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Pension Funds and Urban Revitalization

California Case Study B: Real Estate
CalPERS' California Urban Real Estate Initiative

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Abstract. This paper argues that pension funds can earn attractive risk-adjusted rates of return on targeted real estate investment in underserved capital markets. Targeted investing is designed to achieve both a financial and social return. Fiduciary duty requires public sector pension funds to put financial obligations at the forefront of their decision-making. However these funds also have a vested interest in ensuring vibrant, healthy communities that in turn underpin employer contributions to the fund. We examine the California Urban Real Estate (CURE) program of the California Public Employees Retirement System (CalPERS) as a model of targeted real estate investment in urban and underserved capital markets. From this case study we draw some implications for best practice in targeted investment.

Keywords. Urban revitalization, targeted investment, real estate, economically targeted investment (ETI), public sector pension funds, California Urban Real Estate (CURE)

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Executive Summary

Using the California Public Employees Retirement System (CalPERS) California Urban Real Estate Program we draw implications for best practice in market-based real estate investment in urban revitalization by public sector pension funds.

Engaging in targeted investment

- Targeted investment often requires a board level champion to build support both with the board and consultants to consider targeted investing.
- Once the board agrees to 'take a look' at targeted investment, pension fund internal staff are often asked to commission an expert study of these investment opportunities. Generally staff chooses a known outside expert.
- The targeted investment external study can take as much as a year to complete. During this time both staff and board comfort levels are raised.
- Based on the outside expert report, the board will choose the asset class and level of investment most appropriate for targeted investment given their current asset allocation and diversification targets.
- Often staff will be asked to issue an RFP for external real estate general partners. Board and staff will look for top quartile performers, with a track record of successful targeted investments.
- General partners will co-invest at a significant level with the pension fund and will have considerable assets under management.
- Co-mingled, pooled funds will be attractive to first time investors in targeted investment.

Best practice in targeted investment

- Pension funds provide additional investment once urban revitalization has already begun to take place. Pension funds are not risk takers and severely blighted urban areas will require government, non-profit organizations and entrepreneurial real estate developers to initiate urban revitalization.
- Success is measured in terms of risk-adjusted rates of return.
- Geographic rather than social targeting.
- Social goals are best achieved by partnering with a local non-profit organization whose purpose is to achieve social outcomes.
- Boards set broad geographic targets for targeted investment programs.
- Boards pick top-quartile investment vehicles and stay out of investment selection.
- Sensitivity to emerging trends provides early mover advantage in rapidly shifting markets.
- Track records and relationships remain key to fund manager selection. As with all asset classes, top quartile investment vehicles are always in demand.
- Commingled, pooled funds with reciprocal targeting capability provide good opportunities to diversify targeted investment and reduce risk.
- Responsible contractor policies allow the pension fund to require all contractors to engage in fair labor practices.

Table of Contents

List of Tables

List of Figures

1 Introduction

The 1992 South Central LA race riots shook California as dramatically as any earthquake could. It shook the 'California Dream' and revealed cracks in its foundation. In the aftermath of the riots, the large California pension plan CalPERS realized that like it or not, its capital (then valued at $90 billion, current value $192 billion (Aug. 15, 2005) is inextricably linked to place. That place is California.

In 1992, the California Public Employees Retirement System (CalPERS) Board took a decision to target investment in the State of California as part of its overall investment policies. Two percent of the CalPERS' portfolio was to be invested in the State of California as part of its early Economically Targeted Investment Policy. This target crosses all asset classes including public equity in firms headquartered in California, private equity, fixed-income products, and of course real estate.

CalPERS' targeted real estate program, the California Urban Real Estate (CURE) program committed an initial $375 million with the aim of "creating value through the rehabilitation, repositioning, and development of real estate projects located primarily in the urban neighborhoods of California's major metropolitan areas.

The program began with investments in affordable single-family homes in California. The investment was expected to generate a 22% return, provide construction jobs, and fill a capital gap in the market, while increasing the supply of moderately priced homes in the State. Other targeted real estate opportunities soon followed including offices, industrial, mixed-use developments, infill, mezzanine debt and preferred equity.

By March 31st 2005, the CURE program had a total asset allocation of $3.4 billion with actual investment at $1.2 billion across twelve real estate investment partners.[1] The CURE program at that time had an IRR since inception of 22.2% (PCA, 2005).

CalPERS' decision to invest in California's urban real estate market has paid off handsomely for the fund, its beneficiaries and communities across the state. This paper examines the CalPERS' CURE program as a best practice case study in urban revitalization through real estate investment.

This case study is laid out in the following manner. Section two looks broadly at public sector pension fund real estate investment in urban revitalization. Section three examines the California targeted CURE program generally. Section four focuses on CalPERS' partnership in California Urban Investment Partners with the objective of investment in California's underserved urban neighborhoods. In section five we draw lessons for best practice in urban revitalization real estate investment. We conclude with some observations and implications drawn from this case study.

2 Urban revitalization through real estate investment

Economic change is a hallmark of the American system from the decline of the buggy whip industry to the decline of Motor City. Economic opportunities move to outer rings of cities, to other states, even to other countries. What so often remains is the bricks and mortar of past economic cycles. What marks communities in decline? First and foremost there is a reduction in economic opportunity (read jobs). Economic decline is quickly followed by a loss of population, as skilled and mobile individuals move to new areas of growth. Those who remain or take their place have less economic resources than those who left. Housing stock deteriorates, businesses go bankrupt, tax bases shrinks. As a result, services are cut back, schools lack resources, buildings are abandoned, and the population continues to decline. Poverty rates increase, crime rates increase, and environmental degradation marks the wasteland of once productive factories and warehouses. Reversing this decline requires growth, growth requires investment, and investment requires opportunities. The risk for the investor is whether the community will indeed reverse its decline.

[1] A thirteenth investment partner has subsequently been added.

There multiple ways to invest in communities to stimulate growth. One is through investment in urban infrastructure, the other is through direct investment in enterprises that generate growth and employment in the affected community. For most public sector pension funds, real estate investment provides tangible and accessible opportunities to engage in urban revitalization. After all ‘location, location, location’ is the defining ingredient in most real estate investment decisions and the location advantages of inner city communities have been key to pension funds’ success in the urban real estate market.[2]

The largest 200 public sector pension funds in the US are currently valued at roughly $2 trillion. These plans’ investment decisions are guided by their fiduciary duty to their plan members. This means that risk-adjusted rates of return within appropriate asset allocations are at the forefront on pension fund investment decision-making. But within that context, pension plans for obvious reasons also benefit from investing in the health of their communities. Plan members live and work in these communities and their employers’ pension contributions are underpinned by the health of these communities.

Real estate itself is an exercise in financial engineering where savvy developers use all available tools to get the best financial arrangement for the bricks and mortar that follow. This means accessing capital at its lowest cost, leveraging equity to debt, using government incentives, and dealing with multiple government jurisdictions. It means assembling small parcels of land, decontaminating brown field sites, and working with local communities. It means doing everything possible to “pencil out the deal”.

While all these steps are part of suburban green field development, they pose an even greater challenge when it comes to inner city urban revitalization. To be successful you need is a group of people with access to capital who are able to match the needs of business with the needs of government. CalPERS through its targeted California real estate investment program has partnered with a number of successful urban developers to do just that.

[2] See Michael Porter (1995) on the ‘Competitive Advantage of the Inner City’.

3 CalPERS' CURE Initiative

The California Public Employees Retirement System (CalPERS) is the largest defined benefit pension fund in the United States with current assets of $192 billion (Aug. 15, 2005). This plan covers 1.4 m. public sector employees and retirees in the State of California. As a defined benefit plan, beneficiaries receive a guaranteed pension based on a formula of age, salary and number of years worked.

3.1 Overview of CalPERS' Real Estate Portfolio

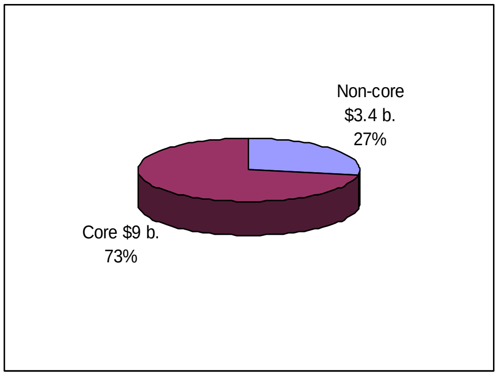
The CalPERS' real estate program is comprised of two portfolios - Core and Non-Core or specialized. In 2004, CalPERS' real estate portfolio was valued at $12.4 billion or 7.6% of total assets. Of that, $9 billion or 73% of invested assets was in Core real estate, with $3.4 billion (27%) invested in Non-Core real estate.

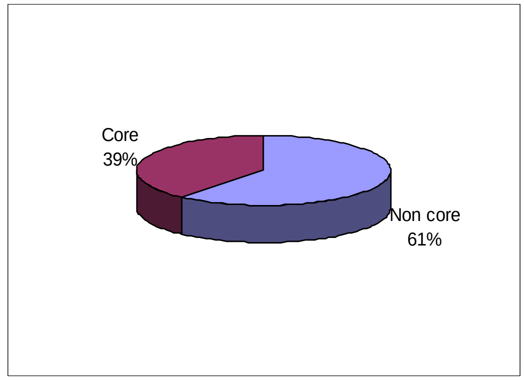
> "The Core Portfolio is managed to be broadly diversified by property type and geography, maintain high occupancy, emphasize current income, and exhibit prudent use of leverage. The Core portfolio includes four property types: apartment, industrial, office, and retail. These investments are acquired and managed through REITs, separate accounts, partnerships, and limited liability corporations between CalPERS and investment advisory firms. CalPERS' Non-Core real estate portfolio focuses on specialized real estate assets that include single family houses, urban development, and timber." (CalPERS, 2004)

While CalPERS' 2005 investments in real estate totals $11.1 b or 5.7% of CalPERS current $192 b. assets in California (all figures as of Aug. 15 2005) portfolio, the asset allocation target for real estate including future commitments is 8% of the total portfolio. Over the last few years CalPERS has maintained its Core real estate investment at a fairly constant $9 b. while steadily increasing its exposure to Non-Core real estate assets. Once allocated, Core real estate will shrink well below Non-Core investment with 61% of the real estate portfolio allocated to Non-Core assets. Fully 96% of CalPERS total real estate portfolio is actively managed.

Figure 3-1 Real estate Portfolio Allocations/Commitments

2004 Invested Real Estate Portfolio 2005 Allocations/Commitments



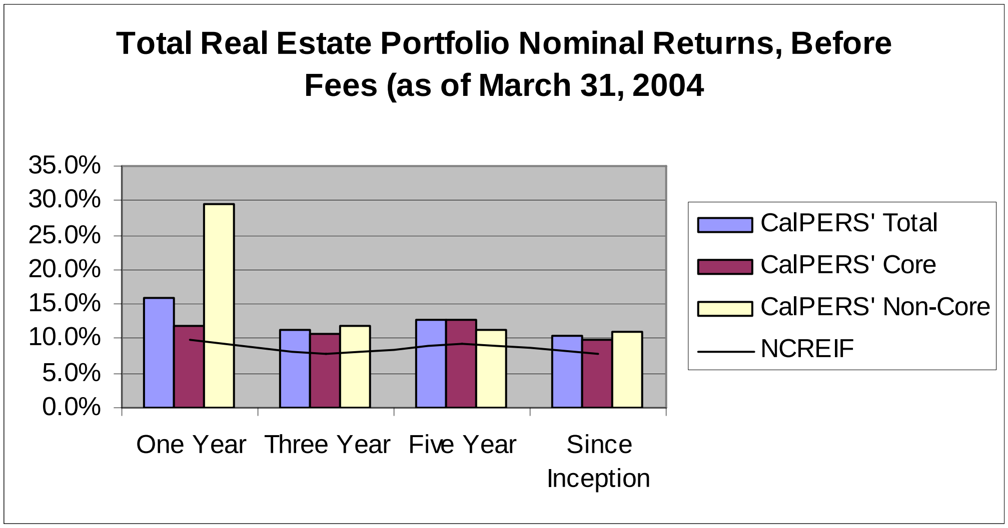


Source: CalPERS 'Facts at a Glance' and Pensions and Investments 2005

The shift from Core to Non-Core followed CalPERS' 2004 actuarial assessment that extended the 'crossover point' between assets and liabilities by ten years, thus allowing for a corresponding shift away from income producing Core real estate and toward Non-Core investment appreciation returns. In 2004, one-year returns from CalPERS' real estate portfolio as a whole was 14.2% after fees, while the portfolio generated nominal after fee total returns (since inception) of 9.6%. The Core one-year return after fees was 10.7% while the Non-Core one year return after fees was 25.6%. Non-Core generated half its nominal after fee total returns since inception (9.6%) from appreciation, while the Core nominal after fee total returns since inception was 9.1%, with income accounting for 90% of its return. Total, Core and Non-Core portfolios all outperformed their external benchmark, the NCREIF Index (National Council of Real Estate Investment Fiduciaries) in all time periods (all figures above as of March 31st 2004).

Figure 3-2Total Real Estate Portfolio

Comparison to NCRIEF Index (Nominal Returns Before Fees)



	One Year	Three Year	Five Year	Since Inception
CalPERS' Total	16.0%	11.3%	12.6%	10.3%
CalPERS' Core	11.9%	10.8%	12.8%	9.7%
CalPERS' Non-Core	29.5%	11.9%	11.4%	10.9%
NCREIF	9.7%	7.7%	9.3%	7.9%

Source: CalPERS Real Estate Portfolio Performance Report (March 31, 2004)

CalPERS' 'Responsible Contractors Policy' plays a key role in the management of their real estate portfolio. CalPERS "supports and encourages fair wages and benefits for workers employed by its contractors and subcontractors…. The System supports many of the ideals espoused by labor unions and encourages participation of labor unions and their signatory contractors in the development and management of the system's real estate investments. The System believes that an adequately compensated and trained worker delivers a higher quality product and service." (CalPERS B, 2005)

CalPERS' California targeted investment commitment is a major factor in their real estate asset class. CalPERS' invests $20.7 b. (10.9%) of its total $192 b. assets in California (all figures as of Aug. 15 2005). Equities, either in public companies headquartered in California or in private equity investments, account for $11.6 b., fixed income products add a further $2.9 b., while real estate investments make up the remaining $6.2 b. or 30% of the California-based investments. However, as a percentage of each asset class California investment dominate CalPERS' real estate holdings, comprising 50% of total real estate assets that are targeted in the State of California.[3]

In-state targeted investing is found in both the Core and Non-Core portfolio. Within the Core portfolio, CalPERS uses pooled, commingled accounts with reciprocal targeting. Such is the case with CalPERS' current $112 m. Core investment in the AFL-CIO Building Investment Trust. This is a national program with annual returns generated from the large national pools and has consistently out-performed its external benchmark (see New York Case study for greater detail). In turn it invests an amount in the state of California that is at least equivalent to CalPERS' investment. Such funds provide targeted investment with a fully diversified portfolio.

Within CalPERS' Non-Core portfolio, the California Urban Real Estate Initiative is the dominant targeted investment with current investments of $1.2 b. and commitments of $3.4 b (PCA, 2005).

3.2 CURE Initiative

In 1992, in the aftermath of the LA race riots CalPERS decided to target some of its then $90 b. portfolio into investment in the State of California. CalPERS' Economically Targeted Investment Program policy states:

> "For purposes of this policy, an Economically Targeted Investment ("ETI") is defined as an investment which has collateral intent to assist in the improvement of both national and regional economies, and the economic well-being of the State of California ("the State"), its localities and residents. Economic stimulation includes job creation, development, and savings; business creation; increases or improvement in the stock of affordable housing; and improvement of the infrastructure." (copyright 2005 by CalPERS)

Real estate was an initial starting point for CalPERS' Economically Targeted Investment Program. CalPERS committed $375 million with the aim of "creating value through the

[3] For comparison California targeted equities make up 9% of CalPERS' total equity portfolio.

rehabilitation, repositioning, and development of real estate projects located primarily in the urban neighborhoods of California's major metropolitan areas." (CalPERS, 1992). The program began with investments in affordable single-family homes in California. At the time very few pension funds had ever invested in single family homes. The investment was expected to generate a 22% return, provide construction jobs, and fill a capital gap in the market, while increasing the supply of moderately priced homes in the State. By 2002, the investment generated a ten-year return of 20.9%. Other targeted real estate opportunities soon followed including offices, industrial, mixed-use developments, infill, mezzanine debt and preferred equity.

By 1995, building on the success of their broadly targeted in-state real estate, CalPERS' took the bold move to specifically target underserved capital markets in real estate investment. With general partner Johnson/MacFarlane Partners (Earvin 'Magic' Johnson and Victor MacFarlane), CalPERS formed the California Urban Investment Partners (CUIP). The explicit goal of this $51 m. investment was to invest in retail properties in underserved urban areas of California. As CalPERS' first and largest targeted real estate investment we will examine this partnership in greater detail in section four of this case study.

In 2000, with the success of CUIP, CalPERS' was ready to extend its urban investment sector to include other partners and opportunities in urban markets within the State. Additional research on the sector was conducted by both internal staff and real estate advisors PCA (Pension Consulting Alliance). Once completed, CalPERS' Board developed the California Urban Real Estate (CURE) investment policy as part of their Economically Targeted Investment program.

> "CURE investments include, but are not limited to low-to-moderate-income housing, multi-family low-income housing, commercial or residential or both, urban infill, community redevelopment, and rehabilitation of Core properties. The System shall make such investments under specified conditions and circumstances as described in this Policy. The structure of investment and long-term rate of return shall relate to the relative risk of the investment due to the type, nature of, and relative control over the investment. Minimum acceptable returns shall stay consistent with those defined by the Statement of Objectives and Policies for the Equity Real

Estate Portfolio. Returns shall remain acceptable unless the level of risk, as a result of guarantees or subsidies, is below the level associated with other real estate investments made by the System.

Investment in the Program does not imply reduced expectations for returns or increased willingness to accept risk. The System shall only invest in situations where the investment risk is no greater than in other real estate investments made by the System. If the risk inherent in a particular project is unacceptably high, then the System shall require guarantees, subsidies, or other financial assistance by government agencies to reduce risk to an acceptable level." (Copyright 2003 by CalPERS)

With the CURE policy in place, CalPERS Board issued a Request for Information (RFI) to find firms capable of delivering targeted investment in underserved communities. After appropriate due diligence CalPERS began to add new vehicles to deliver its CURE commitments. By 2001, in addition to increases to CUIP (a further $100 m. commitment) for retail development in underserved markets, and Kennedy (an additional $50 m.) for office development, CalPERS added CIM Group ($125 m.). Bridge Housing Corporation ($100m.) and RREEF ($100 m.) were also added to the CURE program to deliver the Northern California Infill program. CalPERS also invested in Buchanan Street ($60 m.), Capri ($60 m.), Institutional Housing Partners ($40m.) and American CityVista ($40 m.) to focus on multi-family and single family, well as mixed-use properties in urban setting.

In 2002, CalPERS specifically expanded its Economically Targeted Investment Policy to include a specific section on California's Emerging Markets.

"The primary objective of California Emerging Market Investments is to achieve competitive risk adjusted rates of return while broadening economic opportunity in California's underserved areas. Consistent with this strategy, the objective of this policy is to discover and invest in opportunities that may have been bypassed or not reviewed by traditional, more mainstream sources of investment capital.

Prudent investments in these markets will have the collateral intent of creating economic value and activity in underserved markets, thereby contributing to the well-being of the California economy. By strengthening the State's economy and the revenue base of the State of California, these investments will also serve the broad long-term interests of the beneficiaries of the System.

> All California Emerging Market Investments shall be consistent with the Board's overall fiduciary obligations and approved investment policies and guidelines, including the Board's Economically Targeted Investment Policy….
>
> California Emerging Market Investments shall focus on investment opportunities in traditionally underserved markets located in California. By way of example, underserved markets would include urban and rural areas undergoing or in need of revitalization where there are assets (e.g. an available labor pool, underutilized infrastructure) conducive to business development." "Copyright 2005 by CalPERS" (CalPERS, 2005)

The goal of this extended policy is to eventually have 2% of CalPERS total portfolio invested in California's emerging domestic markets. As with the earlier ETI policy, this objective is to be met through a variety of assets classes including real estate. The CURE initiative is a major component in delivery of this goal.

CalPERS now has thirteen investment partners in its CURE program. Since the initial investment with Johnson/ MacFarlane Partners in 1997, CalPERS has committed $3.4 b. to the CURE initiative. Of that, $1.2 b. has been invested.[4] Since inception the CURE portfolio pro-forma IRR based on invested equity is 20.2% (as of March 31 2005) well above the NCREIF benchmark (see Figure 3 below) and the 9.6% performance since inception of the Non-Core portfolio as a whole (this and the following data is drawn from the Review of the California Urban Real Estate (CURE) Sector, Pension Consulting Alliance PCA, 2005).

Given this out-performance it could be argued that boards of trustees, with their own broad constituencies, increase pension funds' sensitivity to the shifting demographics that push market growth. This certainly was the case in CalPERS' early mover advantage in real estate investment in California. Ten years after the 1992 investments in California single family homes, then Board President Bill Crist said, "CalPERS pioneered a program that has proven its value to our members, the System, and the State of California.

[4] Gross investment in CURE to March 31 2005 is $4.4 billion when leveraged dollars are included.

Ten years ago we believed that we could invest responsibly on behalf of our members and still help communities at the same time." (CalPERS, 2002). By 2002 CalPERS' Single Family Housing Program had built thirty-two thousand homes and generated an annualized return of 20.9%. Understanding the growing demand for urban housing in California was key to generating this result.

Table 3-1Performance

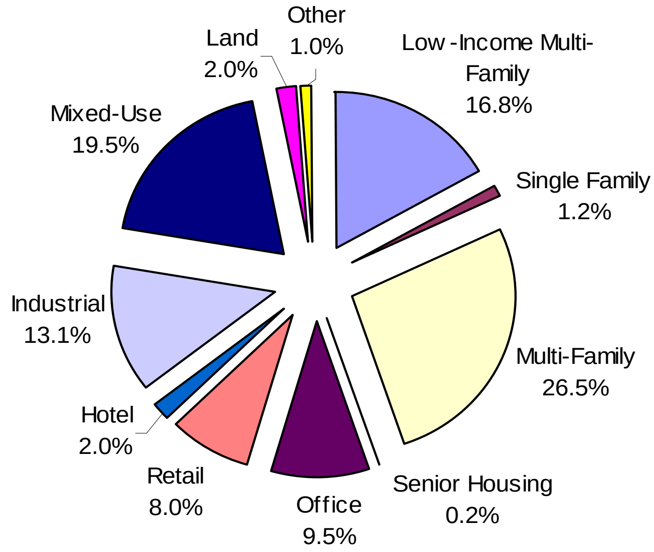
(after management fee but not carried interest as of Dec. 31 2004)

	Inception Date	Allocation	1-Year TWR	3-Year TWR	5-Year TWR	Since Inception TWR	Since Inception IRR[14]	Proforma Net IRR[15]
CURE Sector Total	Feb 1997	$3,410M	50.8%	25.1%	18.2%	15.2%	22.2%	20.2%
NCREIF			14.5%	10.0%	9.9%	8.1%		

Source: Review of the California Urban Real Estate (CURE) Sector, Pension Consulting Alliance PCA, 2005

CURE's thirteen partners invest across a range of investment types, including affordable housing, mixed-use, office, and infill (see Table 3-2 for fund descriptions). The single largest type of investment is multi-family housing (see figure 3-3). There is also geographic diversification, though the primary focus of the program remains California with 77% of total CURE investment in the State.

Figure 3-3 CURE Portfolio Diversification



Source: Review of the California Urban Real Estate (CURE) Sector, Pension Consulting Alliance PCA, 2005

Maximum leverage varies across vehicles. In all cases CalPERS invests as a limited partner and the general partner is expected to have invested at least $10 m. in the vehicle.

Table 3-2 CURE Investment Partners

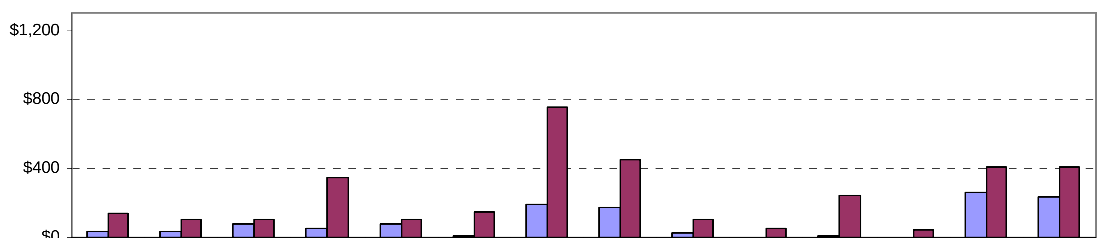
CURE Investment Partner	Business Strategy	Area	Max. Leverage
Build/ Bridge	Affordable housing	Bay Area, CA	65%
Buchanan Urban Investors	Office/Apt/Retail/Mixed-use	Urban CA	N/A
CalSMART/Rreef	Infill development	LA. Region	65%
Capri Urban Capital	Mezz Dept/pref. equity	So. CA	65%
CIM Urban Real Estate Fund	Mixed-use development	Nationwide	80%
Pacific City Home	Affordable for sale housing	California	75%
IHP Investment Fund VI	Income Producing/ For Sale Residential	California	65%
KAREC California Dev.	Office/R&D, Industrial	California	50%

Kennedy Office Dev.	Office/R&D, Industrial	California	50%
KSC Affordable Housing	Affordable Multifamily	California	60%
Legacy Partners Affordable Housing	Affordable Multifamily	California	60%
California Urban Investment Partners	Infill investments	Nationwide	65%
Related California Affordable Housing	Affordable Multifamily	California	60%

Source: CalPERS' CURE Report 2004

These investment vehicles are at a variety of stages along the investment J-Curve (See California Case Study A for a full description of the J-Curve). Levels of capital deployment vary and depend on forward commitments.

Figure 3-4 CURE Invested and Allocated Capital



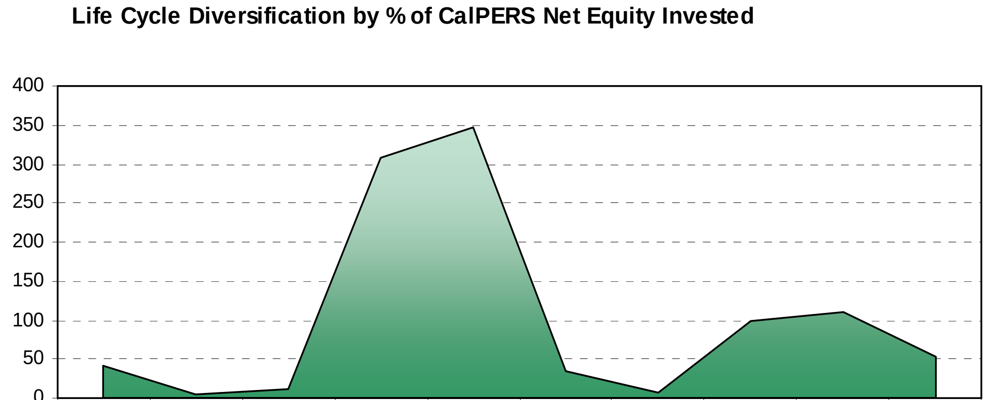
	Capri	Bridge	BUI I	BUI II	Kennedy	KAREC	CUIP	CUIP Credit	PCH	KSC	Legacy	IHP	CalSmart	CIM
Invested	38	33	76	51	75	10	193	171	29	3	11	4	262	232
Allocated	135	100	100	350	100	150	750	450	100	50	240	40	410	405

Invested Allocated

Source: Review of the California Urban Real Estate (CURE) Sector, Pension Consulting Alliance PCA, 2005

Given the young age of the CURE portfolio it is not surprising that three quarters of current investment is still in project development, ranging from un-entitled land to post construction lease up (see Figure 3-5).

Figure 3-5 CURE Current Investment Stages



	Un-entitled Land	Entitled Land	Permitted/ Approved	Pre-Develop.	Constru-ction	Lease-up to Stabil.	Stabilized (Post Const)	Op (<85% Leased)	Op (>85% Leased)	For sale
Net Equity Invested $	42.5	3.8	12.0	308.9	346.1	34.7	7.1	98.1	110.4	51.9
% of Invested NE	4.2%	0.4%	1.2%	30.4%	34.1%	3.4%	0.7%	9.7%	10.9%	5.1%

Source: Review of the California Urban Real Estate (CURE) Sector, Pension Consulting Alliance PCA, 2005

As demonstrated in Table 3 below, internal rate of return (IRR) since inception for CURE external fund managers ranges from a low of -12.4 percent to high of 33.3%. Though the J-curve explains some of the variation in performance, chronic underperformance of three funds has raised concern from the outside real estate consultant PCA.[5]

[5] The three firms identified in the 2005 review of CURE by PCA as having been unsuccessful at deploying meaningful amounts of capital are Related, KSC and IHP (PCA, 2005)

Table 3-3 Performance

(after management fee but not carried interest as of Dec. 31 2004) (1)

CURE Investment Partner	Inception Date	Total Equity Allocation (2)	1-Year TWR	3-Year TWR	5-Year TWR	Since Inception TWR	Since Inception IRR (3)	Proforma Net IRR (4)
Bridge Infill Development	Jun 2002	$100M	-3.0%	n/a	n/a	3.6%	5.0%	13.1%
Buchanan Urban Investors	Dec 2001	$100M	49.6%	24.5%	n/a	30.1%	30.2%	25.1%
Buchanan Urban Investors II	Aug 2003	$350M	8.4%	n/a	n/a	8.4%	15.8%	20.6%
CalSMART	Mar 2001	$410M	22.1%	12.0%	n/a	9.2%	13.0%	15.4%
Capri Urban Capital	Jun 2002	$135M	6.1%	n/a	n/a	7.7%	6.9%	12.0%
CIM Urban Real Estate Fund (5)	Dec 2000	$405M	-6.4%	38.6%	n/a	-9.8%	22.6%	20+%
CityView (5)	Aug 2003	$100M	8.5%	n/a	n/a	-20.2%	6.7%	35.3%
IHP Investment Fund VI	Dec 2001	$40M	-42.3%	-21.9%	n/a	-21.1%	-12.4%	18.5%
KAREC California Dev.	Apr 2002	$150M	53.5%	n/a	n/a	35.5%	47.7%	15.9%
Kennedy Office Dev.	Jan 1998	$100M	37.1%	12.6%	15.1%	12.3%	12.5%	14.3%
KSC	Jan 2003	$50M	-2.9%	n/a	n/a	-6.4%	-6.4%	11.6%

Affordable Housing								
Legacy Partners Affordable Housing	Jun 2003	$240M	-0.9%	n/a	n/a	-0.5%	-2.0%	11.1%
California Urban Investment Partners **(6)**	Feb 1997	$1200M	635.6%	82.4%	46.7%	33.2%	33.3%	24.2%
Related California Affordable Housing **(7)**	Dec 2002	$30M	n/a	n/a	n/a	n/a	n/a	n/a

Source: Review of the California Urban Real Estate (CURE) Sector, Pension Consulting Alliance PCA, 2005

Notes:

[1] Time-weighted returns (TWRs) and total equity allocation obtained from CalPERS Q4-04 real estate portfolio performance report.

[2] Total equity allocation equals original committed equity and does not include re-invested capital.

3 IRRs calculated by PCA using partner since inception cash flows and ENAVs, which are not necessarily externally appraised as of December 31, 2004. IRRs calculated assuming a 50 basis point fee drag on ENAVs. Difference between since inception IRR and proforma IRR attributable to assets being held at cost and the “J curve” effect for many partners.

[4] Proforma IRR after management fee and carried interest. Information from PCA survey of CURE partners for the period ending March 31, 2005.

5 Negative TWR due to majority of quarterly cash flows being negative, while positive IRR is primarily attributable to ENAV.

[6] CUIPhas accrued $43 million in carried interest, which is reflected in their net time-weighted returns above.

7 Related has not yet invested any of CalPERS’ capital commitment.

The same PCA report, while assessing the CURE program generally to be “on-target”, details some concerns that are worth noting.

> “The CURE Investment Policy does not specifically define “urban”. As a result, CURE investment partners have interpreted “urban” in different ways, some of which may or may not be as was originally intended by the Investment Committee.
> No benchmark currently exists for the CURE Sector and no specific benchmark exists for this product type in the industry. However, a specific benchmark is needed that accounts for the embedded risks within these investment strategies. PCA and Staff intend to craft an overall benchmark for the sector and develop customized benchmarks for each partner in the sector based on their strategy and assumed risks over the course of the coming year.
> Investment guidelines and partner contracts are not consistent across partners; many have different fee structures and profit sharing arrangements. PCA and Staff have been working to standardize them going forward.
> Staff has discretion to make incremental allocation increases to individual CURE partners. The Investment Committee and PCA are not involved in these allocation decisions.”
> Review of the California Urban Real Estate (CURE) Sector,
> Pension Consulting Alliance (PCA), 2005

While CURE targets urban investment, it does not either make markets or take excessive risk in very early development of blighted inner city neighborhoods. For these difficult projects, early risk takers, either entrepreneurial developers or non-profit organizations are still required whether it is 125th Street, New York or downtown Los Angeles. But once a neighborhood has begun to show early signs of revitalization potential, CalPERS is prepared to bring considerable investment dollars that enable early development to move to the next level. For example CalPERS’ partnership with CIM in downtown Los Angeles brought the area its first supermarket in eighty years.

4 California Urban Investment Partners (CUIP)

When Victor McFarlane and CalPERS’ joined in a partnership to develop urban underserved real estate in 1995, CalPERS’ officials had only one thing to say to him, “Victor, just don’t lose money.” (Ginsberg, 2004) The partnership with Johnson/MacFarlane “for investment in retail properties in underserved capital markets”

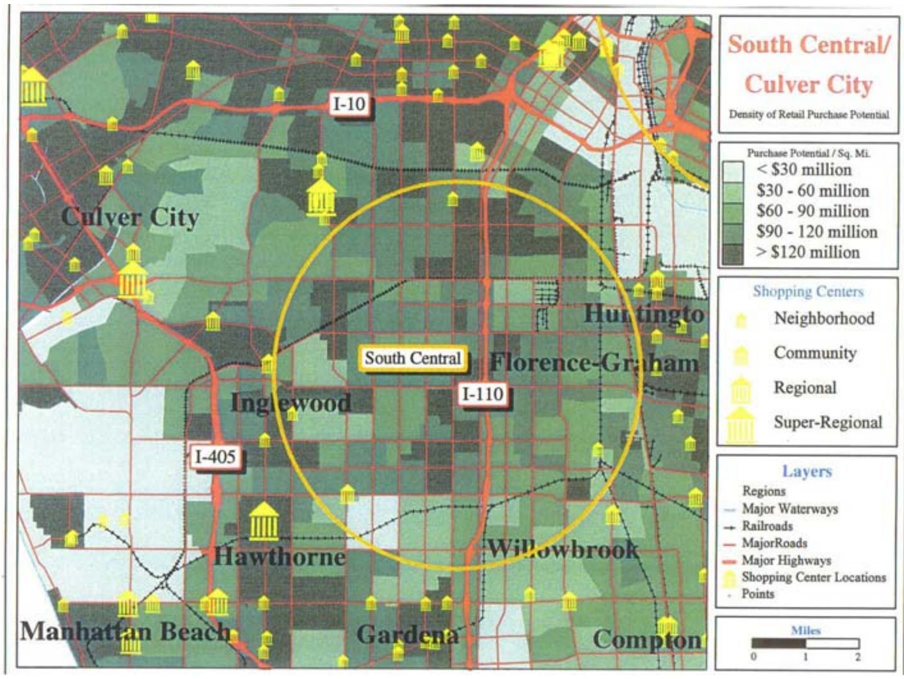
(CUIP, 1995) was a radical step for any pension fund. An extension of CalPERS' decision to target investment in the state of California, it was to be the forerunner of the California Urban Real Estate program. With an annualized net internal rate of return since its 1997 inception of 33%, MacFarlane has delivered on CalPERS' request.

Johnson/MacFarlane was an innovative partnership between Earvin 'Magic' Johnson and Victor MacFarlane designed to capitalize on the untapped and underserved purchasing power of California's inner cities. Johnson Corp. developed and operated "Magic Johnson Theatres' in partnership with Sony Entertainment, while MacFarlane Partners, the nation's largest minority-owned real estate investment company, brought expertise in urban real estate markets. As one of basketball's great players, Johnson's star power gained significant attention for their deals. Both partners and CalPERS' were committed to urban revitalization, but all parties were equally committed to the financial returns these investments would bring. As Chuck Valdes said in 1996, "Besides receiving superior returns, we will be able to create economic opportunities for many minority-owned businesses while providing needed retail products and services to those who live in these communities." (CalPERS, 1996).

Called the California Urban Investment Partners (CUIP), CalPERS' initial investment in Johnson/MacFarlane was $51 million. Victor MacFarlane was already known to CalPERS' who had recruited him in 1992 as part of their emerging external fund managers program. CUIP invests in mixed-use and retail development projects targeted at urban infill in underserved markets. CUIP's development model uses GIS profiling of urban areas in California. They seek densely populated neighborhoods with high purchasing power per square mile, lacking existing high quality retail space (see figures 8 and 9 below for CUIP analysis of South Central LA in 1996 for example).

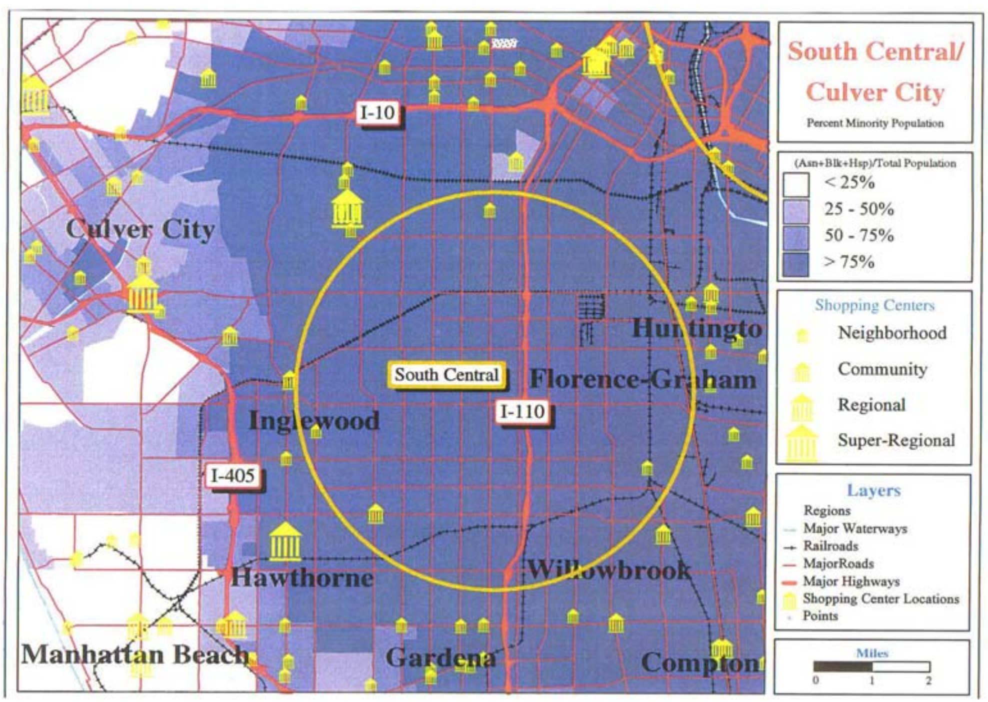
Table 4-1 South Central LA Purchasing Power

South Central LA Purchasing Power Measured Against Retail Opportunities (1995)



Source for both figures 8 and 9: California Urban Investment Partners Investment Program Overview 1997

Table 4-2 South Central LA Minority Population Measured Against Retail Opportunities (1995)



Today CUIP has $1.2 b. of allocated assets from CalPERS, including a $450 m. credit enhancement allocation. CUIP accounts for 35% of CalPERS' total commitments to CURE. It uses a significant amount of leverage in its deal making. In total CUIP investments are 73% leveraged. It has eighteen properties under development, and three exited deals (see Table 4 below).[6] Approximately 16% of CUIP's total housing units are affordable housing. It is estimated that 5,810 construction jobs resulted from CUIP's investments and 3,505 permanent jobs.

Table 4-3 Ancillary Benefits of CUIP Investments

CUIP California Urban Investment Partners

Ancillary Benefits of CUIP Investments

Property	Investment Date	Location	Minority Composition (3-Mile Ring)	Property Type	Commercial Sq. Ft.	Total Housing Units	Affordable Housing Units	Property Status	Estimated Construction Jobs	Est. Direct Permanent Jobs	$ in Millions CalPERS Capital Invested	$ in Millions Total Project Cost/Value*
1100 Wilshire	7/04	Los Angeles, CA	90%	Multifamily	12,500	274	46 **	Under Renovation	270	45	$27	$118
3600 Wilshire	1/05	Los Angeles, CA	86%	Multifamily	22,900	260	0	Under Renovation	290	65	$27	$121
Bay Street Residential	10/02	Emeryville, CA	64%	Multifamily	0	379	57	Under Construction	395	10	$28	$135
Bay Street Retail	11/01	Emeryville, CA	64%	Retail	365,400	0	0	Developed & Sold (10/04)	350	850	$45	$132
Candlestick Cove	2/01	San Francisco, CA	77%	Multifamily	0	420	42	Predevelopment	435	5	$37	$170
Concert Park Lofts	11/04	Los Angeles, CA	52%	Multifamily	10,000	116	52	Under Construction	130	30	$5	$44
Confidential Investment	10/04	New York, NY	48%	Mixed-Use	77,500	293	30 **	Predevelopment	375	205	$34	$1,132
The Crossing Phase II	3/05	San Bruno, CA	65%	Multifamily	0	185	37	Predevelopment	190	5	$15	$50
Dogtown Station	12/04	Venice, CA	43%	Multifamily	0	39	4 **	Under Construction	40	5	$7	$27
Hollywest Promenade	12/99	Los Angeles, CA	74%	Mixed-Use	120,500	100	100	Developed & Sold (10/03)	220	320	$43	$46
Ladera Center	8/97	Los Angeles, CA	81%	Retail	186,800	0	0	Stabilized	n/a	240	$22	$50
Margarita Plaza	2/97	Huntington Park, CA	95%	Retail	76,700	0	0	Acquired & Sold (7/02)	n/a	195	$9	$11
Meridian Apartments	12/02	San Bruno, CA	65%	Multifamily	0	300	60	Leasing Up	120	10	$25	$69
Metropolitan Lofts	12/02	Los Angeles, CA	91%	Multifamily	10,800	264	53	Under Construction	290	40	$61	$59
North Lake Lofts	10/04	Pasadena, CA	63%	Multifamily	17,200	111	0	Predevelopment	130	75	$6	$54
Second & Central	12/03	Los Angeles, CA	93%	Multifamily	12,500	128	26	Under Construction	145	45	$8	$33
Time Warner Center	1/03	New York, NY	49%	Retail/Garage	338,000	0	0	Stabilized	285	30	$10	$495
Tribeca Green	12/03	New York, NY	54%	Multifamily	5,500	274	14	Under Construction	525	845	$27	$110
Unannounced Investment A	11/04	New York, NY	45%	Mixed-Use	106,000	655	99	Predevelopment	980	280	$103	$450
Unannounced Investment B	1/05	Los Angeles, CA	47%	Multifamily	40,000	83	0	Predevelopment	125	105	$56	$271
Wilshire Vermont Station	8/04	Los Angeles, CA	90%	Mixed-Use	35,000	449	90	Under Construction	515	100	$50	$104
Total CUIP Current/Sold Assets as of 3/31/05					1,437,300	4,530	710		5,810	3,505	$645	$3,681

* *Appraised value of stabilized properties; Estimated construction costs for all projects under construction or in predevelopment stages; Gross sales price for sold assets*

** *Off-site affordable housing units*

3/28/05

Source: California Urban Investment Partners Report March 28th 2005

For a program targeting California's under invested urban markets, CUIP's portfolio is broadly diversified. Four of CUIPs development projects are in New York (27% of CalPERS' CUIP investments to date and 8% of the total CURE portfolio). One of those

[6] Exited deals include Margarita Plaza, Hollywest Promenade and Bay Street, Emeryville. Two of the three

four is the Time Warner Center at Columbus Circle, one of Manhattan's hottest new properties. This targeted investment in a US top tier city is similar to the New York City Employees Retirement System's (NYCERS) decision to invest in New York's signature real estate market with developer Tishman/Speyer including its recent purchase of the MetLife Building (Hagerman, 2005). While it certainly generates returns while adding to the building stock of urban America, it is questionable as to whether such investment represents an underserved capital market opportunity.

The Time Warner Center stands in contrast to CUIPs current engagement in the inner city of Oakland CA. Here CUIP is part of a redevelop mixed-use, coliseum project to be built around one of Oakland's inner city BART stations. Victor MacFarlane and his team are working with a local non-profit group, the Oakland Economic Development Corporation to ensure community needs are met. Challenges include small parcels of land, high crime rates and multiple levels of government involvement.

5 CURE Best Practice Implications

Much of the best practice in targeted urban revitalization real estate investment follows the same pattern as best practice found in targeted private equity investment.

First and foremost, pension funds are not risk takers or market makers. They do not take the excessive risk required to develop either severely environmentally contaminated sites or blighted inner city areas where no initial investment has yet taken place. These areas still require a mix of government involvement, non-profit organizations, and entrepreneurial real estate developers prepared to assume such high levels of risk. But these players need to know that once urban revitalization begins, pension funds such as CalPERS will move into the market with sufficient capital investment to take such areas to the next level of development.

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exited deals had disappointing returns of -3.3% and 6.2%. The third exited development gained a return of 19.3%.

Secondly, success in real estate is measured in risk adjusted rates of return first and collateral benefit second. With internal rates of return since inception of CalPERS' CURE program of 22.2% (Dec 31, 2004), such targeted investing has a compelling track record.

Early investment in targeted urban real estate with its location advantages, has allowed CalPERS and other pension funds to gain out-performance on these portfolios. It can be argued that boards of trustees with broad constituencies of their own are sensitive to demographic shifts that allow the pension fund an early mover advantage in rapidly shifting markets.

Best practice in targeted real estate investment uses broad geographic rather than social targeting. It is assumed that positive social impacts are a natural extension of revitalized urban environments that include affordable housing projects and quality retail opportunities. Such investment generates employment both during and post construction. Social goals are best achieved by partnering with a local non-profit organization whose purpose is to achieve social outcomes, rather than the pension fund or real estate vehicle becoming directly engaged in the delivery of social outcomes.

The role of the board of trustees is to be sensitive to shifts in the market and set broad policy direction, while maintaining asset allocation and diversification policies as part of the fiduciary duty of the plan. To avoid charges of political interference, boards should not drive the deals, but rather target the end goal.

Most pension fund targeted real estate is undertaken in limited partnership with external real estate developers acting as the general partner. External real estate developers are expected to invest a significant amount of their own capital in the deal, and are often expected to have considerable assets under development. Track records and relationships are key, and as always, top-quartile performers are in demand.

Many pension funds have adopted a Responsible Contractors policy that stipulates the fair working conditions of firms they invest in. This is particularly important in real estate development where ‘responsible contractors’ are strongly associated with the quality of construction.

Best practice for smaller funds and new entrants to targeted real estate investing includes geographic diversification through reciprocal targeting. This allows pension funds to invest a sum of money in a diversified portfolio with the understanding that the same amount of money will be invested from the broad portfolio, within their geographical area. The Housing Investment Trust (HIT) and Building Investment Trust (BIT) of the AFL-CIO provide this type of real estate investment for many pension funds. While not specifically part of the CURE program, CalPERS’ Core portfolio currently invests $112 m. in the Building Investment Trust with reciprocal geographic targeting.

6 Conclusion

CalPERS’ targets considerable investment in the State of California. Currently 11% of its $192 b. portfolio has an in-state focus. Of that target, roughly $6 b. is invested in California real estate. The California Urban Real Estate Program (CURE) with current investments of $1.2 b. and allocations of $3.4 b., is aimed at investment in California’s metropolitan areas. The CURE program also provides significant investment capital in California’s underserved capital markets with a direct impact on urban revitalization. Investments include low and moderate income housing, mixed-use retail, urban infill, community redevelopment and rehabilitation of core properties.

CalPERS’ investment has resulted in revitalized communities, more affordable housing, quality retail opportunities, and good jobs. It has also resulted in strong financial returns for its investors. The CURE program has a long track record. Since its 1997 inception it has generated an internal rate of return (IRR) of 22.2%. Such returns are well above external real estate benchmarks and point to the success of this program. Given that success in pension fund investment in urban revitalization is measured in terms of risk adjusted rates of return, the California Urban Real Estate Program is a success.

But while the CURE portfolio outperforms the standard NCREIF benchmark and the Non-Core portfolio as a whole, currently there are no standard benchmarks specifically for targeted urban real estate investment. Pension Consulting Alliance is in the process of developing just such a benchmark against which to measure CURE's portfolio performance as a whole and the performance of individual firms in the program.

It could be argued that the sensitivity of CalPERS Board to the changing demographics of California provided it with an early mover advantage in the urban real estate market of the state. Both increases in population and renewed desire to live in 24/7 cities have made California's large metropolitan areas attractive to investors and developers alike.[7] It could also be argued that the 'easy deals' have now been done and that much harder urban revitalization projects remain. However, urban revitalization issues such as brown-field redevelopment with its potential environmental contamination are increasingly easier for developers to deal with and the risks associated with these types of projects are on the decline.

It must be noted that there is no hard and fast definition of what constitutes urban revitalization as it is applied to targeted pension fund investment. For some, it means any investment that is targeted to an urban area. For others, the community must be one with clearly visible underserved capital market requirements. Within this broad definition urban revitalization investment can be directly in urban or inner city businesses through private equity, in the urban building and housing stock through real estate, in mortgages and other fixed income products, or in providing services to communities through infrastructure investment.

Nor are there standard measurements for the collateral benefits that such investment brings to communities. It is assumed that any targeted investment will generate positive

[7] 24/7 cities describe urban areas where people live, work and play.

collateral impacts for communities, and CalPERS does not take responsibility for the social impacts that may result from its investment. However we find that to be successful in urban revitalization, developers must be sensitive to community needs. Most often these developers partner with local non-profit organizations that have deep local knowledge, trust, and specific expertise in attaining social goals. Rather than the simply engaging in a gentrification process that displaces current residents, this type of investment approach is key for generating lasting collateral benefits for existing communities.

CalPERS targets underserved capital markets in both its real estate and its private equity portfolio. While it is too early to judge the success of its private equity 'California Initiative', we find with its longer track record, the California Urban Real Estate program to be a model of successful best practice in pension fund investment in urban revitalization. We encourage other public sector pension funds to look at these investment opportunities in their own communities.

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