



pennsylvania
STATE EMPLOYEES' RETIREMENT SYSTEM

**Commonwealth of Pennsylvania
State Employees' Retirement Board**

Real Estate Statement of Investment Policy

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Real Estate Statement of Investment Policy

Pursuant to Title 71, Section 5931, the Board of Trustees (“Board”) of the Commonwealth of Pennsylvania State Employees’ Retirement System (the “Fund” or “System”) is establishing this Real Estate Statement of Investment Policy (“Policy”) to set forth the long–term objectives and policies for real estate investments. The Board may amend this Policy Statement in whole or in part or provide for certain exceptions to it.

I. Introduction

The Board has determined that, over the long term, inclusion of Real Assets should provide benefits to the Fund’s overall portfolio. The largest component of Real Assets is currently real estate (including timberlands), which is not expected to change over the long run. In real estate, the Board has established the following investment objectives:

1. Generate competitive long-term returns through capital appreciation and current income.
2. Lower overall Fund volatility through diversification to the Fund’s stock and bond portfolios.
3. Provide a moderate hedge against inflation.

In order to achieve these benefits, this Real Estate Statement of Investment Policy establishes the specific objectives and policies required for the implementation and oversight of the Fund’s real estate program. The objectives define the specific risk tolerance and return expectations for the program. The policies provide specifications for acceptable investment styles and management of the various risks associated with the asset class. The members of the board, employees of the board, and agents thereof shall stand in a fiduciary relationship to the members of the System within the constraints of the “prudent investor” standard.

II. Investment Objectives

A. Asset Allocation

The Board approves a strategic long–term asset allocation target for Real Assets annually as part of the Strategic Investment Plan that is based on analysis of the overall long– term opportunities. . SERS’ Investment Office and Board will undertake an analysis to establish the optimal portfolio mix across Real Asset sectors, it is anticipated that a majority of Real Assets will continue to be comprised of real estate given the current exposure and the Board’s historic dedication to real estate investing.

B. Return Objective

The Fund’s performance objective for real estate is to produce a total return, net of managers’ fees,

that exceeds a custom benchmark for rolling five-year periods. The custom benchmark currently consists of three indices; the NCREIF Fund Index—Open-end Equity, the S&P Citigroup Global Index (public real estate securities), and the NCREIF Timber Sub-Index.

III. Investment Policies

A. Investment Universe

The universe of investable real estate opportunities for the Fund is large and diverse and is constantly changing. The Fund anticipates that it will invest in, but it will not be limited to, the following sectors:

1. Private market equity and debt investments in real estate and real estate related companies.
2. Public market investments in real estate investment trusts (REITs) and real estate operating companies.
3. Private equity investments in timber and agricultural properties.

B. Portfolio Composition

Each year, as part of the Strategic Investment Plan, the Board shall approve an optimal portfolio mix across various Real Asset sectors, including public and private real estate, timber and farmland (agricultural properties). Investments will be made within each sector that may cause the composition of Real Assets (and real estate) to vary from the optimal mix approved by the Board or from the composition of an approved benchmark for a particular sector, due to the less liquid nature of most private sector investments, the less frequent valuations, and the generally larger capital commitments to individual investments. These investments will be made for the purpose of causing the sector to achieve superior risk-adjusted returns in order to achieve the program's return objective and the benefits for which the allocation to the asset class was made. Examples of variances from the sector benchmark for private real estate may include property type and location diversification, operating cycle, and leverage. Each sector will be evaluated relative to its benchmark, and the evaluation will include an analysis of the composition of the sector relative to its benchmark.

C. Risk Management

Investments in real estate have risks, including property-level risks, manager risk, and real estate and capital market risks. The Fund will attempt to mitigate risk in a prudent manner. The following policies have been established to address and manage the risks involved with investing in real estate.

1. Investment Structures

The Fund recognizes that real estate is an illiquid investment. Vehicles that maximize the Fund's control, including the ability to exit an investment are preferred, but the Fund acknowledges that it may use vehicles with limited control in order to achieve certain goals, such as diversification, access to specialized investments, or manager expertise. Limiting the

exposure to any single investment strategy and/or manager will be used to mitigate the risk associated with reduced investor control. The Fund will use the following investment structures:

a. Individually Managed Accounts

The Fund may purchase assets on a wholly owned basis through Individually Managed Account structures. The Individually Managed Account structure is the preferred investment vehicle due to their low cost structure and control features that they provide to SERS, except when pooled investment vehicles offer an identifiable advantage for accessing a particular investment strategy. The Individually Managed Account manager may consider joint venture or co-investment ownership within Individually Managed Account structures.

Individually Managed Accounts are actively managed programs with managers buying and selling investments as market conditions and opportunities dictate. All investments are made within the scope of approved investment guidelines in each manager's respective investment management agreement, as well as this Real Estate Statement of Investment Policy. The size of each individually managed account will be determined with reference to the overall allocation to real estate and the level of purchase and sale activity in any given manager's portfolio.

It is the intent that over the long term each individually managed account be self-funded; i.e., that new acquisitions be funded out of portfolio cash flows and sales proceeds. However, it is recognized that the timing of cash flows in these portfolios is difficult to forecast given the uncertainties and lead time involved with the purchase and sale of commercial real estate investments. In addition, it is understood that commercial real estate investments are stand-alone business entities that may require periodic investment of new cash, some of which may be unanticipated and time sensitive, in order to enhance the value of any given investment and honor legal, health and safety, or other obligations, to which the owner (a SERS controlled entity) is bound. At no time will the total amount funded to any individually managed account exceed the commitment amount plus total capital returned as monitored and reported by the real estate/real asset consultant to the Board.

The Investment Office and Consultant will monitor cash flow projections provided by the managers to ensure that the total real estate portfolio will remain within the allocation ranges provided within the Investment Plan. At no time, however, will an individually managed account manager be required to liquidate investments at inopportune times for the purposes of rebalancing.

b. Pooled Investment Vehicles

Investment opportunities may be accessed through the ownership of units or shares of a Pooled Investment Vehicle. Any legally organized vehicle is allowed, including, but not limited to, joint ventures, limited partnerships, public and private real estate investment

trusts, insurance company separate accounts, and limited liability corporations. Preference will be given to those Pooled Investment Vehicle's that offer greater investment and reporting transparency.

2. Diversification

The Fund will seek to diversify its real estate portfolio by the following:

a. Risk Strategy

Traditionally, private equity real estate investments have been categorized by the risk and return features of the underlying properties. SERS recognizes two broad categories: Core investments (operating and substantially leased properties) and other types of real estate investments generally categorized as "Non-Core". Core investments are substantially leased (i.e., 60% or greater leased at time of acquisition) institutional quality, well-located assets in the traditional property types: office, apartment, retail, industrial, and hotel. These properties generally offer relatively high current income returns, and as a result, a greater predictability of returns. The income component typically represents a majority of the expected total return of Core investments.

Non-Core real estate includes a variety of risk and return relationships, property types, and investment vehicles. Non-Core investments offer the opportunity to obtain higher risk-adjusted returns arising from the relatively inefficient real estate markets or real estate capital market imbalances. Non-Core investments generally carry higher risk and expected returns than Core investments. Non-Core includes higher property level risk (leasing, renovation, development or repositioning required); a degree of business or operating risk (e.g., hotels, senior housing, or investments in real estate operating companies); or non-traditional formats or properties (e.g., distressed assets or private to public market arbitrage activities).

SERS anticipates that 25% of its real estate program will remain invested in Core investments.

b. Manager

No single investment manager shall manage more than 25 – 30% of the total real estate allocation determined by the Board. However, there may be instances when the "denominator effect," special situations such as portfolio take-overs and value appreciation of investments, can suddenly cause an "out of balance" situation with regard to any given manager. When this type of situation occurs the Investment Office and real estate consultant will work with the affected manager to bring the portfolio back into balance within a reasonable timeframe.

c. Property Type and Property Location

Diversification by property type and location will be monitored and prudently managed, but the Fund recognizes that its diversification relative to benchmark may vary due to current opportunities available in the market and expectations for optimal risk-adjusted returns going forward. Diversification by geography includes international investments.

3. Leverage

The Fund shall seek to constrain overall leverage within the real estate program to a loan-to-value ratio (“LTV”) of 50% at the time the debt is placed. The LTV ratio in the separate account portfolios shall not exceed 60% at the time that debt is placed. It is understood that market value fluctuations may cause the LTV of all or a component of the program to exceed the limits expressed herein; in such an event, SERS shall not be required to sell investments or pay down debt in order to meet LTV limits expressed herein. The preference is to provide the managers the discretion to use leverage within contractual guidelines, when accretive to returns, without significantly increasing risk; however, debt that is recourse to a separate account will not be permitted unless approved by SERS’ Investment Office.

4. Investment Size

At no time shall the net investment amount in a single property within an Individually Managed Account exceed eight percent (8%) of the net market value of the total Fund’s real estate portfolio at the time of initial investment. Likewise, the Fund’s investment in a single Pooled Investment Vehicle may not exceed eight percent (8%) of the net market value of the real estate portfolio at the time of initial investment.

5. Valuation

All investments in an Individually Managed Account will be independently valued not less than once every three years by a qualified Member Appraisal Institute (MAI) designated appraiser approved by SERS’ Investment Office. During interim periods, the Investment Manager responsible for the investments will perform the valuations. Investments held in Pooled Investment Vehicles shall be valued using the methodology approved with the selection of the Pooled Investment Vehicle.

6. Vintage Year Diversification

SERS’ Investment Office shall prudently monitor and manage the vintage year exposure of the total real estate portfolio, but the Fund recognizes that vintage year exposures will vary due to current opportunities and the expectations for optimal risk-adjusted returns available in the market.

7. International Investing

Targeted international investments totaling up to 20% of the total real estate portfolio shall be permitted as approved by the Board. Incidental non-domestic real estate exposure may exist from Pooled Investment Vehicle investments.

D. Investment Manager Selection, Control, and Monitoring

1. Individually Managed Accounts

The following procedures will be used in the selection and monitoring of investments in Individually Managed Accounts.

a. Manager Selection Process

- 1) Investment managers (both Individually Managed Account and Pooled Investment Vehicle managers) must have significant and direct experience investing and managing money for institutional investors. The manager must have expertise and experience in pricing, selection, structuring, and negotiating real estate investments. It is preferable that key investment personnel have a successful track record of implementing the strategy proposed for this investment, and managing portfolios of capital similar in size to the amount currently sought. Staff and Consultant shall establish specific qualification criteria, desired levels of competency, and respective evaluation factors consistent with the purpose of each search for an Individually Managed Account manager.
- 2) Staff and Consultant shall meet with, review, and evaluate preferred candidates based upon the established criteria.
- 3) Staff and Consultant shall recommend to the Board in writing the manager or managers to be interviewed and selected by the Board.

b. Control and Monitoring

- 1) Preliminary Investment Summary
Individually Managed Account managers shall have full discretion over the acquisition, management, and sale of individual investments. Prior to closing an investment, the manager shall provide a Preliminary Investment Summary to Staff. The preliminary package shall include an analysis of the merits, projected return, and exit strategy for the proposed investment, together with sufficient information for SERS' Investment Office to confirm the proposed investment's consistency with this Real Estate Statement of Investment Policy and the investment manager's guidelines and strategy under its investment management agreement.
- 2) Reporting
Individually Managed Account managers shall adhere to the most recent version of the Real Estate Information Standards established jointly by the National Council of Real Estate Investment Fiduciaries, the Pension Real Estate Association, and the National Association of Real Estate Investment Managers, as well as, generally accepted accounting principles (GAAP). Managers will submit on an annual basis a third-party audited financial statement of the account managed by the Individually Managed Account manager.

3) Responsible Contracting

Managers of the Fund's wholly-owned assets in Individually Managed Accounts shall support and encourage the engagement of responsible contractors to provide building construction and maintenance services for such assets, subject to adherence to the Fund's fiduciary principles of loyalty, care, skill, prudence, and diligence. In all respects, such managers shall recognize and adhere to the principle that only the involved contractor has control over (1) the means and manner by which the contracted services are provided, and (2) the contractor's labor relation policies.

A responsible contractor is a contractor who, among other things: (1) has the appropriate experience, reputation, employee relations, responsiveness, fees, and dependability to perform required work; and (2) provides workers a fair wage and fair benefits for the required work, based on local market conditions. The utilization of such contractors may add value to the Funds' investments by ensuring that essential building and construction services are provided by adequately trained, experienced, and motivated workers.

The Board recognizes the right, as provided by law, of eligible employees to organize into a union or to not organize into a union, as the employees choose, and encourages contractors providing building construction and management services for the Fund's wholly-owned assets in Individually Managed Accounts to recognize and not impermissibly interfere with the lawful exercise of those rights and, upon a proper request, to bargain in good faith with any such lawfully recognized union.

Managers of the Fund's wholly-owned assets in Individually Managed Accounts and contractors providing building construction and maintenance services for such assets shall comply with applicable federal, state, and local laws, regulations and ordinances, including (but not limited to) those related to insurance, tax withholdings, minimum wage, health and safety, labor, and environmental matters.

With respect to those assets that the Fund does not wholly-own, it is desirable that the entity owning such assets comply with the foregoing policy statement.

4) Budget and Management Plan

Not more than 90 days after the end of the calendar year, Staff and Consultant shall meet with the manager of personnel directly responsible for an Individually Managed Account portfolio and asset management for a review and evaluation of the Manager's Budget and Management Plan, which shall include a summary of the prior year's financial performance, budgeted projections for the ensuing year, and the Manager's current hold/sell recommendation for each property.

2. Pooled Investment Vehicles

The following procedures will be used in the selection and monitoring of investments in Pooled Investment Vehicles.

a. Selection Process

- 1) Subject to the minimum manager criteria stated in subsection D(1)(a)(1) above, Staff and Consultant shall establish qualification criteria consistent with the purpose of the search for each Pooled Investment Vehicle manager.
- 2) Staff and Consultant shall meet with and evaluate preferred candidates based upon the established criteria.
- 3) Staff and Consultant shall recommend to the Board in writing the Pooled Investment Vehicle manager or managers to be interviewed and selected by the Board.

b. Closing Process

Completion of due diligence requires Fund counsel's review of the Pooled Investment Vehicle's formation and associated legal documents.

c. Control and Monitoring

Manager shall provide unaudited quarterly statements and reports and annual audited statements, which comply with generally accepted accounting procedures (GAAP). Annual meetings are typically conducted to discuss important developments regarding investment and management issues.

E. Discretionary Authority

The Board provides complete investment discretion within contractual guidelines to its advisors regarding the acquisition, management, and disposition of real estate holdings.

F. Performance Measurement Report

Consultant shall provide performance measurement reports on a quarterly basis reviewing compliance with the Strategic Investment Plan and this Policy Statement. The report shall also include attributes for both the investment managers and the total portfolio including: income, appreciation, gross and net returns; cash flow; diversification; and comparisons with relevant industry performance indices.