III.9. Real Estate Procedures and Guideline

I. REAL ESTATE INVESTMENT OBJECTIVES

A. Investments In Real Estate

The ERS completed an asset allocation study for the investment of its assets. This analysis demonstrated that, over the long term, inclusion of investments in private and public equity real estate and debt positions in real estate properties would enhance the ERS' expected portfolio investment characteristics while reducing expected total portfolio volatility.

In general, the ERS desires to obtain the optimum return on the portfolio consistent with the assumption of prudent risk. While safety of principal is given primary consideration, the ERS recognizes the need to use active asset management strategies in order to obtain the highest attainable total investment return (income plus appreciation) within the ERS' framework of prudence and managed risk.

Real estate investments of ERS shall be made in a manner consistent with the fiduciary standards of the prudent person rule: (1) to safeguard and diversify the real estate portfolio; and, (2) for the sole interest of the participants and their beneficiaries. The selection of investment managers and development of investment policy will be guided to enhance diversification within the Real Estate Program's Portfolio thereby limiting exposure to any one investment, organization, real estate property type and geographic region. (Refer to Section II: Program Management)

1. **Real Estate Defined** - Real Estate assets are defined as those investments that are unleveraged or leveraged, private or public equity or debt positions in real property. The ownership structure should be fee simple, or ownership in shares in a corporation, limited partnership, limited liability company, or similar entity that would protect the interest of the ERS, either wholly-owned or owned jointly with other suitable Investment Partners having the same or greater standards of fiduciary care and responsibility as those adopted by ERS. ERS will pursue both discretionary separate account investment management and discretionary commingled fund investment management for its real estate allocation.

B. Asset Allocation

The ERS allocation to real estate shall remain within the limits authorized by the Board of Trustees. The current target allocation is 9% of the total ERS fund market value.

C. Portfolio Return Objectives

1. **<u>Total Return</u>** - Over rolling 5-year periods, the real estate investment portfolio is expected to generate a minimum total real rate of return (net of investment management fees) of 5% using a Time-Weighted rate of return calculation. The inflation index used to calculate the actual real rate of return is the USA CPI-All Urban.

Individual investment risk categories within the real estate investment portfolio shall have different return objectives established from time to time by the Board in order to account for increased risk relative to a core strategy. The return objectives are as follows:

Risk Category	Return Objectives Over rolling 5-year periods (Unleveraged)
Core	5 % Net real rate of return
Value Added	7 % Net real rate of return
Opportunistic	9 % Net real rate of return
Public REITS (domestic)	NAREIT Equity Index *
Public REITS (International)	FTSE/ EPRA/NAREIT *
Public REITS (Global)	EPRA/NAREIT/Global *

* NAREIT – National Association of Real Estate Investment Trusts
* FTSE – Financial Times Stock Exchange
* EPRA – European Public Real Estate Association

Income Return - Income, which is defined as cash distributed to ERS, should comprise at least 2/3 of the total return over rolling five year periods for core investments. The ERS may use the minimum total rate of return calculation instead of the time-weighted rate of return calculation for the specialty portfolio (value added and opportunistic) with assets or investments strategies reasonably expected to derive all or substantially all investment yields from appreciation. Due to the significant increase in risk associated with the specialty investments, these types of assets shall be limited to 30% of the real estate portfolio market value and have a higher real rate of return target than the total real estate portfolio return objectives as outlined in the above chart.

2. **Minimum Yields** - On separate accounts that invests in core properties, the manager's five(5) year yield (internal rate of return) projection shall exceed the then current ten year treasury yield by no less than 150 basis points. Given a market cycle in which this yield test cannot be met, ERS and its Consultant will review the real estate allocation in light of current market and achievable risk adjusted returns.

II. PROGRAM MANAGEMENT

A. Overview

In compliance with current ERS investment philosophy, the Real Estate Investment Program will utilize discretionary separate account relationships and discretionary commingled fund investment vehicles that are sponsored by real estate Investment Managers. Under this program, the Investment Managers acquire, operate and dispose of real estate assets in accordance with a work assignment that is outlined in the Investment Management Contract (the "Contract") and in the Annual Tactical Plan for separate accounts and the fund documents for commingled funds. The Investment Manager Contract describes the acceptable property types, geographic restrictions, investment structures, leverage and other specific investment parameters. The Annual Tactical Plan is the

Investment Manager's "working plan" for each fiscal year and must be reviewed by ERS Staff and Consultant (Refer to Section IV: Control and Monitoring Systems) and approved by the Board of Trustees. Commingled fund documents typically refer to the fund's offering memorandum or private placement memorandum, limited partnership agreement, and subscription agreement.

B. Participant Roles and Responsibilities

To facilitate the Real Estate Investment Program, each participant has clear lines of responsibility and accountability that it must administer to ensure overall program compliance. The following describes each participant and its responsibilities:

1. **Board of Trustees** - The investment governing authority of the Employees' Retirement System of the State of Hawaii.

   Responsibilities - The Trustees, with assistance from its Staff and Investment Consultant, develops and approves portfolio level investment policy for all asset classes. The Trustees direct the pension investment allocation to real estate in accordance with the overall investment parameters of ERS. For the real estate assets, the Trustees, with assistance from its Staff and Consultant, monitors the program to ensure compliance with ERS' portfolio investment objectives. Specifically, the Trustees select and approve real estate investment management organizations, legal counsel and consulting firms, reviews quarterly performance measurement to ensure risk and return compliance, evaluates Investment Manager performance and cooperation during annual reviews and approves the portfolio objectives and policies.

2. **ERS Staff (Chief Investment Officer)** - The ERS employee supervising the plan Investment Program implementation and administration.

   Responsibilities – The Chief Investment Officer provides portfolio level administration and supervision. This includes implementing ERS directed investment policy and objectives, assigning special projects as requested by the ERS and coordinating the schedule for quarterly performance measurement and annual Investment Manager reviews in conjunction with the Consultant.

3. **Real Estate Consultant** – Professionals retained to assist the Staff and Trustees through the provision of expert real estate advice and technical support.

   Responsibilities – The Real Estate Consultant coordinates the revision of the investment objectives, policies and procedures, develops the quarterly performance measurement report, assists in developing Investment Manager selection criteria, coordinates manager searches, oversees the implementation of the Tactical Plan process, works with staff on special projects, represents the ERS by serving as a member of advisory boards of commingled funds as requested by ERS and is available to administer required portfolio level control and monitoring systems.

4. **Legal Counsel** – Internal Counsel or external Legal Counsel retained by Trustees to

review program documentation to ensure compliance with investment guidelines and policies, and to be available for special projects as they arise.

Responsibilities – Legal Counsel reviews investment management and other related program documentation. Specific transactions may be acknowledged to ensure protection from undue liability and that the System's rights are protected.

5. **Investment Manager** – Qualified real estate organizations, registered as Investment Advisors under the 1940 Act that provides institutional real estate investment management services to the ERS. ERS may invest in commingled fund vehicles that are not registered, however, it is preferred that the commingled fund be sponsored and/or managed by a Registered Investment Advisor.

   Separate Account Manager Responsibilities – The separate account Investment Manager, acting as a fiduciary on behalf of ERS, acquires, manages and disposes of real estate properties in accordance with the annual Tactical Plan and Contract. The Investment Manager retains appropriate property management expertise and provides a list of suitable appraisal candidates along with a recommendation to the Staff for review. The Investment Manager provides reporting as required in its Contract to the Staff and Consultant.

Commingled Fund Manager Responsibilities – The commingled fund_Investment Manager, acting as a fiduciary on behalf of ERS, acquires, manages and disposes of real estate investments in accordance with the terms of the investment vehicle documents.

C. Portfolio Composition

The real estate program will be comprised of two different but complementary components, Core and Specialty.

1. **Core Portfolio** – Core investments include equity or debt investments on existing, substantially leased income-producing traditional property types located principally in metropolitan areas that exhibit reasonable economic diversification. Core properties, therefore, must have the following characteristics:

   - Traditional institutional quality property types including office, industrial, retail and multifamily;
   - Operating and stabilized properties that demonstrate predictable income flows with a high proportion of anticipated total return arising from current income and cash flow;
   - At least 70% leased upon purchase of the asset;
   - Located in institutional markets and in economically diversified metropolitan areas;
   - Credit quality tenants and a staggered lease maturity schedule;
   - Quality construction and design features;
   - Reasonable assurance of a broad pool of potential purchasers upon disposition;

- Properties requiring quality asset and portfolio management but not requiring specialized operating expertise which is not readily available in the market;
- Investment structures using all cash or low leverage. Leverage is limited to 50% on each investment; and
- Total gross return expectations between 6% and 8%.

Core properties can be further classified as:
- Trophy; or
- Commodity.

Trophy properties represent dominant and unique properties that cannot be easily reproduced due to such factors as legislative limitations and physical constraints. Trophy properties are typically located in only the largest metropolitan areas often with a significant global environment.

Commodity properties are core properties without trophy characteristics but with nearly similar economic, financial and operating expectations. Typically, commodity properties should have a competitive advantage in their immediate marketplace by virtue of size, location, tenant base and/or design features.

2. **Specialty Portfolio** – Specialty investments represent equity or debt investments in those properties and/or investment strategies that require specialized acquisition and management expertise or skill to mitigate the business and leasing risk that may be associated with individual investments. Specialty investments which may be referred to as Value Added or Opportunistic have greater volatility compared to core investments and as such are expected to provide yields higher than those associated with core investments.

   2.1 Value Added – Value added investments include equity or debt investments in institutional quality assets that offer the opportunity to enhance value through rehabilitation, redevelopment, development, lease-up or repositioning. A significant portion of return is from appreciation and includes moderately higher leverage than core. Value added investments typically exhibit one or more of the following characteristics:

   - Properties located in primary as well as secondary and tertiary markets which may not be economically diversified and may have accompanying susceptibility to imbalance of demand and supply;
   - Traditional as well as non-traditional property types, including hotels, motels, senior housing, student housing, manufactured and residential housing.
   - Properties that are undermanaged with specific problems that require specialized management skills;
   - Properties that are less than 70% leased upon purchase or where more than 30% of leases expire in the first three years of purchase;
   - Properties which are considered to be in a "work out" mode;

- Properties involving significant appreciation, lease-up, development and/or redevelopment risks;
- Properties using moderate leverage between 50% and 65%;
- Investments in institutional quality properties located in mature real estate markets showing high levels of market transparency outside of the United States and Canada ; and
- Total gross return expectations are between 11% and 13%.

2.2 Opportunistic – Opportunistic investments include equity or debt investments in real estate properties, real estate operating companies and other investment vehicles that offer the opportunity to capitalize on the disequilibrium of the real estate markets caused by dramatic shifts in capital flows or other fundamental real estate characteristics. Opportunistic investments not only include distressed assets in need of lease up but also assets that provide returns from financial restructuring. Opportunistic investments typically exhibit one or more of the following characteristics:

- Strategies that seek to exploit inefficiencies in the capital and real estate markets;
- Strategies that involve financing or acquisition of real estate assets, operating companies, portfolio of real estate assets;
- Properties with substantial leasing, development and entitlement risk;
- Distressed assets;
- Distressed debt;
- Major financial re-structuring required;
- High Leverage of between 65% and 75%;
- Investments in emerging real estate markets driven by growth and continued improvement in market transparency, located outside of the United States and Canada; and
- Total gross return expectations are in excess of 15%.

Allocation Between Core and Specialty –The current investment strategy target objective is 70% (± 10%) in core investments 20% (± 10%) in value added and 10% (± 10%) in opportunistic investments as shown below:

Risk Strategy	Target Objective	Allowable Range
Core	70%	60% to 80%
Value Added	20%	10% to 30%
Opportunistic	10%	0% to 20%

4. Core and Specialty Return Objectives

Core – Consistent with the ERS total real estate portfolio return objectives, the core portion of the portfolio is expected to provide net real returns of at least 5%.

Specialty – The specialty portion of the portfolio is expected to provide returns above the core portfolio return to compensate for the additional risk associated with these types of investments and/or strategies. Value added investments are expected to provide net real returns of at least 7% and opportunistic investments are expected to provide net real returns of at least 9%.

D. Investments and Risk Management

The ERS shall manage the investment risk associated with real estate in several ways:

1. **Institutional Quality** – All assets within the Core portfolio must be of institutional investment quality as evidenced by a history of institutional investment in similar properties; expert analysis which supports the economic viability of the market; high quality construction and design features; and a current or potentially competitive position within the property's immediate market area.

2. **Diversification** – The real estate portfolio shall be diversified by geographic region and property type. Diversification reduces the impact on the portfolio of any one investment or any single Investment Managers' styles to the extent that an adversity affecting any one particular area will not impact a disproportionate share of the total portfolio.

Target Portfolio

The long-term real estate strategy is for the ERS real estate portfolio to be diversified by geographic regions and property type within the following target ranges:

Geographic Regions

West	20% - 50%
Midwest	5% - 30%
South	10% - 35%
East	10% - 40%
International (Non US and Canada)	10% - 20%

Property Types

Apartments	10% - 40%
Industrial	10% - 30%
Office	10% - 50%
Retail	10% - 30%
Other	0% - 10%

"Other" includes property types not classified by the NCREIF Index, such as hotels, motels, residential housing, senior housing and raw land.

3. **Ownership Structure** – The ownership structure for Core investments includes leveraged and unleveraged equity investments owned 100% by ERS or owned jointly with Suitable Investment Partners. "Suitable Investment Partners" include public, corporate and union pension plans, foundations and endowments, insurance company general accounts or separate accounts, and other tax-exempt institutions, having the same or greater standards of fiduciary care and responsibility as those imposed by ERS guidelines. When dealing with specialty investments that are directly owned, Operating Partners shall be added to the list of "Suitable Investment Partners". The ownership structure of Specialty assets within commingled funds will be governed by the fund documents.

4. **Leverage** – Leverage may be utilized in a constrained manner in the Core portfolio in order to enhance yields of the various investments and/or to facilitate the diversification of the portfolio. The use of debt must result in positive leverage where cash flow is in excess of debt service. The total expected return to ERS over the term of the investment must be expected to increase a minimum of 2 basis points for each 1% of leverage, as a result of leverage. For example, leverage returns on an acquisition with 50% debt should be higher than the unleveraged returns for the same property by a minimum 100 basis points. The total level of debt for any single investment will not exceed fifty percent (50%) of the value of that asset for core investments and 75% for specialty investments. Total portfolio debt will be limited to thirty percent (30%) in the core portfolio, 65% in value added investments and 75% in opportunistic investments. The single investment debt level will be measured for compliance at the point leverage is added to the portfolio. The total portfolio debt levels will be measured for compliance at the point leverage is added to the portfolio or a portfolio asset is purchased or sold.

   ERS intends to invest in Specialty (value added and opportunistic) commingled funds that utilize higher levels of leverage as a component of their investment strategy. Total debt for value added investments will be limited to 65% of the total value of the commingled fund and total debt for opportunistic investments will be limited to 75% of the total value of the commingled fund.

   The maximum debt permitted on the total real estate portfolio is 45%.

5. **Manager Concentration** – ERS shall limit its exposure to any single manager. No single manager shall be permitted to manage more than 35% of the total allocation to real estate at the time of investment (i.e., purchase).

6. **Investment Size** – There is no minimum investment size. The maximum net investment in a single property within the separate account shall be limited to 5% of the allocation to real estate at the time of investment. The maximum investment in any single commingled fund shall be limited to 10% of the allocation to real estate at the time of investment. ERS' investments in a single commingled fund shall not exceed 20% of the total net market value of the commingled fund at the time of investment.

III. REAL ESTATE INVESTMENT PROCESS

A. Manager Selection

In an effort to maintain program simplicity and ensure appropriate underwriting of investment management organizations, the ERS shall utilize only ERS approved real estate investment management firms for the acquisition, asset management and disposition of property. In addition to the existing separate account Investment Managers, the ERS has approved a program of commingled fund investing. Each Investment Manager will be provided a specified capital allocation. Investment Manager capital commitments shall periodically be balanced in accordance with the overall real estate asset allocation objectives.

B. Transaction Review and Closing – Separate Accounts

1. **Investment Identification** – Upon identifying a specific investment that meets the program guidelines and Tactical Plan objectives, the Investment Manager must provide to the Staff and the Real Estate Consultant, a written summary of the property characteristics, investment structure and notification of joint venture partners and/or investment partners in the format provided in Appendix A.

2. **Property Closing and Funding** – Once the Investment Manager identifies an investment that meets portfolio objectives, the Investment Manager shall provide to the Staff and the Real Estate Consultant a Critical Dates list which includes scheduled funding dates, wire transfer instructions and other important timing information. In addition, the Investment Manager shall prepare a Closing Report as appropriate. Upon close of the Investment, Manager shall provide to ERS a summary of all uses of capital funded by the ERS.

C. Asset Management – Separate Accounts

In conjunction with its asset management responsibilities, the Investment Manager must comply with the reporting requirements as outlined in Appendix B. Revisions to the original ten year pro forma and capital budget that require unscheduled capital funding must be presented to the Staff for review; however, its is not necessary to present to staff unscheduled capital funding that were already described in the annual property plans. Refinancing or partial dispositions that were not approved as a part of the Annual Tactical Plan must also be presented to the Staff.

D. Disposition – Separate Accounts

Annually, the Investment Manager must review each property managed by it on behalf of ERS and complete a "hold" or "sell" analysis. Assets targeted for sale are identified and documented and a brief explanation of the sell decision and strategy is provided to the Staff, the Consultant and the ERS Board at the annual Tactical Planning presentation. In addition, the Investment Manager must submit to the Staff and the Real Estate Consultant notification of any unsolicited sales offers. Once an offer is accepted by the Investment Manager, the Staff and the Consultant must be provided with a Critical Dates list that details the disposition activities.

E. Commingled Fund Investments

ERS does not anticipate using the commingled fund vehicle for additional Core investing. Rather, separate accounts are the preferred vehicle for Core investments. However, commingled fund vehicles may be used to access "specialty investments" to meet its 30% target as stated above. The selection process used to invest in commingled funds is similar to the process used to retain separate account Investment Managers. Selection criteria for commingled funds shall include minimally conflicted fee structures and maximum investor controls. In addition, the ERS shall use similar strict control and monitoring systems to evaluate the commingled fund Investment Managers as used for evaluating the separate account firm.

IV. CONTROL AND MONITORING SYSTEMS

In real estate investment, separate and distinct from other asset classes, the Investment Manager has direct control over the operations of the assets. This inherent conflict contributes to the lower volatility associated with the asset class but also creates a need for greater oversight by the ERS.

The ERS Board of Trustees shall be notified by the Staff and the Real Estate Consultant of manager reporting problems, significant organizational changes such as mergers, and prolonged under-performance. Investment Managers performing below expectations in any of the before mentioned areas shall be placed on the "Watch List" outlined below. All Investment Managers will be subject to an annual review in Hawaii and may also be called in by the Staff or Board for a special review. Finally, the ERS also recognized that it may elect to terminate separate account Investments Managers within thirty (30) days for "cause" as outlined in the Contracts.

The ERS shall manage the Real Estate Investment Program in the following manner:

A. Annual Reporting Requirements

Separate Account Investment Managers

1. **Tactical Plans** – Annually, the separate account Investment Manager prepares a Tactical Business Plan, an outline of which is in Appendix C. In the Tactical Plan, the Investment Manager outlines its targeted investment plan including the basis upon which targets have been established. The Plan must include property type, investment structure, return expectations and exit strategies as well as any other pertinent strategy specific parameters.

   This Plan is to be completed or revised every year and submitted to the Staff and the Real Estate Consultant. The plan shall be presented in September of each year, unless otherwise directed by ERS Staff or Board, and if appropriate, shall be approved by the Board.

2. **<u>Asset Management Plans</u>** – The separate account Investment Manager must also prepare annual asset management plans for each property managed by the firm and owned by the ERS. Asset management plans include property-specific operating budgets; estimates of cash to be distributed to the ERS, management fees, debt service, lease expirations and rollover, and all other relevant property information. A sample outline is included as Appendix D.

   Asset management plans are due thirty days prior to the ERS fiscal year end and are to be submitted to the Staff and the Real Estate Consultant. When submitting the annual asset management plan, the Investment Manager should review any significant line item variances (greater than 10% and $25,000) from the prior year.

3. **<u>Investment Manager Review</u>** – At least annually, and as often as twice a year as determined by the Board, the Staff and the Real Estate Consultant shall coordinate an Investment Manager review presentation for the Board. Each review is required to discuss how the investments managed on behalf of the ERS have met the previous year's plan as well as the program objectives of ERS. The Investment Manager's organization is also reviewed. This monitoring system is designed to assist the ERS in identifying troubled investments and changes at the organizational level that may suggest additional monitoring is required.

Commingled Fund Managers

At least annually and as often as twice a year as determined by the Board, the Staff and the Real Estate Consultant shall coordinate an Investment Manager review presentation for the Board. Each review is required to discuss the Fund's performance and how the investments managed on behalf of the ERS have met the objectives of the Fund and of ERS. The presentation will include a discussion of important developments regarding the investments as well as the Manager's organization. This monitoring system is designed to assist the ERS in identifying troubled investments and changes at the organizational level that may suggest additional monitoring is required.

B. Quarterly Reporting

1. **<u>Performance Measurement</u>** – Within 35 days for separate accounts and 45 days for Specialty commingled funds of the quarter close, the Investment Manager is required to submit to the Consultant an investment position worksheet and distribution worksheets for use in the calculation of performance figures for that period.

2. **<u>Operations Report</u>** – The Investment Manager shall revise financial statements quarterly comparing budgeted operations to actual investment performance. This analysis must be available at Staff's request within 60 days of the quarter close.

C. Property Valuations

1. **<u>Appraisals</u>** – Appraisals shall be conducted in accordance with the ERS approved

Investment Manager Contracts. Staff, on behalf of the ERS, reserves the right to obtain and review the list of appraisers and their qualifications. This review is for veto purposes only and serves as a control and monitoring system. Otherwise, the Investment Manager may use its discretion to select and rotate qualified appraisal firms. Generally, ERS recommends the following appraisal policy for its commingled and separate account managers.

a. **Commingled Funds** – Investment Managers sponsoring commingled fund vehicles in which ERS may own or consider acquiring an interest should include in the offering documents an appraisal policy such that independent MAI valuations are conducted at least annually. This criterion may be modified in specific cases where the cost of appraisal is greater than the benefit received by the participants. However, if fees are paid based on "market value" of an investment, then in no case should annual independent MAI appraisals be waived.

b. **Separate Accounts** – For separate account structures, independent MAI appraisals are conducted once every three years. These appraisals may be staggered so that the portfolio performance is not adversely impacted by seasonal appraisal costs. In addition, the System reserves the right to direct the Investment Manager to conduct an appraisal, at the System's expense, at any time. In the interim periods between independent appraisals, the manager must conduct annual internal estimates of value and may adjust a property's market value on a quarterly basis should a significant event occur that impacts value. This policy is meant to be consistent with the National Council of Real Estate Investment Fiduciaries (NCREIF) Standards. If NCREIF standards change to increase the appraisal or adjustment to value frequency, ERS' investment managers are to adopt these changes.

2. **Performance Measurement** – For performance measurement purposes, both the MAI appraiser's and the Investment Manager's interim internal estimates of value will be used to calculate returns. Every year, the independent appraisals are to be provided by the Investment Manager in its performance measurement reporting.

3. **Notification of Variance** – Should the Appraised value of any asset vary by more than10% from one year to the next, the Investment Manager must provide to the Staff and the Consultant a written explanation for the variance. This report is due to the staff within 30 days of the final property appraisal.

D. Subcontractors

1. **Property Management** – The selection of property management is left to the discretion of Investment Manager. It is expected and required that the Investment Manager will retain the highest caliber market rate property management service through a third party fee manager or the Investment Manager's affiliated property management division.

2. **Affiliates** – Property management contracts and other service relationships provided by an affiliate of the Investment Manager may be reviewed by the Staff and the Real

Estate Consultant to ensure appropriate compensation and capability. The Staff and the legal counsel need not review contracts with independent vendors as the Investment Manager, in its capacity as a fiduciary, represents ERS' interests. Prior to terminating a property management assignment, the Investment Manager must inform the Staff and the Consultant in writing of the release, and designate the new firm be retained.

3. **Bonding** – All subcontractors employed by the Investment Manager must be bonded. The level of bonding and implementation is left to the discretion of the manager. The manager shall employ the highest standards of care in this matter.

E. Audit Process

1. **Unrelated Business Income Tax** – As a tax-exempt entity, ERS hereby instructs its Investment Managers to avoid transactions generating UBIT. Should ERS be at any time invested in real estate or other assets that result in UBIT, the Investment Manager is to provide immediate notification and an evaluation of the financial impact to the ERS Staff who will then provide a report to the Board.

2. **Audited Financial Statements** – On an annual basis, the Investment Manager will provide ERS with a combined audited financial statement for the total portfolio, to be prepared by a nationally recognized audit firm. The auditor shall complete an income statement, balance sheet and change in cash position analysis.

F. Accounting and Cash Management

1. **Accounting Policies** – All accounting data shall be computed in accordance with generally accepted accounting principles prepared on a current value basis, not historical cost accounting. Therefore the carrying value of real estate assets shall be adjusted annually to reflect the most recent current value based on the most recent independent appraisal value or internal estimate of value. Accrual based accounting is also generally used to allocate revenues and expenses to the appropriate periods.

2. **Cash Management** - The Investment Manager shall provide strict control over cash transactions and balances ensuring that all excess funds are continually invested in accordance with the ERS' approved specifications as outlined in the manager's Contract. Cash balances will be swept to an account designed by ERS in compliance with a previously agreed-upon schedule and in accordance with maximum balance restrictions.

G. Hazardous Materials

1. **Environment Evaluations** – As a standard procedure during the acquisition analysis and due diligence, the Investment Manager will evaluate each property, using a qualified environmental consultant. In carrying out the review, the Investment Manager must comply with the procedures outlined below.

2. **Investment Criteria** – The ERS will invest in properties that contain asbestos or other toxic substances only in accordance with the following criteria:

   a. **Disclosure** – The substance and potential risks are fully disclosed to the ERS and its Consultant and documented in reports developed by an environmental consultant as a result of a Phase II study.

   b. **Legal Compliance** – The property is not in violation of any federal, state or local law, ordinance or regulation relating to the property's environmental condition.

   c. **Removal/Containment Costs** – The estimated cost of removal or containment programs is reflected in the investment pro forma and purchase price assumptions.

   d. **EPA** – The substance can be properly contained or removed in accordance with the current Environmental Protection Agency protocol.

   e. **Leasing** – The Property leasing rollover pattern accommodates a removal program.

   f. **Operations** – The property can continue to operate, commanding the commensurate level of rents, during any removal or containment program.

H. Insurance Coverage

1. **Required Coverage** – The investment Manager will affect insurance for the Physical Properties and assets under its investment management control in accordance with the terms set forth in the Contract in such amounts and, against such risks as, in the Investment Manager's professional judgment shall be in accordance with sound institutional practices applicable to such properties or assets in the specific geographic area. It is expected that such insurance will include, but not be limited to, casualty loss, including where deemed appropriate by the Investment Manager, earthquake, flood and any other disaster-type insurance coverage; comprehensive general liability; and title insurance.

2. **Reporting to the ERS** – Prior to the annual policy renewal date, the Investment Manager will provide the Staff and the Real Estate Consultant with a synopsis of the ensuing year's coverage to include the terms and level of coverage; any risk exposure to ERS resulting from coverage which is unavailable or cost prohibitive; an assessment of the quality of the coverage relative to the prior year; and the price and terms of the projected coverage. In the event the terms of the ensuing year's coverage result in less of the projected coverage than the prior year, ERS staff must acknowledge less coverage by providing written consent to the Investment Manager. All policies shall name ERS as an insured party and shall contain express conditions that ERS shall be given written notice by registered mail at least thirty (30) days in advance of any modification or termination of any insurance coverage.

I. Guidelines for Real Estate Manager "Watch List" or Termination

The performance of the Board's investment managers will be monitored on an ongoing basis. The Board may place a manager on a "Watch List" or terminate a manager at any time.

Managers may be terminated or placed on a "Watch List" for a variety of reasons: personnel changes, violation of policy and investment guidelines, underperformance, asset allocation changes and non-disclosure of material information. The ERS has two clearly stated fund performance objectives in the investment guidelines: the preservation of capital and consistent positive returns. These "Watch List"/ termination guidelines were formulated with these objectives as a foundation. Various factors should be taken into account when placing a manager on a "Watch List" or recommending termination. These can be separated into two broad categories – qualitative and quantitative factors. The former focuses on personnel, organizational and legal issues while the latter addresses performance.

When possible, the Board will issue a warning letter to underperforming managers prior to placement on the "Watch List." However, the Board may place a manager on the "Watch List" at any time whether or not a warning letter has been issued. Placing a manager on the "Watch List" is an intermediate step towards either resolving the problem or terminating the manager. Managers may only be removed from the "Watch List" under these two conditions.

Real Estate Manager Watch List Guidelines – Qualitative Factors

Below are some of the *qualitative* factors that may be considered in determining whether an investment manager should be placed on the "Watch List" or terminated.

Factor	Evaluation Technique	Action Steps
Violation of investment guidelines and/or the laws of the State of Hawaii	Review portfolio holdings vis-à-vis the investment guidelines - Individual properties - Their percentage weight in the portfolio	Correct violation. Review violations with manager to re-establish compliance with appropriate guidelines. Manager to compensate ERS for any losses that occurred from violation. Terminate or place on watch list -terminate on additional violation.
Changes in Ownership	Require immediate notification of any pending changes in ownership	Place on watch list. Qualitatively determine if change detrimentally affect asset performance. If so, terminate.
Turnover of key personnel	Require manager to establish a list of key personnel, and rank in level of importance, at the inception of the account. Manager updates on as needed basis.	Place on watch list. Consider termination if there is excessive key personnel turnover on the account (as specified in the manager provided list) or staffing is deemed insufficient to appropriately manage the ERS account.
Litigation	Require manager to notify ERS staff immediately if entity which manages the funds is involved in any litigation other than property level covered by insurance.	Evaluate nature, seriousness and likely impact of charges on the investment process and take appropriate action.
Failure to disclose significant information which could impact manager evaluation	Require manager to provide immediate full disclosure, in writing, within a reasonable amount of time.	Review non-disclosure to determine if material to manager's ability to manage assets. If so, terminate.
Failure to disclose potential conflict of interest in managing assets	Require manager to provide immediate full disclosure, in writing, within a reasonable amount of time.	Review non-disclosure to determine if conflict was material and should have been known by manager. If so, terminate.

Real Estate Manager Watch List Guidelines – Quantitative Factors

Below are the *quantitative* factors to be considered in determining the appropriateness of terminating an investment manager or placing the investment on the "Watch List."

PERFORMANCE TEST	BENCHMARK	FAIL CRITERIA
Test 1: Relative to Benchmark, for trailing 3 and 5 years	Annualized performance relative to a 5% real rate of return benchmark.	Managers fail if under perform benchmark by .45% per annum over measurement periods, net of fees.
Test 2: Relative to income objective, for trailing 3 and 5 years	Annualized performance relative to a 3.34% real rate of return	Managers fail if under perform benchmark by .30% per annum over measurement periods, net of fees.
Test 3: Peer group comparison. For trailing 3 and 5 years	Performance compared to the Courtland Core Manager Index which is lagged by one quarter.	Fail if cumulative performance is at 65% percentile or lower over relevant time frames.
Test 4: Peer group comparison of income trailing 3 and 5 years	Performance compared to the Courtland Core Manager index which is lagged by one quarter.	Fail if cumulative performance is at 65% percentile or lower over relevant time frames.

The quantitative guidelines above refer to separate accounts and a minimum time frame of three years. Any underperformance for three years relative to any or all of the above referenced benchmarks should trigger a review with the corresponding investment manager. Specialty commingled fund managers will be evaluated against the stated return objective of the fund at the time of the original investment (as included in the fund documents) and ERS' Specialty return objectives of 7% net real return for value added and 9% net real return for opportunistic. All the qualitative criteria should be reviewed along with an explanation of the underperformance from the manager.

The explanation of underperformance is to be accompanied by a plan to resolve the performance issues. The plan should include specific objectives that can be measured by the Board and an appropriate timeframe to accomplish the objectives. The board can choose to allow the manager to resolve the issues or terminate.

APPENDIX A
EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII
REAL ESTATE INVESTMENT BRIEF FORMAT

Date:
Manager:
Property Name/Property Location:
Property Type:
(Scheduled) Funding Date(s) and Amounts (Net Investment):
Third party Debt:
Gross Investment:
Investment Structure:
Investment Partners and Ownership Share:
Expected Return (Year 1 Cash-On-Cash and Nominal IRR both gross and net of fees):

Investment Summary: Elaborate on sellers, investment structure, and major business points.

Real Estate Depreciation: Describe the competitive market area, improvements, major tenants (if applicable); when available include maps, aerial and surface pictures of building interior and exterior.

Expected Return: In addition to the Manager's base case pro-forma, include a forecast that is consistent with the investment strategy utilizing the ERS' CPI assumption and both before and after fee scenarios.

Pro Forma Assumptions: Describe assumptions such as investment period, growth rates and residual capitalization rate.

Investment Strategy: Outline the real estate investment strategy including a review of the anticipated future hold term, financing, development, or redevelopment plans, and any other relevant issues. Also, discuss the investment's classification as core or specialty and the associated risk level (low, moderate, high).

Major Investment or Property Risks: List the major investment risks on a market, property, tenant and transaction level.

Potential Conflicts of Interest: Discuss any potential conflicts of interest and how they will be resolved.

Program Compliance: Discuss the acquisition or disposition rationale and its consistency with the program guidelines, the current Tactical Plan and other governing documents.

APPENDIX B
EMPLOYEES'S RETIREMENT SYSTEM OF THE STATE OF HAWAII
REAL ESTATE INVESTMENT MANAGER REPORTING REQUIREMENTS

REPORT	DUE DATE	RECEIVER	COMMENTS
ACQUISITION			
1. Investment Brief	As identified	Staff	Copy to Consultant
2. Critical Dates List	3 Weeks BF close	Staff	Provide ASAP
3. Closing Report	Before Closing	Staff	As Required
4. Sources/Uses of Capital	Upon Closing	Staff	For Each Capital Call
DISPOSITION			
1. Unsolicited Sales Offer	As Occur	Staff	Report as Received
2. Critical Dates List	Offer Accepted	Staff	Provided ASAP
ANNUALLY			
1. Tactical Business Plan	Annually	Staff	Governs Ensuing Year
2. Manager Review Data	As Scheduled	Consultant	Present to Investment Committee
3. Insurance Coverage	As Renewed	Staff	Due 5 days before or after renewal
4. External Financial Audits	After Fiscal Year End	Staff	Nationally Recognized Firm
5. Independent Appraisals	Anniversary	Staff	External Every 3 Years
6. Variance Notice	As Occurs	Staff	Within 30 days
QUARTERLY			
1. Investment Worksheets	Quarter End	Consultant	30 Days After Close
2. Portfolio Operations Report	Quarter End	Consultant	30 Days After Close
3. Ltd Partnership Inv Summ.	Quarter End	Consultant	30 Days After Close

APPENDIX C
EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII
REAL ESTATE SEPARATE ACCOUNT
TACTICAL BUSINESS PLAN OUTLINE

PURPOSE: The Tactical Business Plan provides the manager an opportunity to articulate its capital allocation objectives for the ensuring 12 month period relative to the Work Assignment as outlined in each contract. Once a year the Tactical Plan is revised and all interim manager work should comply with the business plan. Variances should be discussed with the Staff and Investment Committee. The following is the Tactical Business Plan.

I. EXPECTED PERFORMANCE (Net of Fees)

1. Ratio of Current vs. Total Return;
2. Projected Initial Market Capitalization Rates;
3. Total Net Return Expectations – Both Nominal and Real; and
4. Return Trends For Sector Components (i.e. markets, property types such as community vs. regional retail centers, operating cycle).

II. INVESTMENT OBJECTIVES AND OPPORTUNTIES

1. Targeted Property Type (within work assignment);
2. Targeted Markets and Rationale;
3. Leasing Exposure – Occupancy and Rollover Pattern;
4. Tenant Mix Preferences;
5. Leverage; and
6. Special Opportunities.

III. SELL DISCIPLINE

1. Factors That Would Initiate a Sell; and
2. Properties Targeted For Sale and Rationale.

IV. CAPITAL DEPLOYMENT

1. Acquisition Objectives; and

2. Portfolio Repositioning.

V. PROGRAM ADMINISTRATION AND TIMING

1. Appraisals – Scheduled Internal or External;
2. Audits – Firm and Timing;
3. Insurance; and
4. Other Special Notices.

APPENDIX D
EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII
ANNUAL REAL ESTATE ASSET MANAGEMENT PLAN

PURPOSE: The Annual Asset Management Plan should be prepared by each separate account investment manager for each property held in their respective ERS portfolio. Generally, the following information will be requested.

I. PROPERTY SUMMARY

Narrative discussion of the specific property, including changes to market environment, leasing status, occupancy rate, property manager, renovation or scheduled maintenance details, and other relevant operational issues.

II. BUDGETS

The Annual Asset Management Plan should include at least the following and more as the manager deems appropriate:

1. REVENUE
   - Base Rent
   - Overage Rents
   - Recoveries
   - Interest of Other Income

2. EXPENSES

   Operational
   - Real Estate Taxes
   - Common Area Maintenance
   - Insurance
   - Utilities
   - Ground or Other Rent
   - Building Maintenance
   - General &Administrative
   - Property Management Fees

   Non-Operating
   - Capital Reserves
   - Leasing Commissions
   - Tenant Improvements
   - Management Fees

3. DEBT SERVICE AND FINANCING

4. PROJECTED PERFORMANCE FOR SHORTER AND LONGER TIME PERIODS