

NEW MEXICO EDUCATIONAL RETIREMENT BOARD

Real Estate Investment Policy & Procedures

New Mexico Educational Retirement Board (“ERB”) hereby adopts the following Real Estate Investment Policy & Procedures.

POLICY

Strategic Objectives

ERB believes the risk adjusted returns and diversification of the ERB investment portfolio can be enhanced, on a risk-adjusted basis, by investing a portion of its investment allocation in real estate. The overall objective for the real estate asset class is to provide for the following:

- Generate attractive risk adjusted returns through active management and the ability to access managers with the expertise and capabilities to exploit market inefficiencies in the asset class.

The illiquid nature of real estate investments combined with the complexity of investments make it difficult for many investors to effectively access the asset class. It is the belief of ERB that by investing with top tier managers whose interests are aligned through manager co-investment and incentive based compensation, ERB can maximize risk-adjusted returns from its real estate investments.

- Diversification benefits through low correlations with other asset classes, primarily the U.S. equity markets.
- Provide a hedge against unanticipated inflation, which real estate has historically provided due to lease structures and the increases in material and labor costs during inflationary periods.
- Permit ERB to invest in unique opportunities that arise due to dislocations in markets that occur from time to time.

Allocation to Real Estate Asset Class

ERB has approved a target real estate allocation of five percent (5%) with a range of zero percent (0%) to ten percent (10%) of the ERB investment portfolio.

Benchmark

The real estate portfolio is expected to generate returns, net of all fees and expenses, (i) in excess of the National Council of Real Estate Investment Fiduciaries Index (“NCREIF Index”) over rolling five year investment time horizons.

The ERB understands that, for a given partnership, return can only be reliably measured over the life of the partnership (typically 10+ years) or a complete market cycle. Real estate fund holdings are typically marked to market, however, the valuation methodology used by one general partner may differ significantly from the valuation methodology used by another. In addition, the time-weighted-return performance in the first few years of a partnership’s life is routinely negative due to the J-curve

effect. During this period, partnerships are actively making investments and drawing management fees, which results in a negative capital account balance.

Risk and Return Assessment

As with other types of investments, real estate investment includes the risk of loss of capital on any individual investment, which can be mitigated by the diversification of investments.

Other key risk considerations for real estate include:

- The illiquidity of investments.
- Market risks, including unexpected changes in the overall economy, an increase in competitive supply of new properties and a change in real estate demand patterns due to an economic slowdown or other factor reducing demand for space.
- Leverage. Most real estate investments utilize leverage in order to enhance expected returns. This leverage may cause increased volatility in reported and realized returns and increases the risk of complete loss of capital if cash flow is insufficient to pay regular debt service.
- Capital. Real estate is a capital intensive asset class. Unexpected capital events or repairs may significantly impact returns.
- Obsolescence. Certain forms of real estate or locations can become less desirable over time leading to decreases in value.
- Manager risk. The success of real estate investments is often highly dependent on manager skills and timing.
- Valuation. Valuation policies vary from manager to manager and the lack of consistently applied mark to market mechanisms across funds/managers can impact reported portfolio performance.
- Capital market shifts. A change in capitalization rates due to, for example, an unexpected rise in interest rates, may have a negative impact on real estate values.

ERB believes that the expectation of net-of-fees total returns in excess of the NCREIF Index and the diversification benefits of the asset class justify the risks associated with real estate investing.

Investment Alternatives

ERB's allocation to real estate will be diversified among a variety of private and public market investment types in order to reduce the volatility of real estate returns and the risk of loss of capital. The following are general guidelines for diversification of the real estate portfolio:

ERB has divided the global real estate investment universe into the following sectors, with descriptive attributes to follow:

Core Properties

- Operating, substantially leased office, retail, industrial or residential properties.
- Generally have institutional qualities for size, physical attributes and location.
- Target unleveraged total returns of 6.0%-8.5% per year, gross of fees, with a high proportion of the total return to be generated from current income with a smaller portion of the total return generated from appreciation.
- Core may include property types other than tradition investments when the cash flow or appreciation characteristics are similar (i.e., non-subordinated ground leases).
- Leverage for Core Property Investments is generally up to 60% loan-to-value. Core Property leverage can be higher when tenant credit and remaining lease term is long, or when operating cash flow demonstrates low volatility characteristics and the coverage ratios are high providing a margin of safety.

Value-Added Properties

- Office, retail, industrial or apartment properties that have moderate risk associated with their investment.
- The additional risk associated with Value-Added Investments is generally a deficiency that is identifiable and correctable through leasing, re-development, management and/or recapitalization.
- Other Value-Added Investments include lower risk non-traditional sectors such as parking lots, self-storage, agriculture, and timber.
- Target gross-of-fee total returns for Value-Added Investments are 150 – 300 basis points per year higher than for Core Properties.
- Leverage for Value-Added Investments is generally up to 75% loan-to-value (portfolio and property level).

Opportunistic Investments

- Opportunistic Investments can be comprised of any property sector. Opportunistic Investments can include office, retail, industrial and residential with high-risk attributes. In addition, hotels, international and domestic non-performing loans, operating companies, development, land and distressed properties are all examples of Opportunistic Investments.
- Leverage for Opportunistic Investments can be 75% loan-to-value or higher in certain cases (property and portfolio level).
- Target gross-of-fee total returns for Opportunistic Investments are 300 basis points or higher than for Core Properties per year in order to compensate for the increased risk.

Public Real Estate Securities

- Public REITs and REOCs (real estate operating companies) have modestly higher risk and return characteristics than Core Properties due to leverage and operating company risks.
- Daily pricing and public market trading provide liquidity. However, due to the relatively lower float and limited market capitalization of REITs and REOCs relative to the companies in other sectors of the public markets, liquidity may come at a price.
- The emergence of the international Public Real Estate Securities market has broadened the universe to include Asia, European, Australian and North and South America property companies.
- Numerous long/short managers have emerged providing an option to invest in Public Real Estate Securities in a hedge fund format.
- Historical returns are approximately 9% - 11% over 10-year periods of time.

Commercial Mortgages

- Commercial Mortgage returns are sensitive to interest rates, spreads and credit quality. The duration of a Commercial Mortgage portfolio generally is high due to yield maintenance pre-payment penalties in most mortgages.
- Commercial Mortgages have bond-like risk/investment characteristics, with real estate serving as collateral. Commercial Mortgage backed securities may be priced from time to time with varying upside potential.
- Investment in Commercial Mortgages can be accomplished through public or private market vehicles and can be investment grade (Core) or non-investment grade (Value-Add or Opportunistic).
- The long-term expected return from mortgages, depending on the strategy, is 150-300 basis points over comparable treasuries.

When evaluating real estate investment performance, the real estate portfolio is expected to generate returns, net of all fees and expenses, (i) in excess of the NCREIF Index over rolling five year investment time horizons for private market investments; (ii) in excess of the appropriate public market securities index as determined by Staff in consultation with NMERB's real estate consultant; and (iii) on a vintage year basis, in excess of the pooled mean return for real estate fund investments as reported by ERB's real estate consultant.

Diversification and Risk Management Guidelines

In order to capitalize on the inefficiencies and the private market nature of real estate investments, these policies establish ranges for property type exposure, rather than specific targets. ERB's intent is to adhere to these diversification guidelines for property type, sector or location exposure while simultaneously not forcing investments in areas where the risk adjusted returns are not attractive. ERB acknowledges during the period of time when the real estate portfolio is being established, and during times when managers may simultaneously decide to increase or lighten exposure, that investments within these diversification ranges can in the short term be inconsistent with the policy ranges. In the event of such circumstances, ERB Staff and the real estate consultant will endeavor to reallocate capital to rebalance the real estate portfolio over a 12 to 24 month period of time.

ERB Staff and the real estate consultant have established the following investment diversification policy ranges:

Sub-Asset Class Allocations		Core Value Added Allocations		Allocations by Geography	
Core	0% - 60%	Office	0% to 35%	United States	70% - 100%
Value Added	0% - 60%	Retail	0% to 35%	Non – U.S.	0% - 30%
Opportunistic	0% - 40%	Multifamily	0% to 35%		
Public RE Securities	0% - 30%	Industrial	0% to 35%		
Commercial Mortgages	0% - 30%	Other	0% to 35%		

ERB will seek to control risk in its real estate investment program by diversifying its exposure to real estate through investments in the following:

- Sector Diversification - Core, Value-Added, Opportunistic, Public Real Estate Securities, and Commercial Mortgages.
- Property Type Diversification – The ERB shall seek diversification within the real estate asset class through investments in office, retail, apartments, industrial and non-traditional categories such as hotels, self-storage, senior housing, student housing, medical office, land and other property types.
- Geographic and Economic Location Diversification – The exposure to real estate in the Portfolio shall include investments diversified across various locations globally and in economies with different economic concentrations.
- Investment Manager Diversification – The ERB shall utilize various investment managers within the real estate portfolio.
- Vintage Year Diversification – ERB shall seek to invest in each vintage year to avoid excessive exposure to any one real estate cycle.

The risks associated with the real estate portfolio shall be viewed within the context of the entire Portfolio. Accordingly, ERB will overweight segments of the real estate portfolio in order to take advantage of relative value disparities (on a risk adjusted basis) in the global real estate market.

Other limitations:

- ERB will limit the amount invested with one manager to no more than thirty-percent (30%) of the total allocation for private real estate investments. If one manager manages both public securities and private real estate, the limit will be increased to forty-percent (40%) of the total real estate allocation,
- The maximum investment size for any single allocation to a private investment fund shall be limited to fifteen-percent (15%) of the total real estate allocation. Any one property acquired by a manager as part of a fund should generally be no greater than 20% of the managers portfolio (subordinate to the investment guidelines of the fund). For public securities accounts, unless approved by ERB as part of the managers’ investment strategy, public securities managers should have no more than 10% in a single security (other than cash equivalents).
- Investments shall be held through open and closed-end funds such as limited partnerships, private REITs/REOCs, limited liability companies, separate accounts or corporations. No properties shall be held in the name of the ERB.

PROCEDURES

Role of the Investment Committee (“IC”)

The ERB IC has the responsibility to approve and recommend to the full board for its approval the: (i) Real Estate Investment Policy and Procedures. In addition, the IC will review and approve all investments in real estate. Staff will inform the full Board within 10 working days regarding the investment approvals and consultant selections of the Investment Committee.

Investment Selection

1. Fund Selection Process. The real estate consultant, with the assistance of ERB’s Chief Investment Officer, Investment Officer and relevant ERB staff (collectively “ERB Staff”) shall be responsible for sourcing and performing due diligence on real estate investment opportunities for ERB.

ERB Staff and the real estate consultant shall seek out investment opportunities that (i) have minimum committed capital of fifty million dollars (\$50,000,000) exclusive of the investment from ERB, (ii) are managed by firm principals with an institutional track record, experience and references, and (iii) hold out the prospects for total returns comparable to or better than similar investments made by other professionally managed real estate pension funds.

Due diligence will cover all issues as appropriate on the consultant’s Due Diligence Checklist (Schedule A) and additional issues that may be relevant to the investment. ERB Staff shall review potential real estate commitments. Following completion of due diligence, a recommendation memorandum and materials outlining the transaction will be prepared by the consultant and distributed to ERB Staff. The consultant’s recommendation shall disclose all placement agent, finder’s fees or third party marketing agent fees related to each investment. A formal presentation outlining proposed commitments, along with a presentation from the proposed investment manager (if desired by NM ERB) shall be presented at a meeting of the Investment Committee for comment and approval.

The legal review of all appropriate investment legal agreements, the final documentation, closing and funding will be the responsibility of ERB Staff.

After legal review of all appropriate documents, the following will have contract execution authority for said documents: Chief Investment Officer, Executive Director, or Deputy Executive Director.

2. Direct Investments or Co-Investments. ERB may make Direct Investments or Co-Investments across all sectors of the real estate portfolio (e.g., Core, Value-Added, Opportunistic, Public Real Estate Securities and Commercial Mortgages) on an opportunistic basis. The real estate consultant with Staff assistance shall have primary responsibility for the sourcing, due diligence, selection, monitoring and exit of real estate Direct Investments and Co-Investments. Direct Investments and Co-Investments shall be selectively reviewed and approved in the same manner as other real estate commitments.

Administrative Process

The real estate consultant with the assistance of ERB Staff shall establish processes for:

- Monitoring and documenting the progress and level of performance of each investment and fund compliance with governing documents. This will include, as appropriate, ERB and/or consultant's attendance at annual partnership meetings and participation on limited partner advisory boards.
- Monitoring and administering the funding commitments on a timely basis and coordinating the receipt of distributions from the investments.
- Maintaining complete and accurate records of all transactions related to each investment and maintaining a portfolio accounting and financial control system designed to:
- Protect assets, detect errors and insure the reliability of information generated by funds.
- Provide timely and accurate performance reporting and asset allocation information.

Reporting Requirements

The real estate consultant with the assistance of Staff shall provide the Investment Committee with quarterly reports on the real estate portfolio, which provide the following:

- List of current holdings, diversification summary, cash flows, valuations, time-weighted NCREIF compliant returns, IRR and the current status of the portfolio versus benchmarks.
- Recent historical and prospective market conditions.
- Prospective investment opportunities.
- Annual reviews of compliance/variance with the long-term policy and stated goals and objectives for the preceding 12 months and annual goals and objectives for the next 12 months.

This policy is effective as of the date below and supersedes any prior version of this policy.

These Real Estate Investment Policies and Procedures shall be subordinate to the NMERB Investment Policy Statement, as amended from time to time. In circumstances when the Real Estate Policies and Procedures conflict with the NMERB Investment Policy Statement, the latter shall prevail.