MEKETA

San Diego City Employees' Retirement System

July 11, 2024

SDCERS Real Estate Investment Policy and Annual Investment Plan Review and Recommendation

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A. Market Overview

Market Overview Summary

→ Since March of 2022, the actions of the Federal Reserve aimed at lowering inflation have resulted in debt costs that have more than doubled, near frozen debt capital markets, greatly reduced commercial real estate transaction volume, and price opacity.

→ The year 2023 ended with the trajectory of the US economy remaining uncertain and investors adjusting their return expectations assuming a higher for longer interest rate environment.

→ While headline inflation has been moderating, the pace has been slower than anticipated and inflation remains above expectations. The Federal Reserve has indicated, that based on economic data, they are inclined to keep rates higher for a longer period of time.

→ Cooling tenant demand coupled with the increasing cost of debt and slowing rent growth are weighing heavily on commercial real estate property values. In addition, the lack of transaction volume has made it more difficult to determine "fair value."

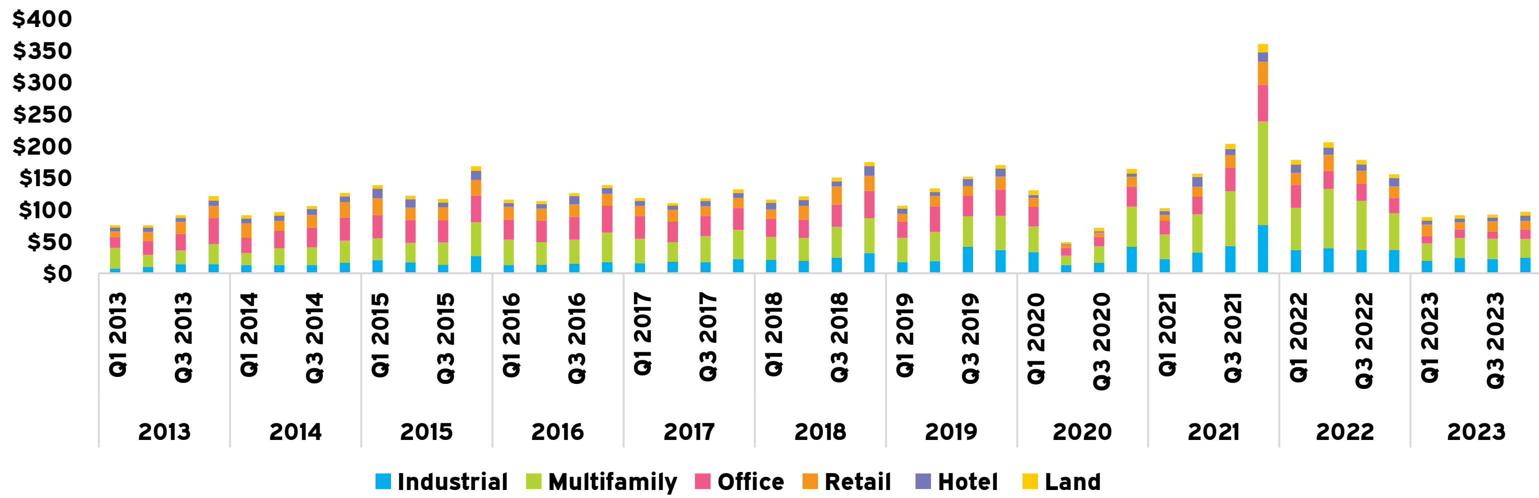
→ Some asset owners with maturing debt, or expiring interest rate caps, could have difficulty obtaining financing and be forced to sell their commercial real estate asset(s) or to give the asset(s) back to the lender.

→ The amount of distressed assets that may come to market remains unclear. Commercial real estate loan exposure at large banks is generally less than levels held at smaller/regional banks.

→ Lenders have become more conservative leading to lower advance rates and stronger covenants.

→ As long as the uncertainty surrounding the US economy and capital markets endures, we expect transaction volume to remain suppressed and appraisal-based valuations to continue to decline.

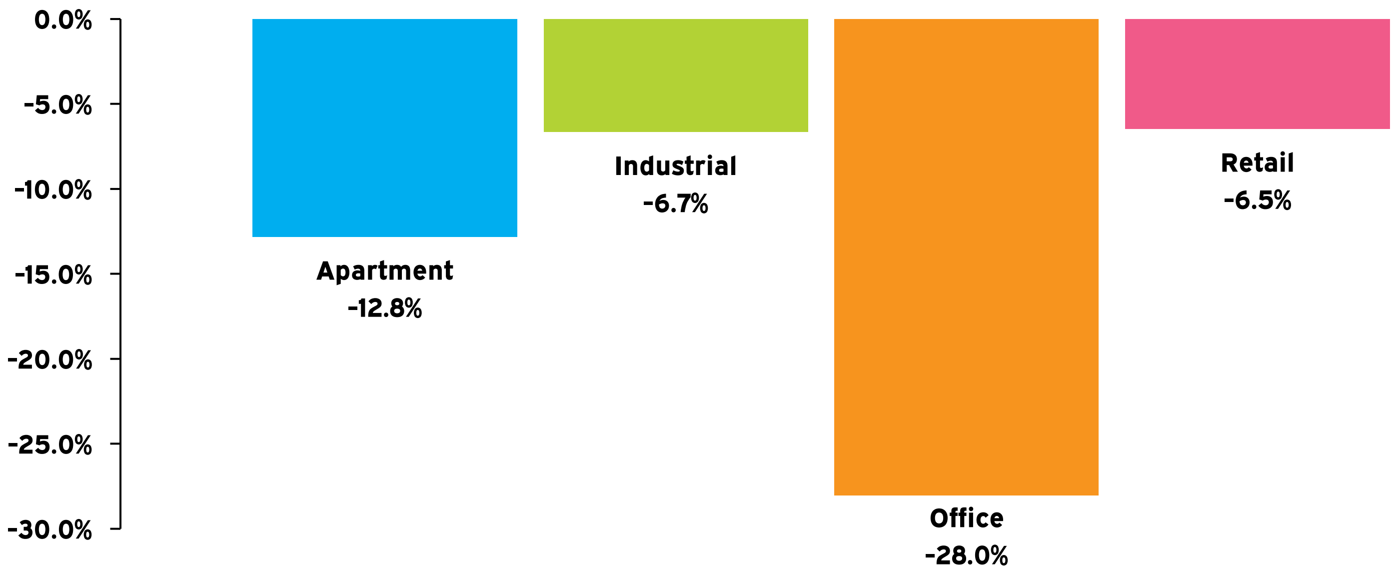
Quarterly Transaction Volume by Property Type



- → Private real estate transaction volume for properties valued over $2.5 million was $96.5 billion in the fourth quarter of 2023, slightly up from the $92.1 billion total last quarter, but remaining generally low overall relative to prior quarters as a result of continued high interest rates and cap rate expansion.
- → The office sector experienced the largest increase in transaction volume from the prior quarter of $3.8 billion. The multifamily and retail sectors decreased by $2.8 billion and $1.9 billion, respectively, with the remaining sectors experiencing minimal positive changes.
- → While the fourth quarter had the largest transaction volume amount of 2023, building on the increases of prior quarters, overall transaction volume remains subdued.

Source: NCREIF Property Index (NPI).

Trailing One-Year Valuation Change Based on Cumulative Appreciation Returns (As of December 31, 2023)



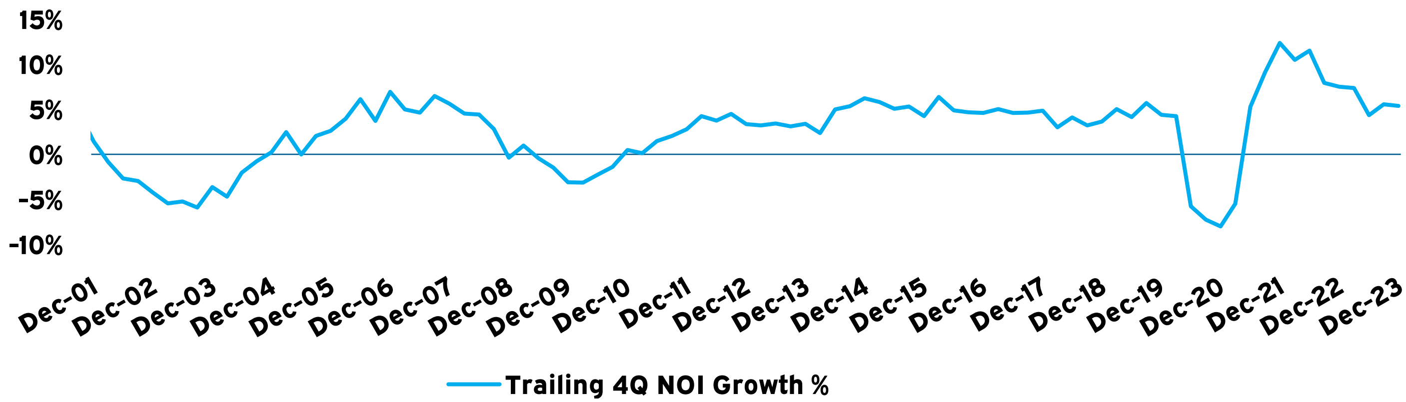
→ Properties within the NPI and ODCE indices have experienced negative appreciation for the past five quarters, despite overall property level fundamentals, such as occupancy, remaining healthy.

→ More property write-downs are anticipated due to interest rates remaining higher for a longer period of time and continued market volatility.

→ Office properties, especially those buildings which are older and/or dated, are expected to continue to bear the brunt of write-downs.

Source: NCREIF. NPI unlevered appreciation returns for ODCE properties in the NPI (at share).

Trailing One-Year Net Operating Income ("NOI") Growth



→ The overall trailing twelve-month rate of NOI growth decelerated in the fourth quarter of 2023 to 5.4%, as compared to 5.6% in the third quarter of 2023. The decrease was primarily driven by office and retail sectors.

→ Office decelerated the greatest amount (307 basis points), resulting in a trailing 12-month NOI growth rate of 1.5%.

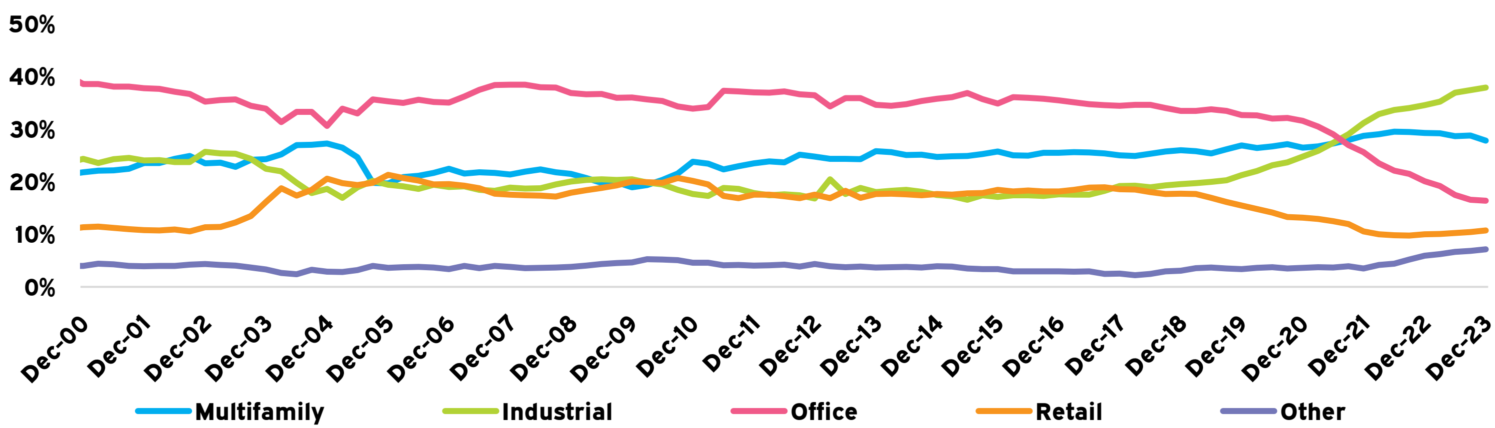
→ Retail decelerated by a small amount (135 basis points) but maintains a 2.8% NOI year-over-year growth rate as of December 31, 2023.

→ Multifamily NOI growth accelerated approximately 100 basis points to 4.4% growth year-over-year.

→ Industrial NOI also accelerated 249 basis points during the quarter to 12.3% NOI growth year-over-year and has the highest trailing 4Q NOI growth rate across all property types as of December 31, 2023.

Source: NCREIF Property Index (NPI)

Property Type Changes Within the Equal Weighted ODCE Index



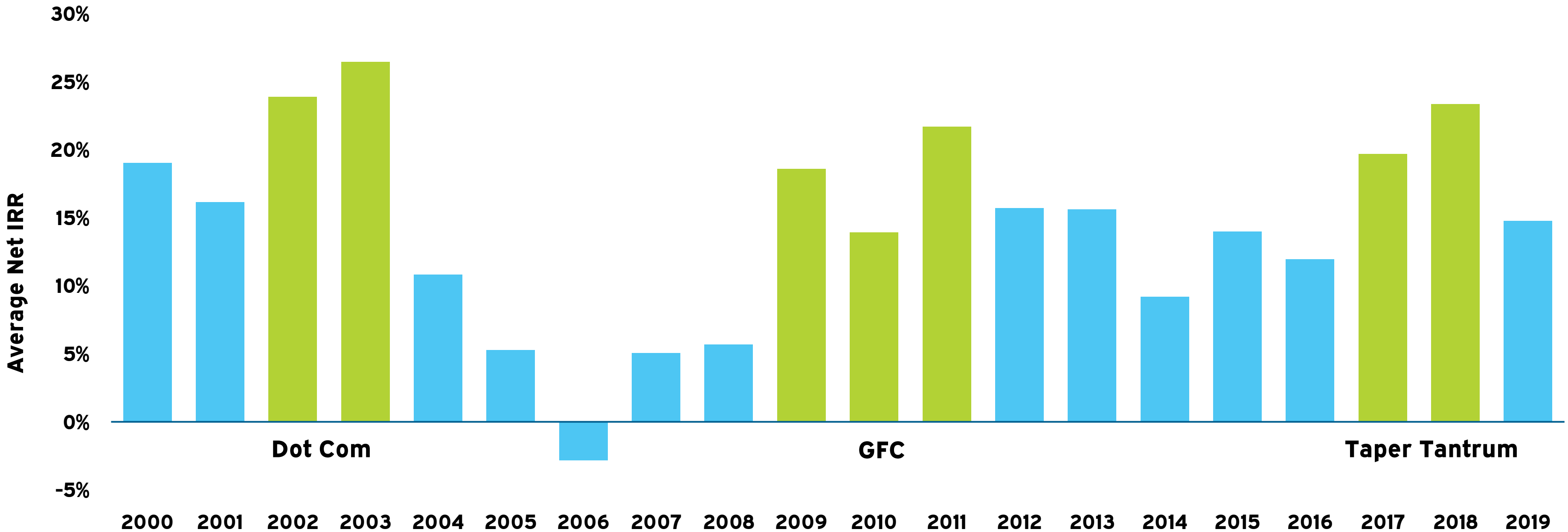
→ The NFI-ODCE Equal Weight Index currently comprises 28% multifamily, 38% industrial, 16% office, 11% retail, and 7% in other property types, based on its net asset value ("NAV") as of the fourth quarter of 2023.

→ The heavy weight towards multifamily and industrial is due to increased investor interest and consistent growth within each sector over the past five years. Office exposure continues its steady decline since 2020. The office sector has had the largest decline of the property types within ODCE during the past year.

→ Retail exposure has trended upwards during the past year experiencing modest growth since December 2022. Property types in the other category have seen increased investor interest in recent years.

Source: NCREIF

Average Net IRR by Vintage Year, US Closed-end Value-Add Funds



→ Private real estate value-add funds launched after economic shocks have historically outperformed.

→ With property values down from recent highs and underlying property fundamentals remaining strong, history is poised to repeat itself. However, the timing and extent of outperformance in private real estate is dependent on a number of factors and therefore remains uncertain.

Source: Heitman and Preqin; U.S. Closed-end Value-Add Real Estate Funds >100 Million

B. Real Estate Program Overview

Target Allocation and Funding Status as of 4Q-2023

→ SDCERS is within its tactical range for real estate but is below its strategic target of 11.0%

- Real estate values have declined
- Total Plan assets have increased

	RE FMV ($M)	Total Plan ($M)	RE Allocation	Tactical Range	In Compliance
4Q - 2021	$1,134	$11,008	**10.30%**	6% - 16%	Yes
4Q - 2022	$1,206	$10,310	**11.70%**	6% - 16%	Yes
2021 – 2022 Variance ($)	**$72**	**($698)**			
2021 – 2022 Variance (%)	**6.4%**	**(6.3%)**	**140 bps**		
4Q - 2022	$1,206	$10,310	**11.70%**	6% - 16%	Yes
4Q - 2023	$1,128	$11,170	**10.10%**	6% - 16%	Yes
2022 – 2023 Variance ($)	**($78)**	**$860**			
2022 – 2023 Variance (%)	**(6.5%)**	**8.3%**	**(160 bps)**		

Risk Classifications

→ SDCERS is within its tactical ranges for Core and Non-Core real estate

→ SDCERS is within the proposed tactical ranges for Real Estate Equity and Real Estate Debt

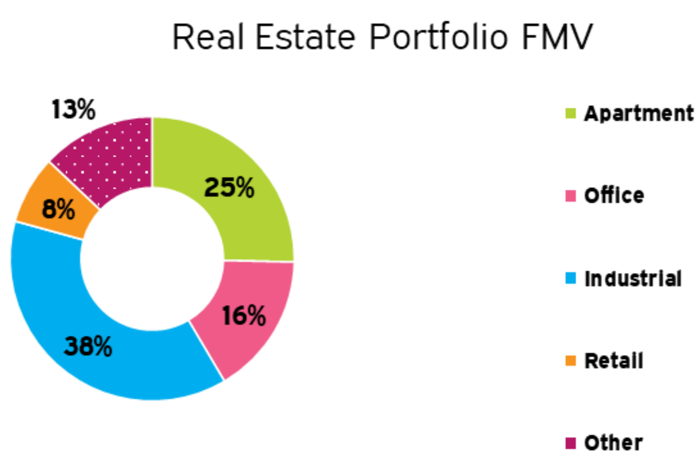
	Strategic Targets		Portfolio Composition (12/31/23)	
	Target	Tactical Range	NAV	NAV + Committed
Total Real Estate	11%	6% - 16%	10.1%	12.1%
Core Portfolio	70%	55% - 85%	80%	69%
Non-Core Portfolio	30%	15% - 45%	20%	31%
Real Estate Equity (Proposed)	*90%*	*80% - 100%*	*89%*	*87%*
Real Estate Debt (Proposed)	*10%*	*0% - 20%*	*11%*	*13%*

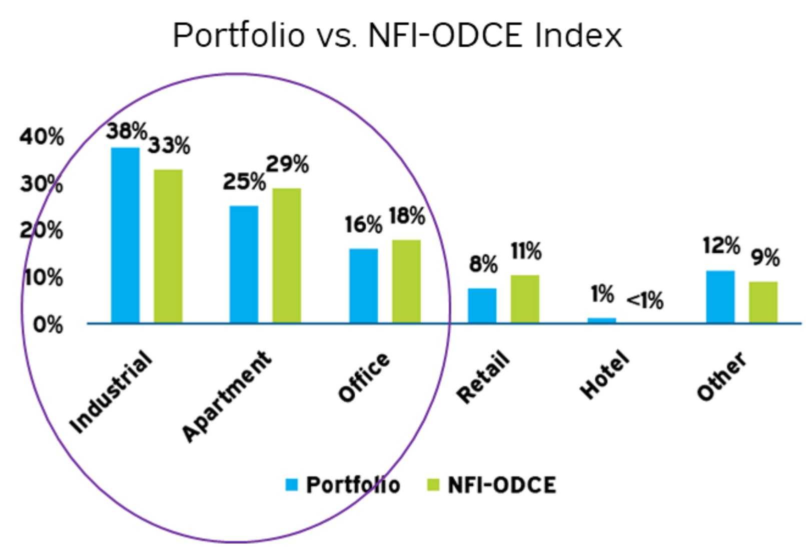
Guideline Adherence

→ The SDCERS portfolio is within its leverage and diversification guidelines

	Target	Guideline	Actual as of 12/31/23	Guideline Adherence
Core Leverage	20% - 30%	<45%	34%	Yes
Portfolio Leverage	35% - 45%	<50%	40%	Yes
Debt Investments		<30%	11%	Yes
Single Manager		<30% (Includes Unfunded)	12% (Morgan Stanley / Mesa West)	Yes
Property Type		+/- 15% of ODCE	+ 5% (Industrial)	Yes
Geographic Region		+/- 15% of ODCE	- 5% (West)	Yes
Non-U.S.		<15%	5%	Yes

Property Type Diversification





- Other is composed of: Hotel, Self Storage, Senior Housing, Student Housing, Life Sciences, Medical Office, Land, Manufactured Housing, Life Sciences, and Other Alternative property types.

Key Observations

→ Broadly diversified by property type, including (Other) niche sectors

→ In compliance with policy guidelines

→ Favorably overweight Industrial

→ Favorably underweight Office

→ Unfavorably underweight Apartments

C. Risk/Return Assessment

SDCERS Real Estate Investment History and Position

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

→ As of 4Q-2023, its RE allocation on a Fair Market basis is 10.1% vs. the 11% target allocation, roughly a $60M shortfall.

→ Target portfolio exposure is 70% to Core and 30% to Non-Core.

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

- Staff and Consultant consider supply and demand fundamentals in new allocation decisions.
- SDCERS is underweight to the Office sector, which is widely recognized as the sector with the most near-term demand uncertainty.
- During FY24, $25M was committed to a Non-Core diversified debt fund; no commitments were made to funds that specifically target the office sector.

→ Trailing 1YR returns illustrate a methodic resetting of values in response to a higher risk-free rate:

Trailing Quarterly Returns (Net TWR)				
Period	1Q23	2Q23	3Q23	4Q23
SDCERS Return	(2.7%)	(1.8%)	(2.4%)	(4.3%)
Benchmark[1]	*(3.3%)*	*(2.8%)*	*(2.0%)*	*(4.9%)*

[1] NCREIF Fund Index-Open End Diversified Core Equity (VW) (Net) + 12.5 bps

Portfolio Risk/Return Assessment Summary

Core / Core Plus Funds

→ Six of eight ODCE funds are outperforming the ODCE Index the past three years

→ Both Core Debt funds delivered low single digit returns the past three years and have high exposures to office loans

→ Both Core Plus industrial funds delivered a 16%+ net return the past three years

Non-Core Funds

→ Opportunistic funds have a wider return dispersion than value-add funds

→ 20 of 24 Non-Core funds had negative returns in calendar year 2023

→ 9 of 20 active Non-Core funds with a vintage of 2019 or earlier have a since inception net IRR of less than 5%

- $86 million of FMV (8% of total RE portfolio)

Core / Core Plus Snapshot

Fund	3YR Net TWR as of 12/31/23	Year over Year Change
Clarion LIT (Core Plus Industrial)	**19.2%**	**(6.5%)**
DWS CPIF (Core Plus Industrial)	**16.6%**	**(6.6%)**
CBRE Core	8.6%	(4.9%)
Morgan Stanley Prime	6.7%	(2.6%)
MetLife	5.6%	(5.7%)
Principal	4.5%	(4.3%)
PRISA	4.4%	(4.7%)
RREEF America II	4.1%	(6.4%)
JP Morgan SPF	1.8%	(5.9%)
UBS TPF	0.6%	(4.2%)
MetLife Core Mortgage (Debt)	**3.6%**	**+0.2%**
Mesa West Lending (Debt)	**0.0%**	**(5.1%)**
ODCE (Net) Value Weight	*4.0%*	*(5.0%)*

Core Plus relative outperformance compared to SDCERS benchmark.

Six of the eight diversified Core (ODCE) funds outperformed the SDCERS benchmark.

Core Debt relative underperformance compared to SDCERS benchmark.

D. Capital Projections and Pacing

FY 2025 Capital Projections and Pacing Summary

Overall Objectives

→ Manage overall exposure from current 10.1% to the 11.0% target and maintain exposure close to 11.0% through the analysis period

→ Manage overall Core exposure down from 80% toward 70% target

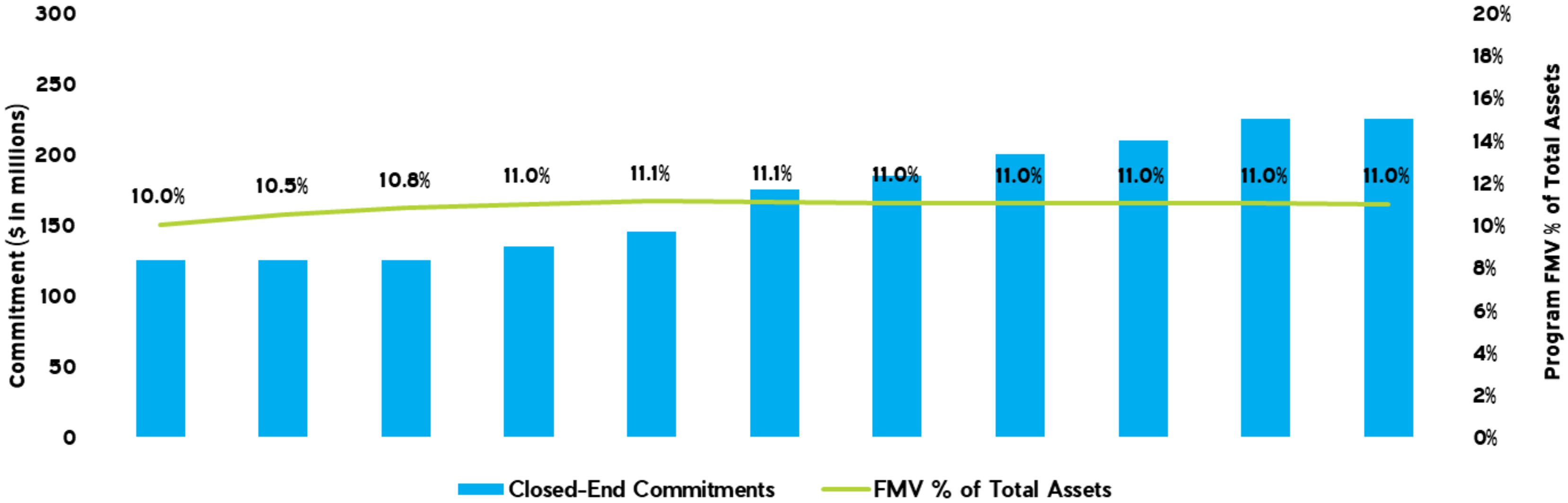
- Long term tactical exposure target of 50% diversified Core Equity and 20% Core Plus Equity

→ Maintain steady Non-Core commitment pace to avoid vintage concentration

- Focus on Value-Add Equity and Non-Core Debt strategies
- Long term tactical exposure target of 20% Value-Add and 10% Non-Core Debt

	2025 ($M)	2026 ($M)	2027 ($M)
Core/Core Plus Commitments	115	105	90
Non-Core Commitments	125	125	125
Redemptions/Distributions	(115)	(153)	(168)
RE Exposure	10.0%	10.5%	10.8%

Recommended Commitment Pacing



Commitment Allocations

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11
Opportunistic	0	0	0	0	0	0	0	0	0	0	0
Value-Added	70	70	70	80	90	110	120	130	140	150	150
RE Debt	55	55	55	55	55	65	65	70	70	75	75
Closed-End Total	125	125	125	135	145	175	185	200	210	225	225
Core											
Commitments	*115*	*105*	*90*	*60*	*35*	*40*	*45*	*50*	*55*	*60*	*65*
Redemptions	*5*	*35*	*40*	*35*	*0*	*0*	*0*	*0*	*0*	*0*	*0*

Fair Market Value by Strategy

				Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11
Opportunistic	0%	-	40%	9%	7%	5%	4%	3%	2%	1%	1%	0%	0%	0%
Value-Added	0%	-	40%	9%	9%	10%	12%	13%	14%	16%	17%	18%	19%	20%
RE Debt	0%	-	20%	4%	6%	8%	9%	10%	10%	10%	10%	10%	10%	10%
Core	55%	-	85%	78%	77%	76%	75%	75%	74%	73%	72%	71%	70%	70%
Total				100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

E. Real Estate Investment Policy

Annual Investment Policy Statement Assessment

Summary of Changes

→ Revision of the current real estate debt investment guideline

Investment Structure	Current Guideline	Proposed Target	Proposed Range
RE Debt	Max 30%	10%	0% to 20%
RE Equity	n/a	90%	80% to 100%

→ Incorporation of recently approved expansion of the Core/Non-Core tactical ranges was approved at the March 2024 Board Meeting

→ Clarification of benchmarking language to reflect actual performance reporting and common industry practice

- Net time-weighted returns and net IRR
- Revise "Private Market Equivalent" to "Public Market Equivalent" reference

F. Annual Investment Plan

FY 2025 Portfolio Considerations

Exposure Targets

- → Manage overall exposure to be within a functional 10.0% - 12.0% tactical range
- → Manage Core/Non-Core allocation toward the 70 / 30 target

Property Type Allocations

- → Remain underweight Office and overweight Industrial
- → Increase Multifamily to at least neutral weight

Core Portfolio Composition

- → Evaluate options to replace Core Debt investments with exposure to higher conviction strategies

Non-Core Portfolio Composition

- → Focus on sectors with favorable supply/demand fundamentals and/or demographic tailwinds (invest with specialists)
- → Capitalize on capital market dislocation through structured debt opportunities

FY 2025 Investment Plan - Core

Core Equity

→ Rescind redemption request for MetLife Core Equity ($55M remaining)

- Mitigates risk of the RE portfolio moving further below target

→ Commit $40 million to high conviction existing manager(s)

- Potential to acquire at a discount to NAV

→ Remain in UBS Trumbull Property Fund redemption pool ($26M remaining)

- Potential to manage down asset management fees through revised loyalty program, without impacting timing of redemptions

Core Plus Equity

→ Commit $75 million to new diversified or residential focused open-end fund

- Potential to increase residential exposure toward equal weight

Core Debt

→ Submit redemptions from Mesa West and MetLife Core Mortgage on a 50/50 basis to higher yielding Non-Core Debt investments

FY 2025 Investment Plan – Non-Core

Non-Core Equity

→ Commit $70 million to funds focused on sectors with clear tenant demand drivers and expected capital inflows

- Two (2) $35 million commitments

Non-Core Debt

→ Commit $55 million

- $25 million to new manager
- Consider $15 million upsize to Torchlight VIII ($25M commitment approved November 2023)
  - Existing manager
  - Fee discount
- Consider $15 million to Waterton Debt Sidecar Fund alongside Waterton XV ($25M Fund XV commitment approved November 2022)
  - Existing manager
  - Targeted apartment property sector
  - Favorable economics

G. Recommendations for Approval

Summary of Recommendations for Approval

Investment Policy Statement

- → Replace current Real Estate Debt Guideline of a "Maximum 30% exposure" with "10% target exposure and a 0% to 20% tactical range"
- → Add corresponding Real Estate Equity target of 90% with an 80% to 100% tactical range
- → Incorporate recently approved expanded range for Core/Non-Core segments
- → Revise "Private Market Equivalent" reference to "Public Market Equivalent"

Annual Investment Plan – Core

- → $115 million in new commitments
- → Rescind the full redemption request from MetLife Core Equity Fund
- → Remain in the UBS Trumbull Property Fund redemption pool
- → Submit redemptions from Mesa West and MetLife Core Mortgage funds, on a 50/50 basis, as new commitments are made to Non-Core Debt funds

Annual Investment Plan – Non-Core

- → $70 million in new commitments to equity funds
- → $55 million in new commitments to debt funds

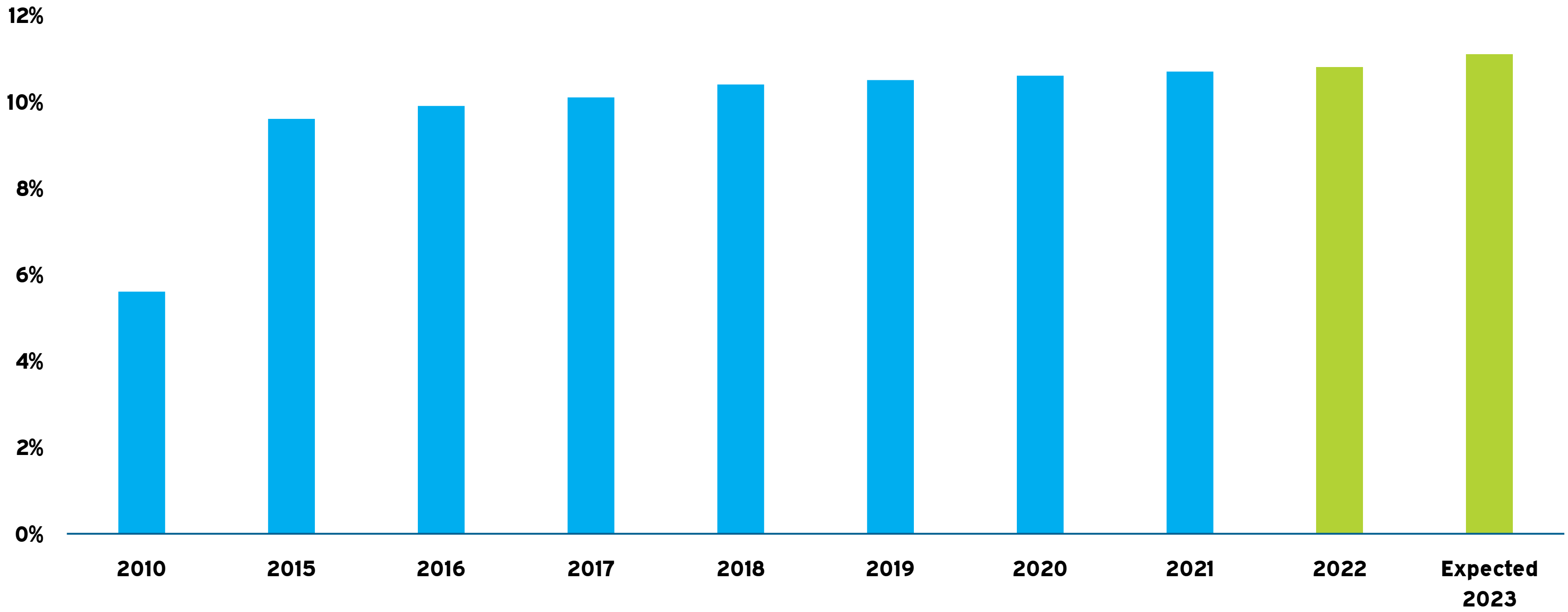
Core / Non-Core Allocations – Impact of Recommendations

Portfolio / Risk Profile	4Q 2023 NAV ($M)	4Q 2023 Allocation	FY2025 Action ($M)	NAV after FY2025 Action ($M)	Exposure Impact	Allocation after FY2025 Action	Target
Core Equity	$632	56%	$13	$645	(6%)	50%	50%
Core Plus Equity	$175	16%	$75	$250	4%	20%	20%
Core Debt	$89	8%	($55)	$34	(5%)	3%	0%
Subtotal Core	*$896*	*80%*	*$33*	*$929*	*(8%)*	*73%*	*70%*
Non-Core Equity	$193	17%	$70	$263	3%	20%	20%
Non-Core Debt	$39	3%	$55	$94	4%	7%	10%
Subtotal Non-Core	*$231*	*20%*	*$125*	*$356*	*8%*	*27%*	*30%*
Total	**$1,127**	**100%**	**$158**	**$1,285**	**14%[1]**	**100%**	**100%**

[1]Total SDCERS RE pro forma exposure increases 14% from 4Q 2023 NAV.
Figures rounded for illustrative purposes.

H. Appendix

Institutional Investor Real Estate Target Allocations

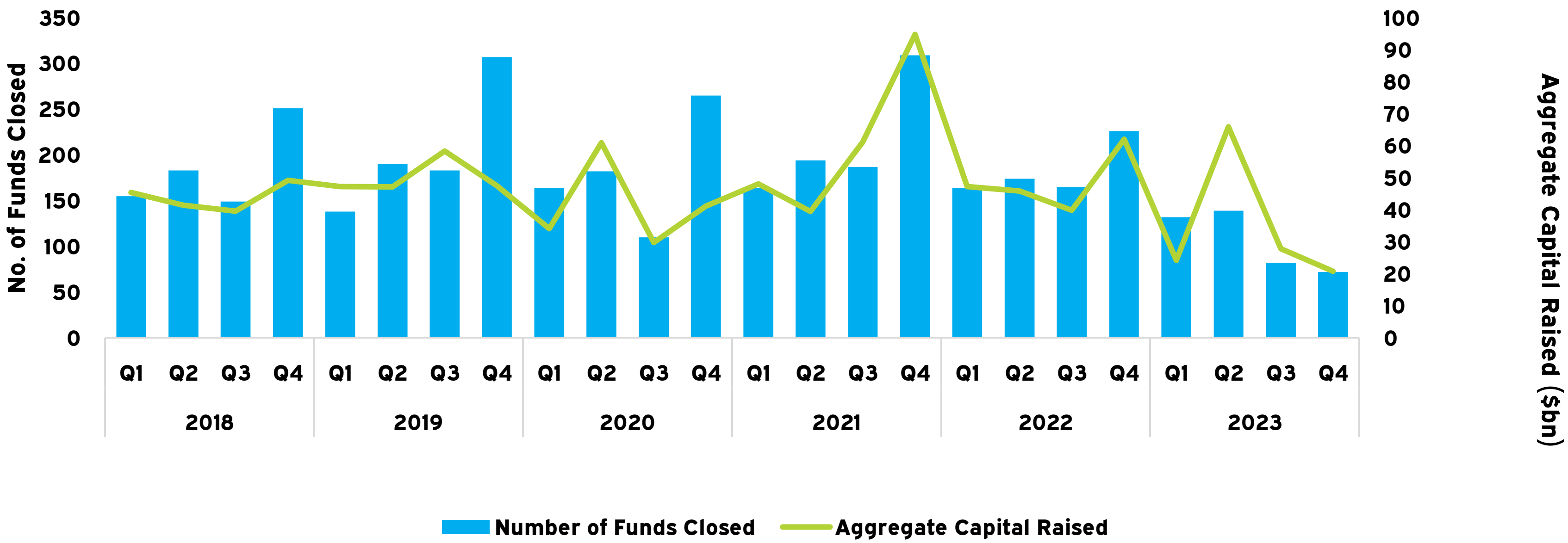


→ Institutional investors are maintaining their allocations to real estate with an average target of 10.8% between 2022 and 2023.

→ While many institutions are at or over their target allocations due to the growth in public equity investments and the resulting denominator effect, allocations to private real estate are anticipated to come down as private real estate values decrease.

Source: Hodes Weill 2023 Institutional Real Estate Allocations Monitor. Published November 2023.

Global Quarterly Closed-end Real Estate Fundraising Q1 2018 – Q4 2023

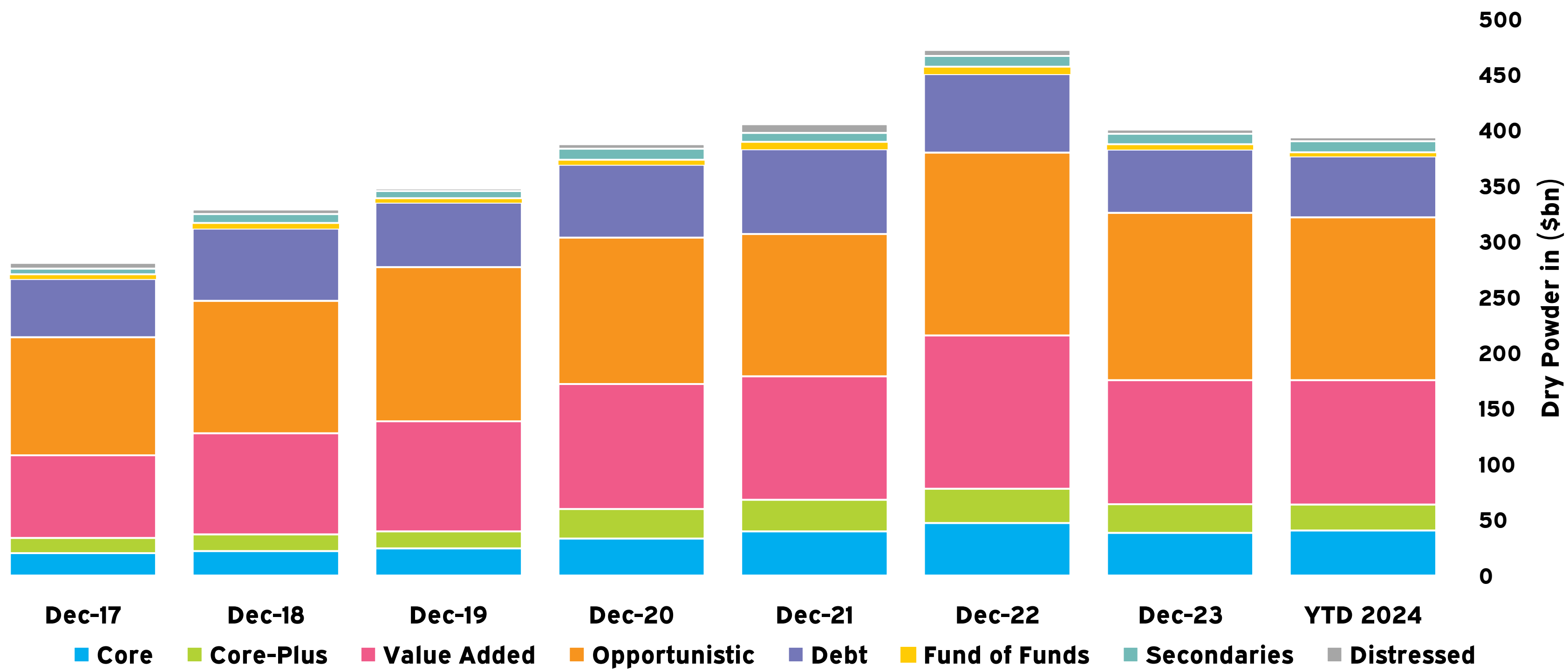


→ The number of fund closings and amount raised in the fourth quarter of 2023 is lower than the prior quarter and dramatically lower than the second quarter primarily due to the closing of a mega-fund (Blackstone Real Estate Partners X).

→ In addition, year-over-year fourth quarter activity was much lower than the same quarter in 2022 and hit the lowest point for number of funds closed and capital raised since the first quarter of 2018.

Source: Preqin Pro.

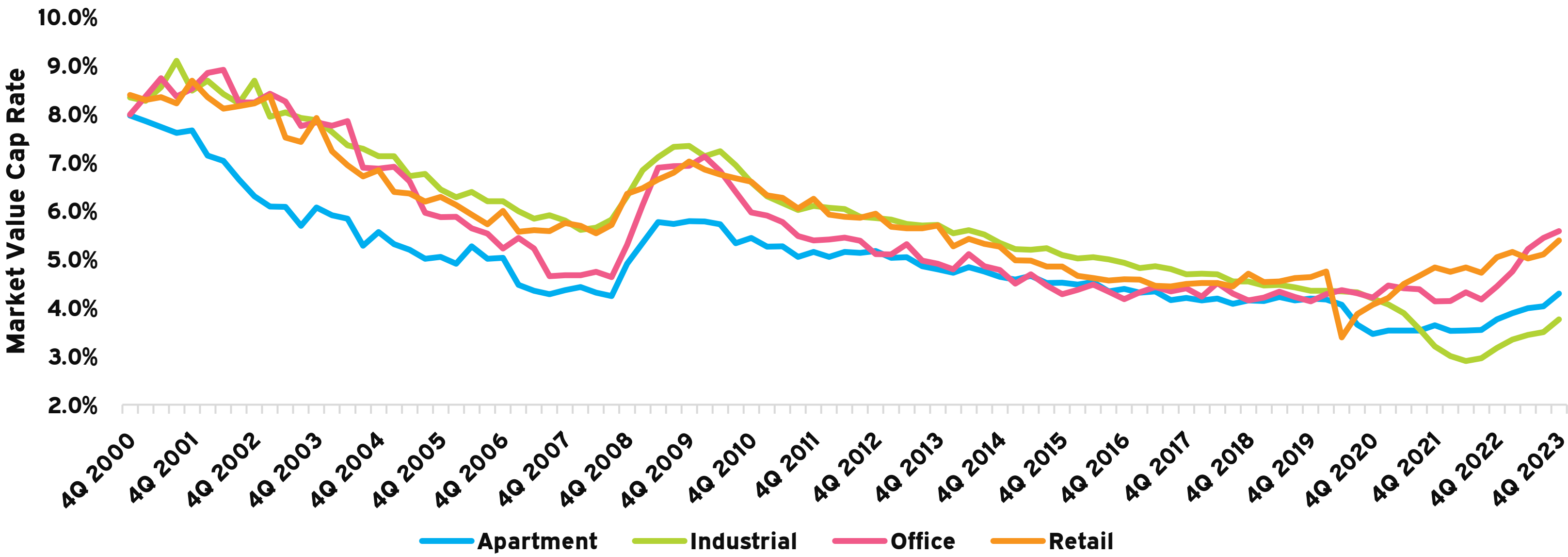
Dry Powder for Real Estate Closed-end Funds



→ The amount of capital available globally to invest across private real estate strategies decreased in 2023 but remains high from a historical perspective at just under $400 billion. The preliminary 2024 year-to-date amount, is showing a slightly lower amount in comparison to December 2023.

Source: Preqin Pro. Data as of March 2024.

Market Value Cap Rates by Property Type



→ During the fourth quarter, retail cap rates had the largest increase at 29 basis points, while apartment and industrial each witnessed increases of 26 basis points and office experienced an increase of 14 basis points. Higher cap rates mean lower values, all else being equal.

→ Industrial and apartment property types continue to have lower cap rates than office and retail.

→ All property types presented have higher cap rates now than one year ago.

→ It is anticipated that cap rates will continue to rise as property values decline.

Source: NCREIF Property Index (NPI).

PREA Consensus Forecast Survey of the NCREIF Property Index ("NPI")[1]

Category	Total 1-Year Return 2023 (Actual)	Total 1-Year Return 2024 (1Q 2024 Survey)
Total NPI	(7.9%)	(2.0%)
Office	(17.6%)	(9.9%)
Retail	(0.9%)	3.2%
Industrial	(4.1)	0.9%
Apartment	(7.3)	(2.3%)

→ The PREA consensus forecast survey indicates that participants expect the NPI Index for the year 2024 to have greatly improved total returns, but returns are anticipated to still be below normal.

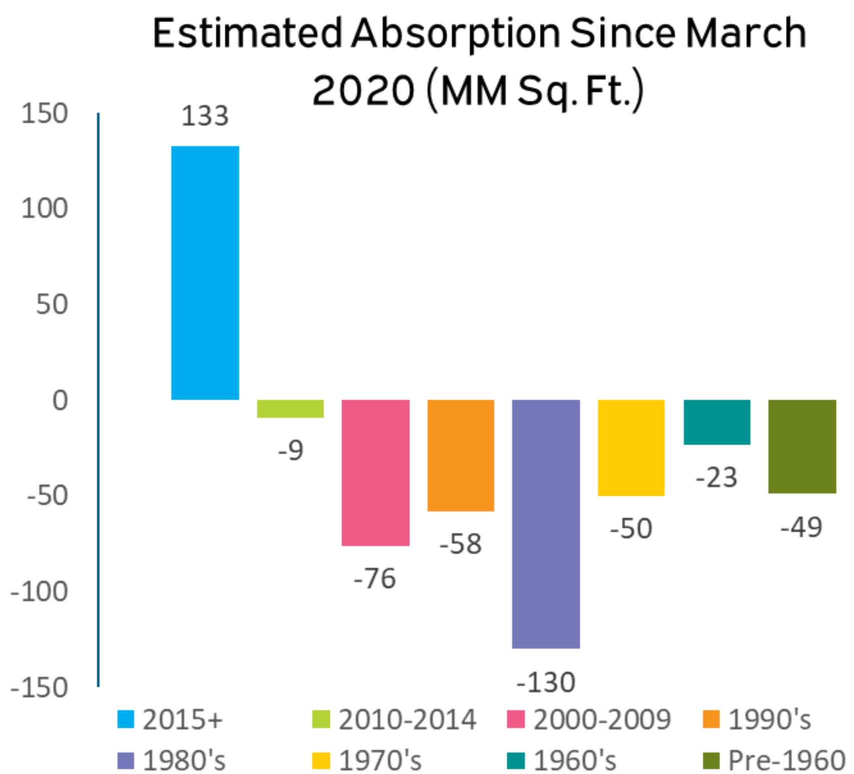
→ The survey also indicates a continued dispersion of returns among the property types.

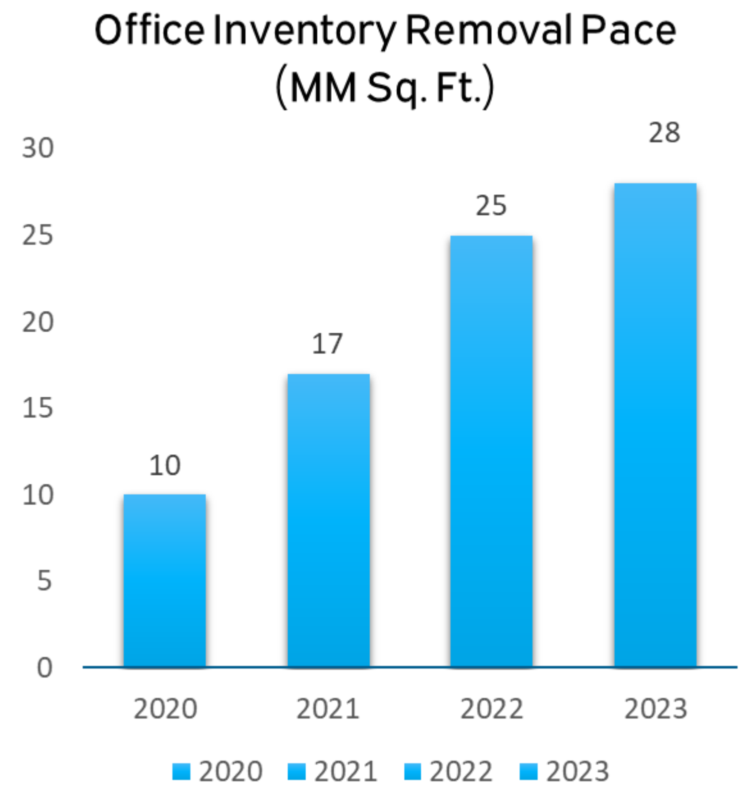
→ It is currently anticipated for office to continue with its downward trend and for retail to continue its bounce back from pandemic lows.

[1] The NPI returns shown are gross and unlevered.

Source: Pension Real Estate Association ("PREA") Consensus Forecast Survey of the NCREIF Property Index. Survey conducted during May 2024.

Office Leasing and Removal Trends

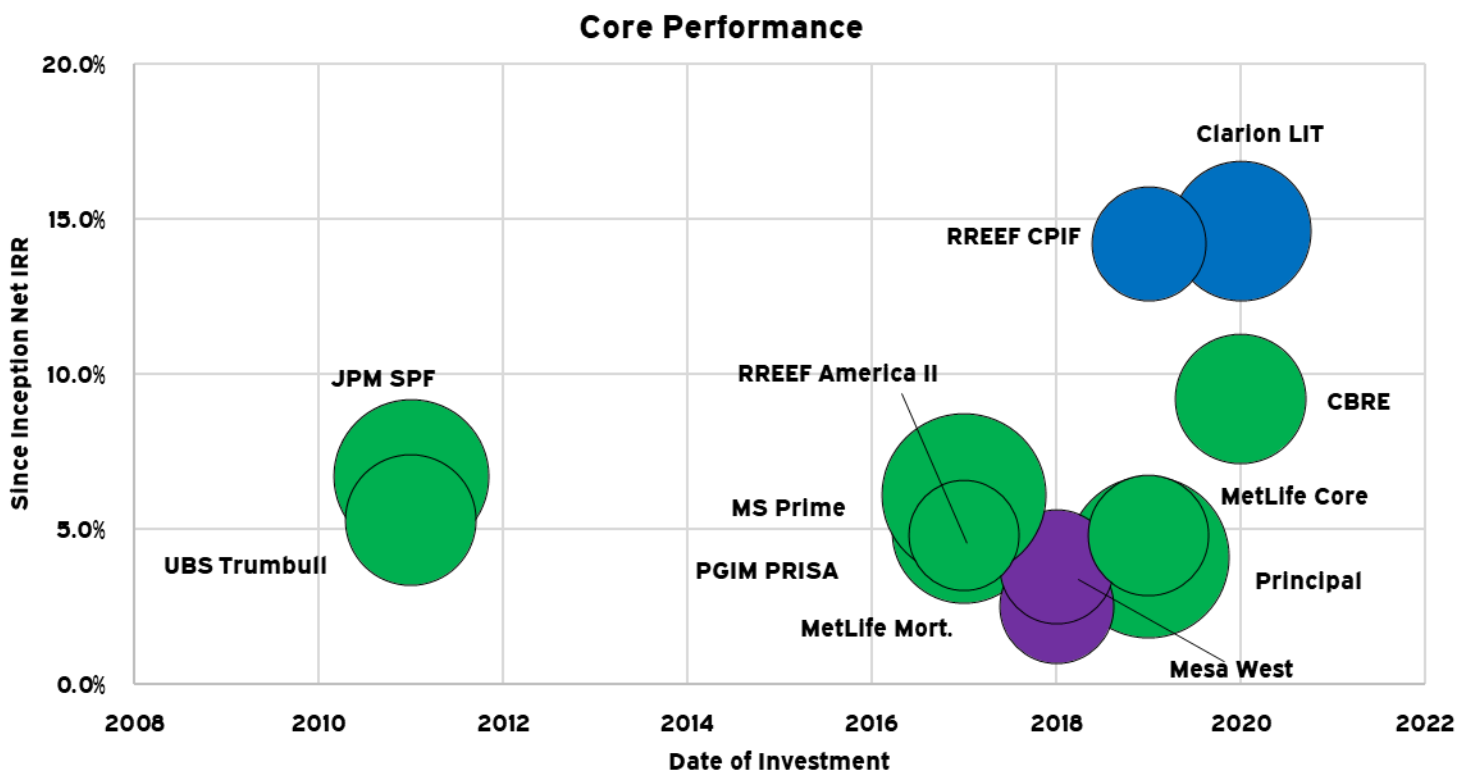




Source: JLL US Office Outlook 1Q-2024

Core Portfolio Risk / Performance Snapshot[2]

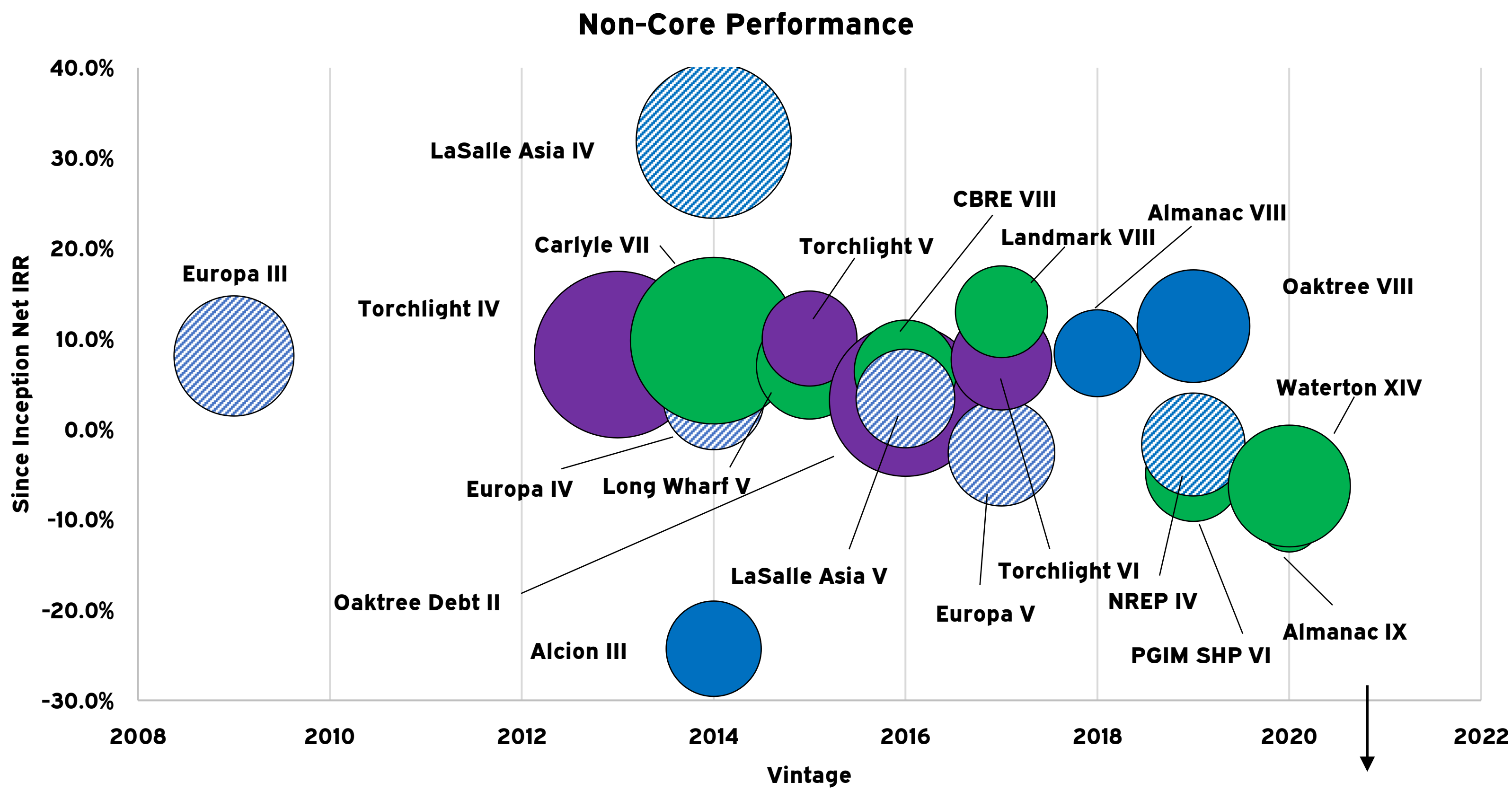
Core Debt Diversified Core (ODCE) Core Plus Industrial



[2] Bubble size based on SDCERS' historical contributions

Non-Core Portfolio Risk / Performance Snapshot – 2020 Vintage or Earlier[3]

Debt Value-Add Opportunistic /// = Non-U.S.



[3] Bubble size based on SDCERS' historical contributions

Challenged Investments[4]

Fund	Vintage	4Q23 NAV ($M)	Since Inception IRR	Comment
Alcion III	2014	2.0	(24.3%)	Exposure to traditional office and Chicago apartments
Europa V	2017	6.4	(2.6%)	Exits expected to be challenged in the near term
PGIM SHP VI	2019	14.7	(4.9%)	Senior Housing Fund significantly impacted by COVID-19 and higher than expected cost of construction financing
NREP IV	2019	18.3	(1.7%)	J-Curve amplified by development investments still in process
Total		**$41.4 / <4% of RE Portfolio**		

[4] Summary Table for Closed-End Funds Marked at 0% net IRR or lower with more than $1MM NAV, a 2021 vintage or earlier, with realized investments.

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