AGENDA ITEM DETAILS

Subject: *Review, Discussion and Consideration of Real Estate - (ACTION)

- Review and Discussion of the Real Estate Market Update and Program Overview
- Review, Discussion and Consideration of Amended Real Estate Annual Tactical Plan For Fiscal Year 2021 – (ACTION)
- Review, Discussion and Consideration of Proposed Real Estate Annual Tactical Plan for Fiscal Year 2022 – (ACTION)

RECOMMENDED ACTION:

ERS' Investment staff recommends the following motion to the **Investment Advisory Committee:**

> Move that the Investment Advisory Committee recommend that the Board of Trustees of the Employees Retirement System of Texas approve the ERS Private Real Estate Program Amended Annual Tactical Plan for Fiscal Year 2021 and the proposed tactical plan for Fiscal Year 2022, as presented in Exhibit E and F.

Contingent upon adoption of the above motion by the Investment Advisory Committee, staff recommends the following motion to the **Board of Trustees:**

> Move that the Board of the Trustees of the Employees Retirement System of Texas approve the ERS Private Real Estate Program Amended Annual Tactical Plan for Fiscal Year 2021 and the proposed tactical plan for Fiscal Year 2022, as presented in Exhibit E and F.

Background:

During the December 12, 2017 Joint Meeting of the ERS Board of Trustees (Board) and the Investment Advisory Committee (IAC), the Board approved increasing the Real Estate Program's target allocation weight to 12% from 10% of the Trust's assets, to be phased in through 2021. During the same meeting, the Board also approved Pension Consulting Alliance as the real estate consultant. Following a merger in early 2019, Pension Consulting Alliance is now Meketa Investment Group (Meketa).

The Covid-19 pandemic has created a healthcare and financial crisis across most of the globe. With the recent success and unprecedented rapid development and deployment of vaccines, the pandemic will hopefully be behind us soon. Stock markets sold off and unemployment spiked in the early part of the outbreak. Governments and Central Banks across the globe responded quickly with extraordinary fiscal and monetary support for the economy. Unemployment initially rose and then dropped, but remains higher than pre-pandemic levels. Stock markets have rebounded and set new record highs, but gains have not occurred evenly across all industries.

Real Estate was hit hard as a sector by the pandemic's impact. It is still too early to tell the full extent the pandemic will have on people's long term behaviors and the potential impact to various property types. Almost a year into the pandemic, Real Estate has performed better than expected when closures began but has still experienced pain. The pandemic accelerated several trends that were already taking place, such as the penetration of eCommerce and the demise of physical retail operations. However, it also created uncertainty about the future demand of Office and Hotel sectors due to the adoption of work from home and virtual meetings to comply with social distancing guidelines and travel restrictions. Government mandated closures wreaked havoc on Hotels and Retail businesses, but there are spillover impacts to other properties like multifamily due to unprecedented job losses. While the economy heals, rental collections have recovered remarkably since the beginning of the pandemic, but there are still numerous retailers, businesses and individuals unable to pay rent. With the possible exception of industrial and data centers, most property types felt some pain.

Additionally, with all the meaningful fiscal and monetary support by governments across the globe, inflation is now a potential factor to be monitored closely. Real Estate is an imperfect inflation hedge, but typically benefits depending on how inflation manifests itself. Understanding if these changes are cyclical or secular, which will determine the amount of time it will take to get the market back into balance and will determine if inflation becomes systemic, will be of prime importance. Ultimately, real estate will not become obsolete and human beings are social creatures that want and need to be together for work and leisure.

Maintaining a precise, constant weight for Private Real Estate is challenging in normal times, and it is certainly challenging in today's volatile markets. Due to the illiquid nature of these investments, the exact Private Real Estate weight is difficult to precisely maintain or quickly rebalance. Consequently, the Private Real Estate weighting will vary from quarter to quarter and year to year. The Private Real Estate Portfolio is now below its target weight of 9%, currently around 7.9% due to the rebound in the stock market and corresponding increase in ERS' non-real estate investments.

The Fiscal Year 2022 Annual Tactical Plan will explain the details of future commitments and pacing. Since the Fiscal Year 2021 Tactical Plan was produced last April, at the start of the pandemic when the stock market was at or near its lows, it now appears too conservative and staff is requesting amendments to adjust to the current market conditions.

Key guidance for the Real Estate Program located in the *ERS Investment Policy Statement* are:

Category	Weighting	Investment Types	Geographic Weightings
Real Estate Listed Securities	3% (0%-13%)	Public Equities (REITs and REOCs)	Based on FTSE EPRA/NAREIT Index (and tracking error)
Private Real Estate	9% (4%-14%)	Private Equity and Private Debt (typically in a limited partnership structures)	1. 70% Domestic (+/- 15%) 2. 30% International (+/- 15%)
Detailed Private Real Estate Core Non-Core	 43% (+/-15%) 57% (+/-15%)		
Property Technology and Services (PropTech)	0% - 5% (included in private real estate)	Similar to private real estate (limited partnership structures)	

Real Estate Team Staffing – In the early stages of implementing the real estate platform, a total staff of five to seven people were contemplated with personnel to be added over several years as the program matured. The team has reached the original anticipated maturity with seven employees. Sriyas Pande, an analyst, was hired in August to support both the Public and Private Real Estate Teams.

Director of Real Estate				
Bob Sessa, CFA				
27 years work experience, 20 real estate BS from Fordham University and MBA from UT Austin				
Portfolio Managers:				
Annie Xiao, CFA	**Ken McDowell, CPA**	**Amy Cureton**	**Simon Mok, CPA, CFA**	**Tony Cardona**
-Int'l Listed Securities	-Private Real Estate	-Private Real Estate	-Private Real Estate Focused	-Public Real Estate Focused
-20 years work experience, 20 real estate	-30 years work experience, 30 real estate	-18 years work experience, 13 real estate	-22 years work experience,19 real estate	-12 years work experience, 7 real estate
-BS from Zhengzhou University and MBA from Duke	-BA and BS from Ohio State University	-BA and MBA from UT Austin	-BA and MPA from UT Austin	-BS from Cornell University
Analyst				
Sriyas Pande				
Supports both Public and Private Real Estate Teams 5 years work experience, 4 years real estate BA from Texas Christian University and MS from Baruch College				

Update of ERS' Real Estate Program – The Real Estate Portfolio contains publicly traded real estate securities (REITs/REOCs) and private real estate investments. As of December 31, 2020, the portfolio was valued at $3.3 billion, or 10.7% of the Trust's assets compared to a target weight of 12%. This compares to prior year's net asset value (NAV) on December 31, 2019 of $3.2 billion, representing 10.8% of the Trust's assets. Investments in REITs are approximately $900 million, while Private Real Estate is valued at $2.4 billion. Property Technology and Service (PropTech) investments (included in private real estate) represents $6 million or 0.20% of the Real Estate Portfolio.

Real Estate Program Performance *(Time Weighted - net of fees)*		
	Fiscal Year 2021 (4-month period through December 31)	**Year** (12 month period ending December 31)
REITS Portfolio	9.0%	(6.7%)
Private Real Estate Portfolio	2.3%	2.3%
Combined Real Estate Program	4.0%	(0.6%)

Real Estate Listed Securities (REITs/REOCs) – As outlined in the Investment Policy and Real Estate Asset Class Guidelines, listed securities are targeted at 3% of the Trust's assets, with an allowed band of 0% to 13%. At 2.9% of the Trust's assets, the portfolio is slightly below its 3% target weight.

The Real Estate Listed Security Portfolio is managed as an enhanced index portfolio. The overall portfolio has two sub-portfolios: domestic and international. Risk controls include a tracking error limit of 300 basis points (bps) to the FTSE EPRA/NAREIT Global Index. Consideration is also given to the property type and country weights to ensure the portfolio is not significantly over or under exposed to any particular area.

The Real Estate Team attempts to enhance the portfolio return relative to the benchmark by using various models and analytics based on relative values for the securities under coverage. This analysis is done within each country. Ideally, valuations would be compared across countries, but it is difficult to come up with such a model at this time. Many factors complicate a cross-country relative value analysis, including divergent reporting metrics, REIT structures, tax implications, and data availability. In an attempt to further add value and diversify risk, stocks external to the benchmark may be included as long as they comply with the ERS Investment Policy and the Asset Class Guidelines.

Private Real Estate - The Private Real Estate Program began making commitments following the approval of the Policies and Procedures and Tactical Plan documents in August 2009, with the first real estate commitment in January 2010. As of December 31, 2020, the NAV of the Private Real Estate Program was $2.4 billion, or 7.8% of the System's assets, representing 83 investments (73 are active and 10 of the investments have been liquidated) with $5.3 billion worth of commitments and $1.4 billion in uncalled commitments.

Risk/Return	Commitments ($ million)	Called ($ million)	Unfunded ($ million)	% of Total Unfunded
Core	$995	(910)	85	6%
Non-Core	$4,298	(3,118)	1,355	95%
Total	$5,293		$1,430	

Note: Figures are in millions; Please note the numbers will not add up exactly as some funds recycle capital or we might have been in an early close whereby capital was returned after subsequent investors closed.

ERS has very little committed capital left to invest in the core space, but ERS has identified several compelling investments which should close this fiscal year. Before the pandemic, staff could not find attractive core investments that would be a good fit for the portfolio. Furthermore, it appeared that non-core investments offered a more attractive risk adjusted return compared to core investments. However, a few compelling core or core-plus opportunities have presented themselves recently. Therefore, commitments to core investments are slowly increasing through core plus blind pool funds and co-investment opportunities. The majority of future investment dollars are to be devoted to the non-core (value added and opportunistic) strategies. As a percentage, core investments represent only 6% of total unfunded capital. This was intentional as core investments did not appear to offer attractive risk adjusted returns. However, with the recent market volatility and economic turmoil, staff is revisiting these weightings.

The current portfolio is overweight Residential (includes multifamily, student housing, manufactured housing, etc.) while underweight Office, Retail and Industrial. The Retail and Office underweights will most likely persist unless very compelling opportunities arise. Staff went overweight Residential, as this property type has typically outperformed on a relative basis during downturns. Industrial has shifted to underweight from a neutral position due to the increase in the index weight and strong returns. Staff is looking for compelling opportunities to bring it back to neutral, but it is trading off peak valuations and peak rents. "Other" is a combination of various investments, including self-storage, parking garages and property technology with over half of these investments consisting of self-storage properties. Staff has not invested in any dedicated hotel only funds and the only exposure to this category is through non-core diversified managers. The current weighting is about 4% globally.

Approximately 23% of the portfolio is international, with Asia being the largest exposure at 14%, followed by the United Kingdom (4%) and Europe (5%). Latin America exposure is negligible. Asia appears to offer better risk adjusted returns and will most likely continue to grow as a percent of the portfolio.

ERS has advisory seats on 71 funds. A listing of funds by risk/return strategy and geography is included with this agenda item as **Exhibit A**, and more details on Private Real Estate investments through December 31, 2020 is included in **Exhibit B**.

The Private Real Estate Portfolio's net internal rate of return (IRR) was 11.1% with a 1.3x equity multiple (inception through December 31, 2020). The portfolio's Distributions to Paid In Capital ("DPI") is 0.8x and the Total Value to Paid In Capital is 1.4x.

Staff is proposing to amend the Fiscal Year 2021 Tactical Plan to increase target commitments from $300 million to $500 million. The Fiscal Year 2022 Tactical Plan proposes targeting $350 million in commitments. Through December 31, 2020, commitments made for fiscal year 2021 stand at three investments totaling $175 million.

The following is a brief summary of those investments in chronological order.

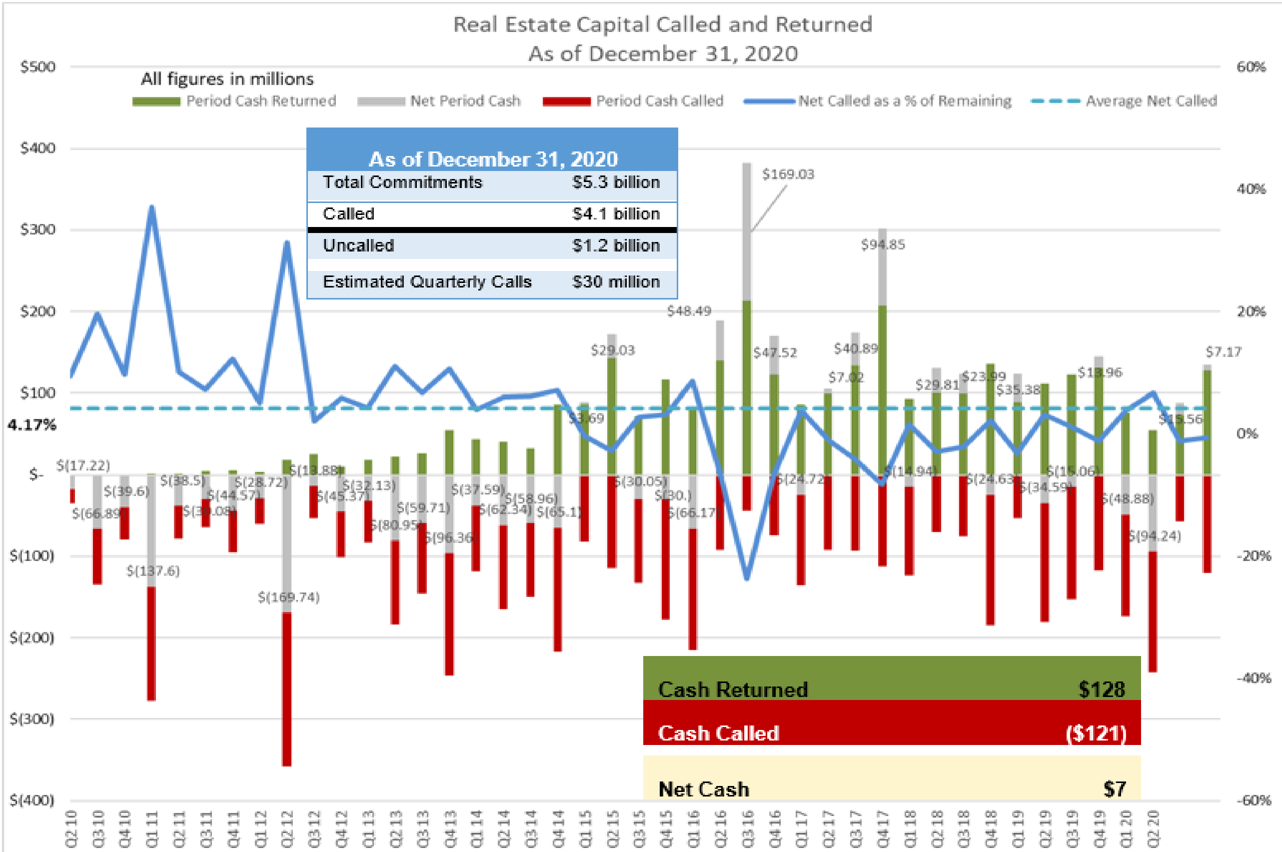
1. $75 million commitment to a US focused diversified non-core fund targeting gateway and “tech” cities (e.g. Austin, San Francisco, Boston, NY, DC). Net Target Returns of 10%-14%.
2. $50 million commitment to a non-core data center fund focused on secondary cities (e.g. cities such as Dallas, Denver, Phoenix, Seattle, Portland, etc.). This is ERS’ first commitment to the manager. Net Target returns of 16% - 18%.
3. $50 million commitment to a diversified non-core fund focused on Boston, NY and Washington DC. The manager targets middle market asset sizes. Net Target returns of 11% - 13%.

A typical fund’s life cycle can be anywhere from seven to 10 years with the first three to four years being the investment period when capital is called, and in the later years, the manager will sell the assets as they become stabilized after executing their business plans. The capital call and distribution schedules are never in an even measured pace or go as expected. It is not unusual for a fund to only call 85% to 90% of the commitment amount, as they like to keep reserves or raise their successor fund.

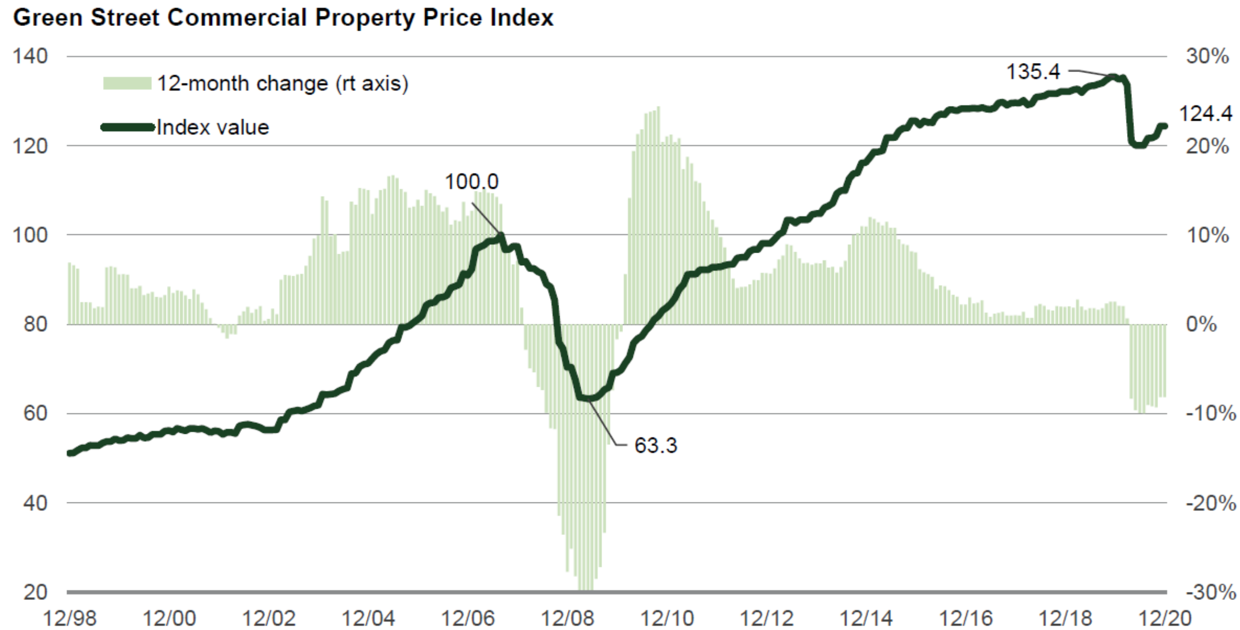
To date, 10 investments, two of which were co-investments, have been completely liquidated or are close to being liquidated. Seven outperformed original expectations. The three underperforming debt funds had respectable absolute performance, but did not meet our original expectations mainly due to a decrease in interest rates. The first was a US Core debt fund that returned 7%. The second, a European mezzanine debt strategy, returned 10%, but currency adjustments and a drop in interest rates impacted the original return assumptions. The third, a US mezzanine debt fund, returned 8%. Capital called for the fiscal year through December 31, 2020 totals $143 million with distributions of $150 million.

Forecasting cash flows for the Private Real Estate Portfolio is both a science and an art. Prior to existing fund investments being liquidated, new commitments must be made since new fund capital will typically be drawn down over a number of years. Hence, it is a constant process of determining when a fund will call capital and return it, as well as determining how much new capital to commit. In addition, NAV and uncalled commitment amounts combined (i.e. economic exposure) will be greater than the target portfolio weight because of these timing differences. However, staff and the consultant are constantly monitoring the various moving parts to ensure the portfolio stays fully invested. It should be noted that positive or negative impacts to the other asset classes in the System’s portfolio also play a part in this calculation due to the denominator effect (e.g. the size of the overall portfolio will vary as well due to increases or decreases in value to public equities, fixed income, etc.). Most notably, severe market declines like that experienced in 2008, and more recently, impact the overall System’s portfolio value and consequently, the real estate weight.

The following chart shows the Private Real Estate Portfolio liquidity, comparing capital called and returned. The red bars represent “cash called” (cash outflows) and green bars represent “cash returned” (cash inflows) from the investments. The gray bar represents the “net cash” into the portfolio (cash inflows less cash outflows). In addition, the blue solid line in the chart reflects the net capital calls (calls net of distributions) as a percentage of remaining commitments over the different time periods. As the portfolio matures, distributions are increasing and offsetting the capital calls.

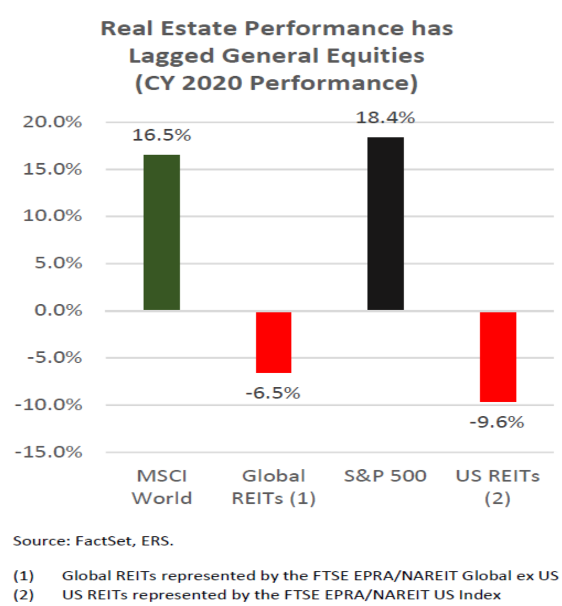


Real estate had been priced at all-time highs prior to recent market events related to the pandemic. With the search for yield, low funding costs, and a strong economy, core properties in gateway markets had surpassed their valuations from the prior peak in 2007 by over 30%. The chart below depicts this graphically with the Green Street Commercial Property Price Index, which is considered a measure of prime properties. As one can see, for the prior year, the *all* property price index declined 8%, but it varied by property type. Industrial and manufactured home values increased about 10% while malls, office and other retail declined 15% - 25%. Negative price declines was also evident in the return data from the NPI-ODCE index (ODCE) which is a compilation of about 30 open ended core funds. For the prior year, the value weighted ODCE index total return was about 30 basis points with negative appreciation of about 3%, but income of almost 4% helped offset those price declines. Real estate values now appear to have reached a bottom and are showing signs of recovering.



Source: Green Street

Real estate has significantly lagged general equities over the past year, but this trend could reverse as businesses and societal interactions open back up over the next year or two. REITs are currently trading at a material valuation discount to general equities.



Source: Raymond James. Cohen & Steers. (1) Represents (FFO) Funds from operations, the REIT industry's key earnings metric. (2) U.S. Equities represented by the Russell 3000 Index. (3) U.S. Real Estate is represented by UBS' coverage universe of U.S. real estate companies from October 2002 to December 2010; data thereafter shows Cohen & Steers coverage universe.

It is unclear if the pandemic will create a permanent shift in behavior. For example, will work from home become more common place impacting office demand? Will people return to major cities, which typically rely on mass transit and are denser than smaller cities and the suburbs? How will business travel rebound now that people have become accustomed to conducting meetings virtually? It will take time to truly understand the full impact to the Real Estate Sector and the ERS Private Real Estate Portfolio.

Some analysts estimate that net office demand could shrink by 5% - 15% (work from home offset by more space per employee to account for social distancing). It is our opinion that the focus should be on the timing of when supply/demand gets back into balance, which will be a function of whether these are cyclical changes or secular disruptions. If it is a secular change, it will take longer for the market to get back to equilibrium. In person interactions is still critical to doing business in many industries and geographies, whether with your company colleagues or calling on customers. Therefore, we anticipate there will still be a need for real estate.

Regarding major/gateway cities, these locales (such as NYC, San Francisco, LA and Chicago) were already experiencing a population exodus due to housing affordability concerns, high taxes, and fiscal issues at the city and state levels. The pandemic accelerated this trend as individuals were freed to work anywhere, and since they could not take advantage of city living amenities such as museums, theaters, and restaurants. Despite these concerns, such cities continue to have a strong continuation of industrial clusters. It is not easy to replicate those environments, as it took decades to build and form. Declining pricing and rents should also help attract people back to the cities and anecdotally this is starting to happen.

ERS is also monitoring and analyzing potential secular shifts due to new government measures impacting the economy and real estate. A particular factor worth monitoring is the potential for increased inflation. It is highly likely that inflation will increase as we approach herd immunity and the economy is on a clearer recovery path. The question will then become is this trend permanent or just a temporary spike due to pent up demand.

Moving forward, ERS is monitoring the following trends that warrant attention:

1. Acceleration of existing trends – Before the economic impact of Covid-19, a few trends were already occurring that could now accelerate:
   - eCommerce penetration – especially grocery
   - Supply chain reconfiguration – diversifying away from China to other locales including moving some manufacturing back to the US
   - Cloud computing – the pandemic has further highlighted the need for greater online access
   - Relocations from coastal cities to sunbelt. Before the pandemic, companies and individuals were relocating from coastal cities
2. Live, Work and Travel behavior changes – it is unclear if or how people change their behavior post pandemic. Other major catastrophes (i.e. 9/11, major earthquakes, hurricanes, etc.) have not significantly altered long term behavior. Asian countries have dealt with several epidemics and might be a useful guide of potential changes to come, none of which are material (e.g. wear face masks more often, take temperatures). Office demand could see a net demand decrease of 5% - 15% (work from home offsetting larger space per employee).
3. Inflation – the amount of government spending globally could ignite inflation.
4. Government intervention in the economy – rent control legislation was enacted in a few municipalities targeted at the multifamily sector due to affordable housing concerns. The pandemic exacerbated these issues and governments allowed tenants to defer or skip rental payments coupled with an eviction moratorium.
5. Protectionism/Nationalism – countries could act even more protectionist in light of the pandemic

Intensive due diligence is critical to the real estate investment process. While travel was restricted, staff conducted conference calls and attended meetings virtually. Over the last twelve months, ERS staff attended more than 350 meetings with over a 100 different managers and conducted extensive due diligence on more than 12 funds and 5 co-investments. Qualitative and quantitative factors are evaluated in considering an investment. For a prospective investment in the Private Real Estate Portfolio, significant consideration is given to the prior track record of a manager and the likelihood of that manager's success going forward. Attribution analysis is performed to understand the quantitative aspects of a manager's track record. Staff assesses the answers to questions such as: Were the returns commensurate with the risk taken? Did they execute on their strategy? How much of the return was generated by leverage?

Investment structure and strategy, manager qualifications, advisory board participation, and control rights are also important parts of the due diligence process. Does the organization have unusual personnel turnover? Do they have the capacity to handle existing investments along with a new fund? Does the strategy make sense within ERS' portfolio? Is the General Partner (GP)'s interests aligned with investors?

Another area of focus is the fee/return structures. Do the fees make sense and provide incentives for behavior beneficial to the limited partners? Incentive compensation should be appropriate for the investment vehicle. If the Trust participates as a lead investor, it should expect a reduced management fee. Acquisition, financing, and disposition fees should be avoided in most situations. If such fees are paid, the preferred return hurdles should be higher, promoted interest percentages should be lower, and/or the manager co-investment must be higher. Investment managers should provide claw back provisions to address a situation in which the investment manager potentially received more than the specified incentive compensation. This can be accomplished through an incentive fee reserve or holdbacks held in escrow.

Once an investment is made, monitoring becomes an essential part of the process. Attending advisory board meetings, frequent communication with management and other limited partners, reading and analyzing quarterly reports, and other general partner information are all important to ensure the manager is executing the intended strategy as promised and to identify any potential issues that may arise jeopardizing returns or increasing risk.

Accomplishments and Initiatives – The Real Estate Program is at a steady state and realizing gains from its investments made during the trough of the cycle. REITs continue to complement the Private Real Estate Portfolio and have provided beneficial exposure to the asset class.

1. The internal REIT Portfolio has outperformed the benchmark for the 1, 3 and 5 year periods ending December 31 by 179, 82 and 43 basis points respectively. Since inception, the internal portfolio has beat the benchmark by 72 basis points. Staff continues to incorporate an option strategy to the portfolio to further add value. It is mainly used to write covered calls or sell puts for select stock positions.
2. The Private Real Estate Portfolio has generated a net 11.1% IRR since inception of the program.
3. In conjunction with TRS, ERS co-hosted the multi-asset class Emerging Manager Conference in January of 2021. The conference continues to be well-received by the 3,482 participants.
4. Co-investments are still a strong consideration for the program even though no direct co-investment deals have closed this fiscal year. LaSalle Global Partner Solutions (formerly Aviva), has been retained to source and underwrite deals on a global basis to supplement internal efforts to increase co-investments.
5. In the Private Real Estate Portfolio, staff will continue to monitor the Covid-19 economy and its impact to real estate but also look for opportunities to deploy new capital.
6. Staff will continue to explore separate accounts, club deals and co-investments. This will allow ERS to be more tactical and efficient in deploying capital. Additionally, debt investments for the Opportunistic Credit sleeve and/or the Real Estate allocation will continue to be explored. International exposure may be increased, with more investments in Asia and the UK.
7. In collaboration with our consultant, ERS has negotiated favorable economic terms for private real estate investments, saving the Trust an estimated $150 million over the life of the investments. The portfolio average management fee is 110 bps and the average carry is 16.7%. Additionally, staff from ERS' Office of General Counsel, along with the Real Estate Team, has negotiated favorable non-economic provisions that have strengthened ERS' investment position.
8. Continue to monitor and evaluate how technology is impacting real estate trends.

The list of investment parameters for real estate investments is set out in **Exhibit D** of this agenda item. The program remains in compliance with all policies.

Review and Consideration of Amended Real Estate Annual Tactical Plan for Fiscal Year 2021 – (Action)

In accordance with the Employees Retirement System of Texas (ERS) Investment Policy Statement, Chapter IV (A), employees are charged with preparing and presenting an Annual Tactical Plan (Plan) to the ERS Board of Trustees (Board) for its review and approval. The Plan reviews the current status of the Real Estate Portfolio, recent historical and prospective market conditions, and proposes the steps to implement the Real Estate Program over the next fiscal year. These steps include the types and number of investments to be sought as well as any other actions or considerations germane to the success of the program.

The proposed amendment to the ERS Private Real Estate Portfolio Annual Tactical Plan for Fiscal Year 2021 is included with this agenda item as **Exhibit E**.

The Fiscal Year 2021 Tactical Plan was approved by the Board and IAC at the May 2020 ERS staff, in collaboration with Meketa (asset class consultant), prepared the tactical plan in March and early April 2020 during the depths of the market sell off and uncertainty surrounding the economy. The Private real estate weight was at its target weight of 9% at that time. Therefore, a cautious approach was taken.

STAFF RECOMMENDATION:

The initial Fiscal Year 2021 Tactical Plan approved last year proved to be overly conservative as the quick unprecedented fiscal and monetary response lifted the stock market to new highs. The current private real estate weight is 7.8% of the trust. Therefore, staff, with the consent of Meketa, recommend increasing the tactical plan commitments from a target of $300 million, with an upper range of $600 million, to a target of $500 million, with an upper range of $800 million.

Staff has closed on three deals during FY21 totaling $175 million and has identified a strong pipeline of deals that will easily surpass the existing $600 million limit assuming successful underwriting. Staff recommends amending the tactical plan to account for the meaningful underweight to private real estate as well as provide a cushion in the event future attractive deals materialize.

The proposed Private Real Estate Portfolio Amended Annual Tactical Plan for Fiscal Year 2021 was prepared by Meketa Group in collaboration with the Real Estate Team. Staff recommends that the plan be approved and adopted in accordance with ERS' Real Estate Guidelines and Procedures.

Review and Consideration of Proposed Real Estate Annual Tactical Plan for Fiscal Year 2022 – (Action)

In accordance with the Employees Retirement System of Texas (ERS) Investment Policy Statement in Chapter IV (A), employees are charged with preparing and presenting an Annual Tactical Plan (Plan) to the ERS Board of Trustees (Board) for its review and approval. The Plan reviews the current status of the Real Estate Portfolio, recent historical and prospective market conditions, and proposes the steps to implement the Real Estate Program over the next fiscal year. These steps include the types and number of investments to be sought as well as any other actions or considerations germane to the success of the program.

The proposed ERS Private Real Estate Portfolio Annual Tactical Plan for Fiscal Year 2022 is included with this agenda item as **Exhibit F**. Highlights are summarized as follows:

Fiscal Year 2021 in Review – As of December 31, 2020, the value of the private portion of the Real Estate Portfolio is approximately $2.4 billion.

1. As reported in the market update and program overview agenda item, the targeted commitments for Fiscal Year 2021 were originally $300 million, but staff has proposed amending commitments to a target of $500 million. Fiscal Year 2021 commitments made through December 31, 2020 total $175 million to three investments. Over the course of the last 12 months, staff conducted more than 350 meetings with 100 different managers and conducted extensive due diligence on 12 funds and 5 co-investments.

The expected total commitments will not exceed the upper range of the revised commitment target of $800 million for Fiscal Year 2021.

STAFF RECOMMENDATION:

Funding Levels for Fiscal Years 2022-2024 – Staff will continue committing capital to private real estate on a selective basis, and currently targets $350 million in commitments for Fiscal Year 2022. While there is always uncertainty about the future, it is especially true in the current environment. Covid-19 and the government response (much quicker and larger than any previous crisis) has disrupted the economic and real estate picture. The economy and real estate markets in general will still be beholden to the virus until it is fully contained. Staff will continue to assess the environment and any potential secular changes to behavior in analyzing new commitments and strategies.

As of December 31, 2020, the current Private Real Estate Portfolio stands at 7.8% of overall trust assets, below the policy target of 9%. With this proposed commitment amount, ERS should continue its "steady state" allocations going forward and gradually increase the weight to the target. In addition, the recommended funding level seeks to replace returned capital as managers from early vintage years complete fund liquidations.

For Fiscal Year 2022, staff will continue to review and analyze the market conditions and post pandemic world. Coming out the pandemic, coupled with a new Administration, creates more uncertainty than usual. The government response in most countries has been quicker and at a much higher level relative to GDP than any other crisis. The pandemic could also change long-term behaviors, further increasing the uncertainty.

Recognizing the importance that income plays in long-term real estate returns, ERS will focus on strategies and managers where the portion of return derived from income, as opposed to capital appreciation, is significant relative to the respective risk return strategy. However, the post pandemic world might create very favorable investments that are back end loaded (i.e. most of the return comes from capital appreciation). Opportunities in niche sectors in both the core and non-core space, including strategies with lower correlations to traditional core property, will be selectively reviewed. Examples include Medical Office, Life Science, Manufactured Housing or Core Properties in international markets. Debt is another area where staff is spending more time. Additionally, the Real Estate Team seeks to continue to diversify and increase its international exposure closer to the target level of 30% of the Private Real Estate Portfolio (currently at 23%). Separate accounts and co-investments will continue to be an area of focus.

The proposed Private Real Estate Portfolio Annual Tactical Plan for Fiscal Year 2022 was prepared by Meketa Group in collaboration with the Real Estate Team. Staff recommends that the plan be approved and adopted in accordance with ERS' Real Estate Guidelines and Procedures.

** We are accredited by the State Pension Review Board (PRB) as a Minimum Educational Training (MET) sponsor for Texas public retirement systems. This accreditation does not constitute an endorsement by the PRB as to the quality of our MET program. This agenda item may be considered in-house training provided by ERS to board trustees and the system administrator for purposes of fulfilling the MET program requirements. ERS is an accredited sponsor of MET for its system administrator and trustees for continuing education.*

ATTACHMENTS:

1. Exhibit A - PRE by Risk Return Strategy March 2020
2. Exhibit B - 2020 Summary of Commitments by FY
3. Exhibit C - Sector Underweights and Overweights
4. Exhibit D - Private Real Estate Compliance Chart
5. Exhibit E - Private Real Estate FY 2021 Amended Annual Tactical Plan
6. Exhibit F - Private Real Estate FY 2022 Annual Tactical Plan
7. Slides – Real Estate