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Real Estate Portfolio

# Fiscal Year 2022 Investment Plan

July 8, 2021

# SDCERS

San Diego City Employees' Retirement System



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# A. Real Estate Investment Policy Review



# Real Estate Investment Policy Review

- The key highlights of SDCERS’ Real Estate Investment Policy are summarized below.
- This policy is reviewed annually alongside the Annual Investment Plan.
- Townsend reviewed the policy and is not recommending any changes at this time.
- The full policy is attached in section G of this report.

PROGRAM FRAMEWORK	STRATEGIC GOALS	RISK CONTROLS
<p><b>ALLOCATION TO REAL ESTATE</b></p> <ul style="list-style-type: none"> <li>• 11% of total plan assets*</li> </ul>	<p><b>RETURN OBJECTIVE</b></p> <ul style="list-style-type: none"> <li>• Generate income and provide diversification benefits to the total portfolio, while providing competitive returns relative to the benchmark.</li> </ul>	<p><b>INVESTMENT DIVERSIFICATION</b></p> <ul style="list-style-type: none"> <li>• Single Manager: 30% Limit</li> </ul>
<p><b>CORE/NON-CORE BLEND</b></p> <p><b>Core: 60%-80% of Total Real Estate</b>  <i>Structural Core: 56-80% of Core</i>  <i>Tactical Core Equity: 0-24% of Core</i>  <i>Tactical Core Debt: 0-15% of Core</i></p> <p><b>Non-Core: 20%-40% of Total Real Estate</b>  <i>Value-Add: 0-100% of Non-Core</i>  <i>Opportunistic: 0-100% of Non-Core</i></p>	<p><b>BENCHMARK</b></p> <ul style="list-style-type: none"> <li>• The Total Real Estate Portfolio Benchmark over a five-year rolling period is the net NCREIF Fund Index Open-end Diversified Core Equity Index (“NFI-ODCE”) + 50 basis points (“bps”).</li> </ul>	<p><b>GEOGRAPHIC DIVERSIFICATION</b></p> <ul style="list-style-type: none"> <li>• Maximum of 25% outside the United States.</li> <li>• For each U.S. region: Within +/- 15% of NFI-ODCE</li> </ul>
	<p><b>DIVERSIFICATION</b></p> <ul style="list-style-type: none"> <li>• Low or negative correlation with stock and bond returns.</li> </ul>	<p><b>DIVERSIFICATION BY PROPERTY TYPE</b></p> <ul style="list-style-type: none"> <li>• For each property type: Within +/- 15% of NFI-ODCE</li> </ul>
		<p><b>LEVERAGE LIMIT</b></p> <ul style="list-style-type: none"> <li>• Total Portfolio: LTV ≤ 50%</li> <li>• Core: ≤40%</li> <li>• Value-Add: ≤65%</li> <li>• Opportunistic: ≤85%</li> </ul>

\*Long-term target. Medium-term target of 13% was approved in 2017.

## B. Real Estate Program Overview



## Real Estate Program Overview

### Target Allocation & Funding Status

- SDCERS has an 11% long term target allocation to real estate.
  - 12/31/20 Market Value of \$1,021 M (10.5%)
  - 12/31/20 Unfunded Commitments of \$194 M (2.0%)

### Risk Classifications

- SDCERS is outside of its target ranges for Core and Non-Core but will be within range once Core redemption requests\*\*\* are fulfilled, IMA asset sales are completed, and recent Non-Core commitments are called.

	Strategic Targets		Portfolio Composition (12/31/2020)	
	Target Allocation	Tactical Range	Funded	Funded & Committed
<b>Total Real Estate</b>	<b>11%</b>	<b>N/A</b>	<b>10.51%</b>	<b>12.51%</b>
<b>Core Portfolio</b>	<b>70%</b>	<b>60% - 80%*</b>	<b>86.60%*</b>	<b>73.26%*</b>
<i>Structural Core</i>		<i>56% - 80%**</i>	<i>71.90%**</i>	<i>71.39%**</i>
<i>Tactical Core Equity</i>		<i>0% - 24%**</i>	<i>16.92%**</i>	<i>17.51%**</i>
<i>Tactical Core Debt</i>		<i>0% - 15%**</i>	<i>11.18%**</i>	<i>11.10%**</i>
<b>Non-Core Portfolio</b>	<b>30%</b>	<b>20% - 40%*</b>	<b>13.40%*</b>	<b>26.74%*</b>
<i>Value Add Portfolio</i>		<i>0% - 100%**</i>	<i>31.03%**</i>	<i>42.46%**</i>
<i>Opportunistic Portfolio</i>		<i>0% - 100%**</i>	<i>68.97%**</i>	<i>57.54%**</i>

\*Of SDCERS Total Real Estate Portfolio

\*\*Of SDCERS Core/Non-Core Portfolio

\*\*\*\$80 million of redemptions outstanding: AEW Core Property Trust (\$39.2 million) and UBS Trumbull Property Fund (\$40.8 million)

## Real Estate Compliance with Strategic Plan Guidelines

- As IMA asset sales continue, Core redemption requests are fulfilled and commitments to Non-Core are funded, the portfolio will reach compliance with tactical ranges.

	Target	Tactical Range	In Compliance	Funded (as of 12/31/20)
<b>Portfolio Construction</b>				
Target Real Estate Allocation	<b>11%</b>	<b>6% - 16%</b>	✓	<b>10.5%</b>
Core	<b>70%</b>	<b>60% - 80%*</b>	X	<b>86.6%</b>
<i>Structural Core</i>		<i>56% - 80%**</i>	✓	71.9%
<i>Tactical Core Equity</i>		<i>0% - 24%**</i>	✓	16.9%
<i>Tactical Core Debt</i>		<i>0% - 15%**</i>	✓	11.2%
Non-Core	<b>30%</b>	<b>20% - 40%*</b>	X	<b>13.4%</b>
<i>Value-Add</i>		<i>0% - 100%**</i>	✓	30.9%
<i>Opportunistic</i>		<i>0% - 100%** / &lt;20%*</i>	✓	69.1% / 9.3%
Leverage	<b>40%</b>	<b>&lt;50%</b>	✓	<b>27.7%</b>
<b>Diversification</b>				
Private Markets – Non-Equity Investments	N/A	<30%	✓	9.7%
Public Markets Exposure	N/A	<15%	✓	0.0%
Single Manager – Commingled Fund		<30%	✓	Largest manager is Principal at 10.6%
Property Type		+/- 15% NFI-ODCE	✓	-
Geographic Region		+/- 15% NFI-ODCE	✓	-
International Exposure		<25%	✓	3.6%

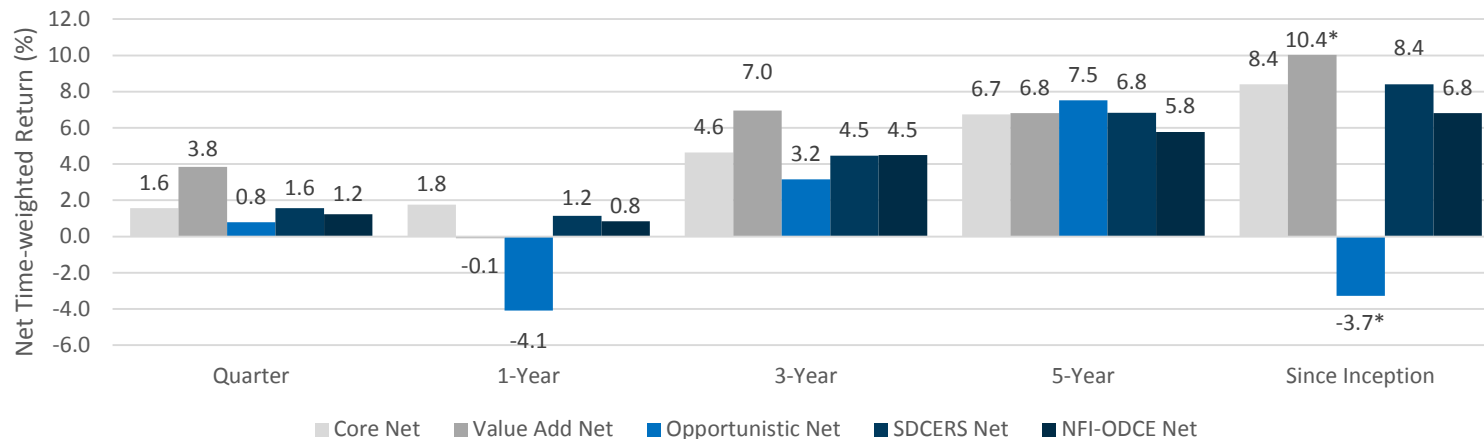
\*Of SDCERS Total Real Estate Portfolio

\*\*Of SDCERS Core/Non-Core Portfolio

# Real Estate Performance Detail

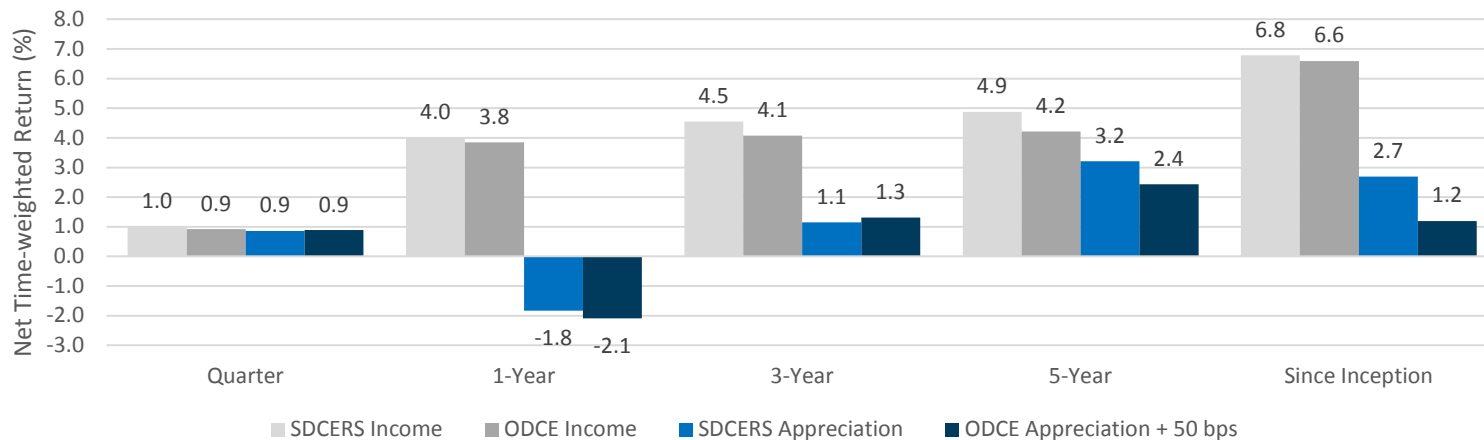
## Returns by Risk Category

Net Time-weighted Returns (%) as of 12/31/20



## Income & Appreciation Returns

Time-weighted Returns (%) as of 12/31/20



\*Value Added and Opportunistic have different inception start dates than the total portfolio

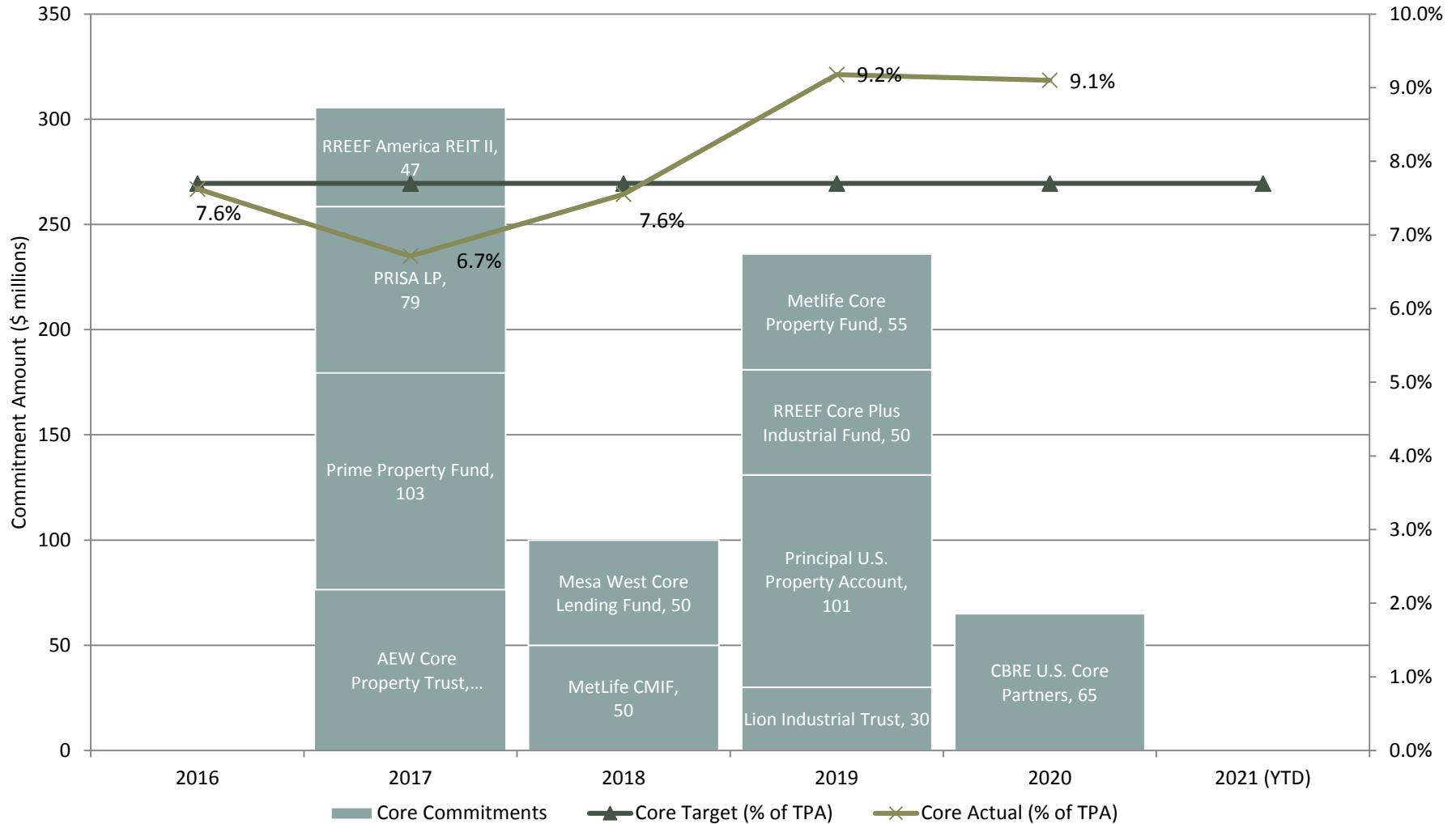


## C. Commitment History & Update on FY2021 Objectives

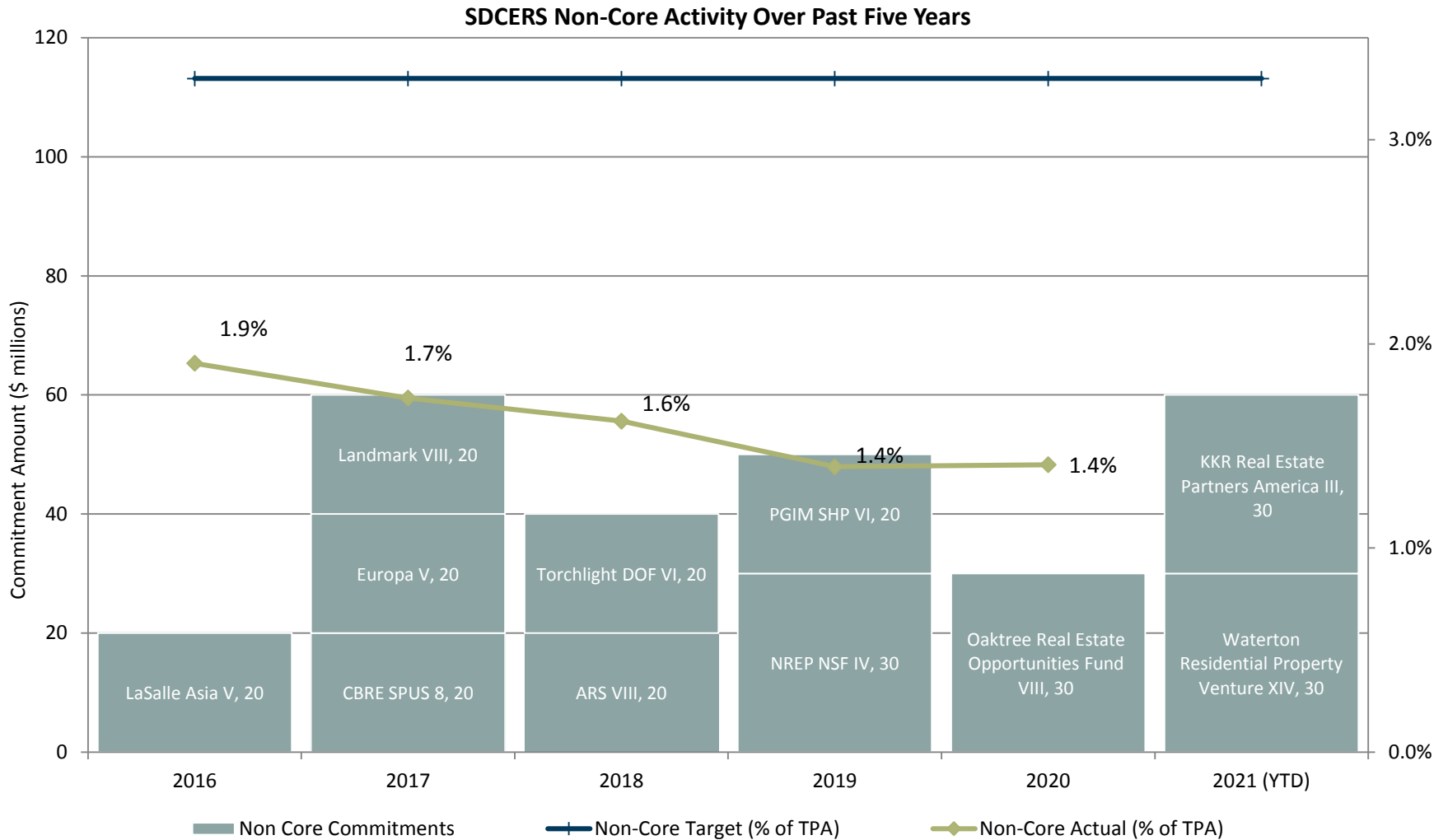


# Core Commitment Activity

## SDCERS Core Commitments Over Past Five Years



# Non-Core Commitment Activity



## Update on FY 2021 Annual Investment Plan Objectives

The FY 2021 Annual Investment Plan included the following capital recommendations:

### Core Real Estate Rebalancing Plan

- Continue DWS IMA Transition Plan
  - Target sales of remaining two assets (~\$27 million) once market environment improves
  - **2021 Update: 1 of 2 remaining assets is scheduled to sell by the end of the fiscal year after COVID-19 delayed exit plans. The last remaining asset is expected to be sold in the second half of 2021.**
- No additional Core fund commitments/redemptions were recommended after significant rebalancing activity in prior years.

### Non-Core Real Estate

- Target up to \$60 million of new commitments for Non-Core strategies
  - Target 2-3 funds at \$20-30M each
  - **2021 Update: \$60 million were committed to two funds:**
    - **A \$30 million commitment to Waterton Residential Property Venture XIV and a \$30 million commitment to KKR Real Estate Partners America III both closed in 1Q 2021.**

### Overall Considerations

- Decrease office exposure to reach an underweight position
  - **2021 Update: SDCERS' office exposure decreased from 32.1% at year-end 2019 to 29.4% at year-end 2020 through funding of new non-office investments. The current underweight compared to the NFI-ODCE office exposure is 3.5%.**
- Maintain retail underweight and industrial overweight
  - **2021 Update: SDCERS has a 2.6% underweight to retail and a 5.4% overweight to industrial compared to the benchmark exposures.**
- Focus on fee savings to lower gross-to-net spread across the portfolio
  - **2021 Update: The commitment to KKR Real Estate Partners America III came with a 75 bps fee break on unused capital during the commitment period (50bps through Townsend negotiated aggregation and 25bps through timing of closing).**



## D. Portfolio Risk Assessment



# Relative Risk Positioning



Funds are categorized by risk style (Core Debt, Core Equity, Value-Added, Opportunistic), but within risk styles funds are not ranked in any particular order.

Source: Managers, Townsend; Actual, projected, and realized fund returns are reported net of fees and current as of 12/30/2020 unless otherwise noted

*Denotes funds with challenged vintage years 2005-2008 (see next slide)*

*Italics denotes new and approved commitments*

*\*net of all fees and expenses, but before the fund level performance fee*

## Relative Risk Positioning

Notes            Green denotes funds with a Value-Added strategy  
                       Blue denotes funds with an Opportunistic strategy

### Vintage Years and Expected Conclusion Dates for challenged funds:

Fund Name	Vintage Year	Estimated Termination
Invesco Real Estate Fund I	2005	Liquidated
Cornerstone Hotel Income and Equity Fund I	2006	Liquidated
California Smart Growth Fund IV	2006	2022 <sup>(1)</sup>
Capmark (NREP) Structured Real Estate Partners	2006	Liquidated
Fidelity Real Estate Growth Fund III	2007	Liquidated
Cornerstone Apartment Venture III	2007	Liquidated
Cornerstone Hotel Income and Equity Fund II	2008	Liquidated
Invesco Real Estate Fund II	2008	Liquidated
Colony Investors VIII	2008	2020 <sup>(2)</sup>

Source: Manager, Townsend

(1) Fund term expired 9/23/2014; PCCP was granted an extension of the fund term through 2018. Fund currently holds 4 remaining assets, 3 of which are expected to be sold in 2021 with the final disposition expected in 2022.

(2) Fund NAV solely comprised of cash expected to be distributed in 2021.

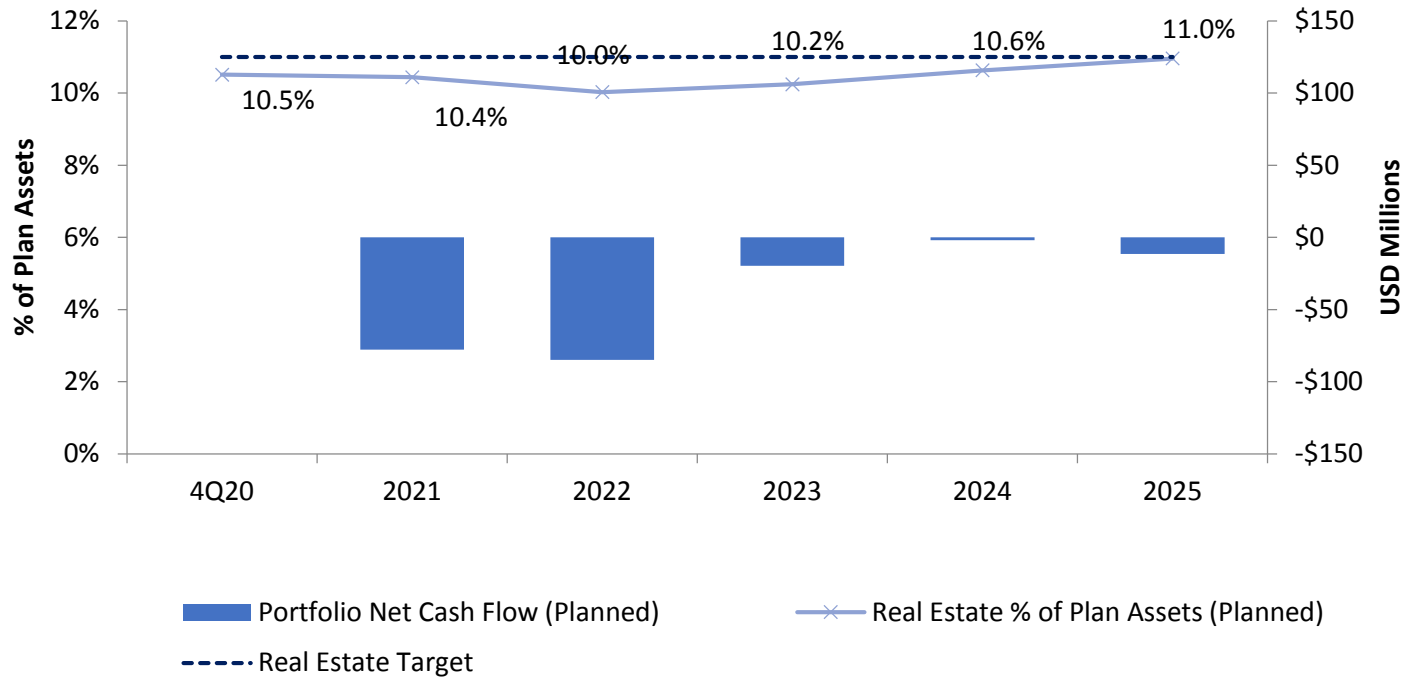
# E. Capital Projections





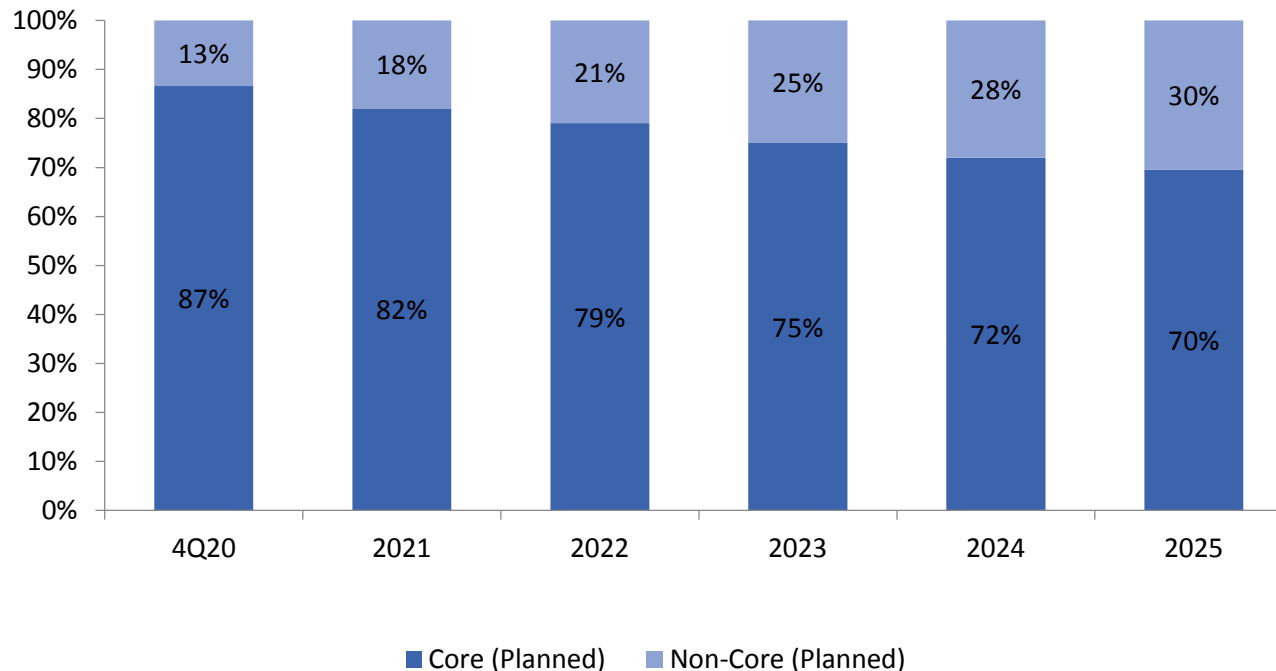
# Projected Exposures and Cash Flows

**Real Estate % of Total Plan Assets (Including All Planned Commitments)**



# Projected Risk Exposures

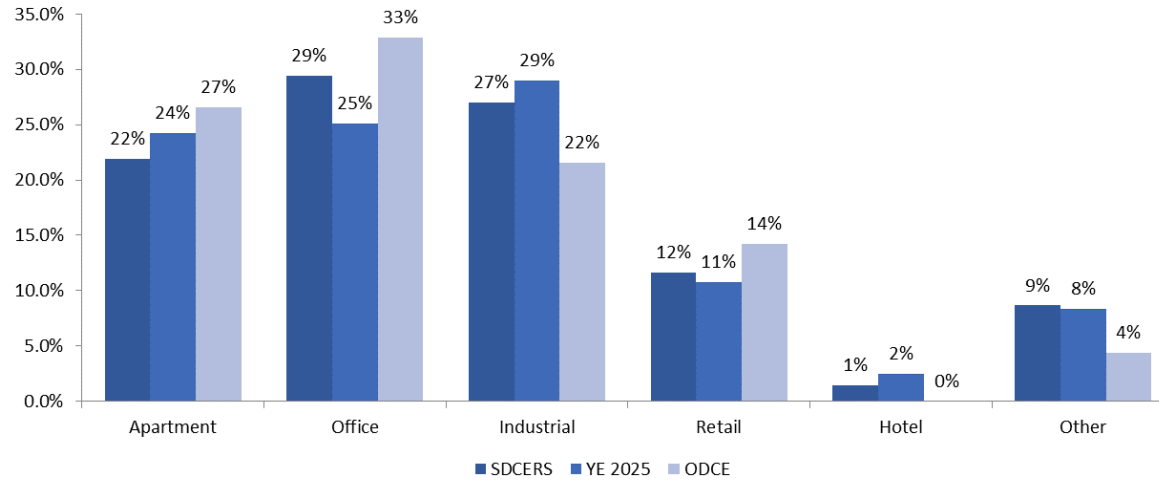
## Risk Sector Allocation



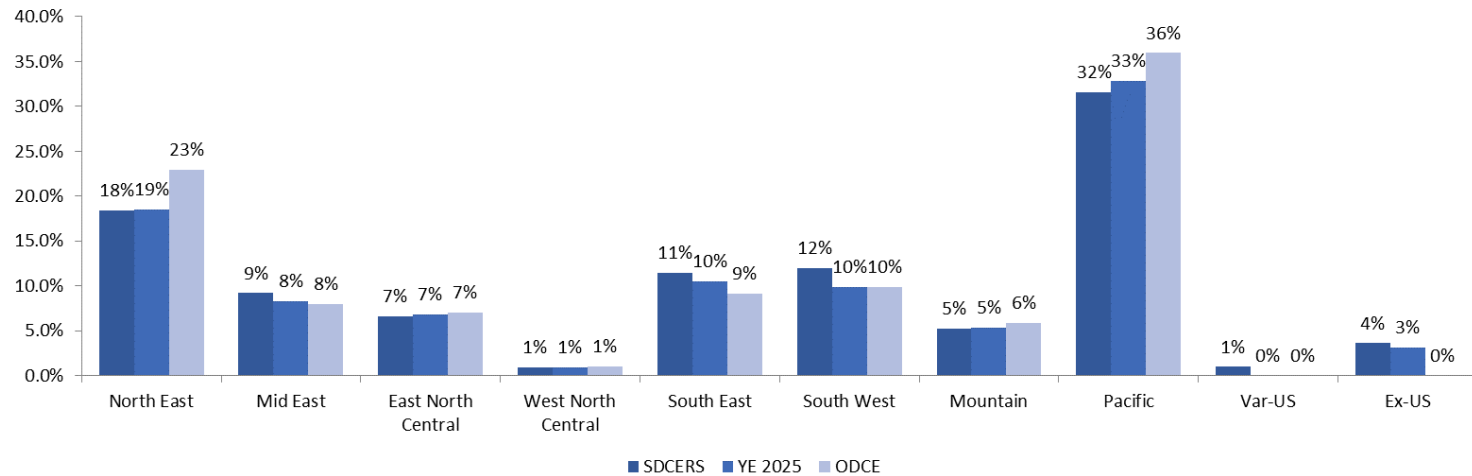
Assumptions for placeholder commitments include \$70 million of new non-core commitments in FY2022 and \$70 million of annual non-core commitments in FY2023, FY2024 and FY2025. The same assumptions are used in the capital projections provided on the previous page and will be refreshed quarterly.

# Current and Projected Diversification

SDCERS Property Type Diversification  
4Q20



SDCERS Geographic Diversification  
4Q20



# F. FY2022 Recommendations for Approval





## Recommended FY 2022 Annual Investment Plan

The FY 2022 Annual Investment Plan includes the following capital recommendations:

### Core Real Estate

- **Structural Core Equity Program Actions:**
  - Continue DWS IMA Transition Plan
    - Complete sales of remaining two assets (~\$26 million).
  - Remain in redemption queue for UBS Trumbull Property Fund.
    - As of year-end, SDCERS's remaining market value was \$40.8 million. The current queue totals above 50% of the fund's net asset value, and while the manager expects meaningful redemption payments in 2021, the expectation is that paying down the full queue might take 3-4 years.
  - No additional capital commitments/redemptions are recommended at this time after significant rebalancing activity in prior years.
- **Tactical Core Equity Program Actions:**
  - Remain in redemption queue for AEW Core Property Trust.
    - To date, SDCERS has received \$50.5 million in redemptions with a remaining balance of \$39.2 million. AEW currently expects to pay out the remainder by mid-2022.
  - No additional capital commitments/redemptions are recommended at this time after significant rebalancing activity in prior years.
- **Tactical Core Debt Program Actions:**
  - Monitor exposure relative to 15% policy limit and consider partial redemptions if necessary to remain within allowed range.
    - If partial redemptions are recommended in the future, proceeds would most likely be redeployed into Structural or Tactical Core Equity.

## Recommended FY 2022 Annual Investment Plan

The FY 2022 Annual Investment Plan includes the following capital recommendations:

### Non-Core Real Estate

- Target \$70 million of new commitments to Non-Core strategies.
  - Target 2 funds at an average commitment size of \$35M per fund.
    - Average commitment size is based on not only the opportunity being considered, but also the SDCERS Strategic Plan Guidelines, projected available capital for Non-Core deployment over the coming five-year period, historical average commitment size and desire to remain diversified by vintage year.
    - Number and size of actual fund commitments will depend on the opportunity set and fundraising timing for high conviction strategies over the coming fiscal year.
  - Consider re-up commitments to high conviction managers already represented in the portfolio.
  - Further explore niche investment opportunities that are expected to generate outsized risk-adjusted returns, and/or provide a level of diversification to the portfolio (downside protection, sector exposure, etc.).
    - Townsend continues to conduct manager research in niche opportunities such as U.S. cold storage, life sciences, data centers, single family residential, and Non-US industrial (Europe and Asia).
  - Continue to focus on fee savings to enhance net returns across the portfolio.

# G. SDCERS Real Estate Investment Policy

