - Evaluate options to reallocate underperforming Core Debt investments to high conviction Core Plus strategies
- **Non-Core Portfolio Composition**
 - Focus new activity on sectors with favorable supply/demand fundamentals and/or demographic tailwinds (invest with specialists)
 - Take advantage of period of capital market dislocation through structured debt

FY 2024 Capital Projections Summary

- **Overall Objectives**
 - Manage overall exposure down from current 11.7% to the **10.5% - 11.5% range**
 - Gradually reduce Core exposure down from 80% toward **70% target**
 - Maintain steady non-core commitment pace to avoid vintage concentration
 - **Focus on value-add strategies**
- **Base Case – No Reallocation of Core**
 - \$100M in new non-core commitments
 - Estimated \$43M in core redemptions (UBS Trumbull and MetLife)
- **Alternate Case (Recommended) – Reallocation of \$100M of Core Debt to Core Plus**
 - Same as Base Case, plus:
 - \$25M in new core plus commitments (per year x 4)
 - Additional \$33M in core debt redemptions (per year x 3)



Commitment Allocations

	FY24	FY25	FY26	FY27	FY28	FY29	FY30	FY31	FY32	FY33	FY34
Opportunistic	0	25	0	0	25	0	0	25	0	0	25
Value-Added	75	75	100	100	100	125	125	125	150	125	150
RE Debt	25	0	0	25	0	0	25	0	0	25	0
Closed-End Total	100	100	100	125	125	125	150	150	150	150	175

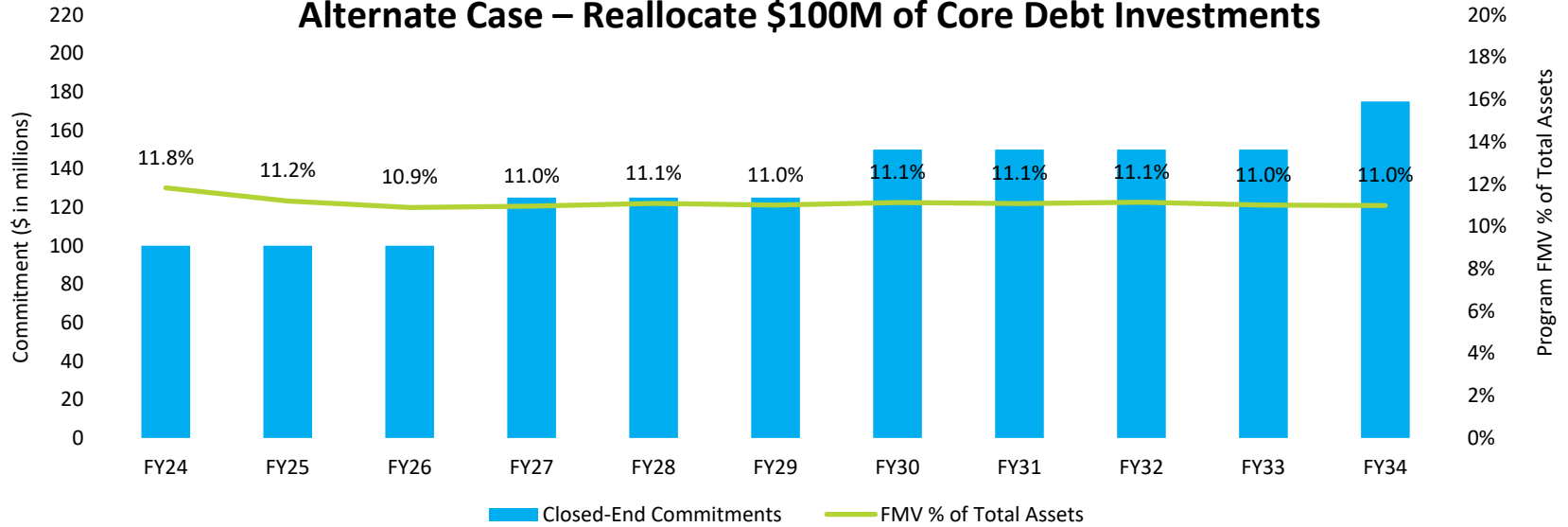
Core

<i>Commitments</i>	0	0	0	0	0	25	0	25	0	25	0
<i>Redemptions</i>	43	43	8	8	0	0	0	0	0	0	0

Fair Market Value by Strategy

	Target Allocation	FY24	FY25	FY26	FY27	FY28	FY29	FY30	FY31	FY32	FY33	FY34
Opportunistic	0% - 40%	8%	8%	7%	6%	5%	4%	3%	3%	3%	2%	2%
Value-Added	0% - 40%	10%	12%	14%	16%	19%	22%	24%	25%	27%	28%	29%
RE Debt	0% - 30%	3%	3%	3%	3%	3%	2%	2%	2%	2%	2%	2%
Core	60% - 80%	80%	78%	77%	75%	74%	72%	71%	70%	69%	68%	67%
Total		100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Alternate Case – Reallocate \$100M of Core Debt Investments



Commitment Allocations

	FY24	FY25	FY26	FY27	FY28	FY29	FY30	FY31	FY32	FY33	FY34
Opportunistic	0	25	0	0	25	0	0	25	0	0	25
Value-Added	75	75	100	100	100	125	125	125	150	125	150
RE Debt	25	0	0	25	0	0	25	0	0	25	0
Closed-End Total	100	100	100	125	125	125	150	150	150	150	175
Core											
<i>Commitments</i>	25	25	25	25	0	25	0	25	0	25	0
<i>Redemptions</i>	76	76	41	8	0	0	0	0	0	0	0

Fair Market Value by Strategy

	Target Allocation	FY24	FY25	FY26	FY27	FY28	FY29	FY30	FY31	FY32	FY33	FY34
Opportunistic	0% - 40%	8%	8%	7%	6%	5%	4%	3%	3%	3%	2%	2%
Value-Added	0% - 40%	10%	12%	14%	17%	19%	22%	24%	25%	27%	28%	29%
RE Debt	0% - 30%	3%	3%	3%	3%	3%	2%	2%	2%	2%	2%	2%
Core	60% - 80%	79%	77%	76%	75%	74%	72%	71%	70%	69%	68%	67%
Total		100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

F. FY 2024 Recommendations for Approval

FY 2024 Capital Recommendations:

- **Core Real Estate Portfolio**
 - Complete liquidation of DWS IMA
 - *Expected to be fully dissolved by 3Q23*
 - Remain in redemption queue for UBS Trumbull Property Fund (\$32M remaining)
 - *Full redemption could take three years*
 - Remain in redemption queue for MetLife Core Fund (\$69M remaining)
 - *Full redemption could take several quarters*
 - Evaluate further consolidation of Core ODCE Fund holdings from six to five (excluding UBS and MetLife)
 - *Potential to reduce fees without materially reducing diversification*
 - Reallocate up to 100% of Core Debt Fund holdings (Mesa West - \$50M and MetLife Mortgage - \$50M) to Core Plus Equity
 - *Core Plus offers additional return potential through a mix of income and appreciation*

FY 2024 Capital Recommendations:

- **Non-Core Real Estate Portfolio**
 - Make three to four new commitments totaling **\$100M**
 - **\$50M - \$75M** in sector specific strategies supported by favorable demand trends and/or demographics
 - Residential, logistics, healthcare, self-storage, data center, hospitality, neighborhood/community retail
 - **\$25M - \$50M** in structured real estate debt
 - Consider re-up opportunities: compare with competing funds
 - Torchlight (Debt), Ares/Landmark (Secondaries)
 - Consider additional commitment to Waterton XV (apartments)
 - Evaluate co-investment opportunities
 - Monitor secondary market pricing of legacy fund tail-end positions

G. Appendix

A. Real Estate Investment Policy

See Real Estate Investment Policy in Attachment

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