

Date: September 26, 2018

To: Employees' Retirement System of Rhode Island (ERSRI)

From: Pension Consulting Alliance, LLC (PCA)

**RE: Functional Asset Allocation - Inflation Protection Class
Core Real Estate Sub Portfolio Recommendation:
PRISA Fund**

Background

Effective with the 2017-18 fiscal year, ERSRI implemented a revised asset allocation. As part of this change, private core real estate investments will serve as a portion of the Inflation Protection allocation. Previously, the System had categorized real estate as a distinct asset class, and had an allocation target of 8% of total ERSRI portfolio assets. These investments permitted private and public real estate, diversified by core risk and non-core risk investments, as well as by geography and property type. Currently, all of ERSRI's real estate holdings are in a series of open and closed end private commingled funds. As of March 31, 2018, approximately 8.3% of plan assets were invested and committed to invest in real estate. Approximately 63% of the invested and committed amounts are in five core funds totaling \$432.8 million and 69% of total NAV, and 37% are invested and committed to 11 non-core funds totaling \$258.7 million and 31% of NAV.

As part of the new functional asset class portfolio structure, core open-end funds are included within the Inflation Protection class. The target NAV of this sub-portfolio is intended to be reduced, in a gradual process, to 3.6% of the total ERSRI portfolio. It is currently estimated that a reduction of approximately \$80 million will assist ERSRI in achieving its core real estate target allocation within the Inflation Protection class.

PCA has worked with Staff in examining the System's core real estate investments and recommends that ERSRI redeem its \$77.3 million investment balance (as of June 30, 2018) in the Prudential Insurance sponsored open end fund. ERSRI made its initial investment in PRISA in 2005.

Merits/Strengths for Redemption

- A redemption from the PRISA fund would reduce the number of core real estate managers from five to four and will provide more efficient supervision of the portfolio. The SIC and Staff's human resources are constrained, and the ability to invest with a smaller number of managers enhances oversight.
- When viewed ex ante, redeeming the PRISA interest does not reduce the overall diversification by geography or property type in an adverse manner by creating concentrations, nor reduce the rate of income return which is distributed quarterly to ERSRI.
- The current management fee ERSRI is charged by the PRISA fund is the highest of all ERSRI's core fund investments. ERSRI is not only sensitive to a Fund's fee structure, but the PRISA fund most recently raised management fees while other funds have lowered fees.

- As of March 31, 2018, PRISA’s gross total return in comparison to the NFI-ODCE benchmark outperformed for the current quarter and on a trailing one-, three-, and five-year basis, and underperformed for the ten-year period. The loan-to-value (LTV) ratio during the first quarter 2018 was below the NFI-ODCE benchmark LTV of 21.1%. During the financial crisis in 2008-09, PRISA underperformed ERSRI’s other core funds.
- PRISA has historically not been rewarded by meaningful excess risk adjusted returns for its forays into non-core investments such as new development.

Figure 1 **Since Inception Net Total Returns** ^{(1), (2)}

Fund Name	ERSRI Since Inception Net Total Return	NFI-ODCE Since Inception Net Total Return
AEW Core Property Trust	12.0%	10.6%
Heitman America Real Estate Trust	9.6%	9.6%
JP Morgan Strategic Property Fund	6.2%	5.9%
Morgan Stanley Prime Property Fund	7.8%	6.4%
Prudential PRISA	6.0%	6.4%

As of March 31, 2018

- (1) ERSRI’s since inception net total returns shown will differ from each respective fund’s since inception net total return due to different management fee structures, different initial capital call dates from ERSRI and different inception dates of each respective fund.
- (2) The since inception NFI-ODCE Index net total returns shown are based on ERSRI’s inception date for each respective fund.

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