

**EMPLOYEES' RETIREMENT SYSTEM
OF THE CITY OF BALTIMORE
INVESTMENT OBJECTIVES AND GUIDELINES
REAL ESTATE**

I. *REAL ESTATE INVESTMENT OBJECTIVES*

A. INVESTMENTS IN REAL ESTATE

The Board of Trustees (the "Board") of the City of Baltimore Employees' Retirement System (the "System") is obligated by its investment guidelines to periodically conduct an asset allocation study for the investment of their respective retirement fund assets. The System's most recent study demonstrated that, over the long-term, inclusion of equity-oriented, real estate investments would enhance the System's expected portfolio investment characteristics while reducing expected total portfolio volatility.

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

Real estate investments of the System should 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 should be designed to enhance diversification within the real estate program's portfolio; consequently, exposure to any one investment, organization, real estate property type and geographic region should be limited (Refer to Section II: Program Management).

1. Real Estate Defined - Real estate assets are defined as those investments that are unleveraged or leveraged positions in real property and real property-related assets, broadly defined. The System's real estate portfolio may be invested in public real estate securities (REITS) and/or private real estate through commingled or separate accounts. Should the System decide to invest in private real estate separate account vehicles, Appendices A through E apply. In the case of timber investments, the ownership structure should be fee simple, but may vary according to the situation.

B. ASSET ALLOCATION

The System's allocation to real estate shall remain within the limits authorized by the Board as part of its overall System asset allocation.

C. PORTFOLIO RETURN OBJECTIVES

1. **Total Return** - 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 6% using a Time-Weighted rate of return calculation. The CPI-All Urban inflation index should be used to calculate the actual real rate of return. Specialty investments having greater associated volatility and higher expected yields compared to core investments, are expected to generate a minimum total real rate of return (net of investment management fees) of 8%.

2. **Global Real Estate Securities** – for global real estate securities products, the Investment Manager's benchmark shall be the FTSE EPRA NAREIT Global Real Estate Index (net total return in U.S. dollars). The Investment Manager's objective should be to exceed the benchmark over rolling three-year periods.

II. PROGRAM MANAGEMENT

A. OVERVIEW

The System may utilize discretionary closed-ended and open-end commingled fund investment vehicles that are sponsored by real estate Investment Managers. Investment Managers overseeing commingled investment vehicles must operate in accordance with the stated strategy, guidelines, and terms of the commingled fund established when the investment decision was made by the Board, unless altered by investor approval in accordance with fund documents. Although the primary focus of program implementation will be commingled funds, the guidelines stated herein also apply to separate accounts unless otherwise indicated. Specific guidelines pertaining solely to separate accounts are located in the Appendix.

B. PARTICIPANT ROLES AND RESPONSIBILITIES

Each participant in the real estate investment program, 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. **System Board of Trustees** - The investment governing authority of the System.

Responsibilities - The Board directs the pension investment allocation to real estate in accordance with overall investment parameters of the System. The Board develops and approves portfolio level investment policy for all asset classes with assistance from its Consultant. The Board monitors the program to ensure compliance with the System's portfolio investment objectives. Specifically, the Board selects and approves 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. **System Staff** - System employees supervising the real estate investment program implementation and administration.

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

3. **Consultant** - Professionals retained to assist the Staff and the Board through the provision of expert real estate advice and technical support.

Responsibilities - The Consultant coordinates the revision of the investment objectives, policies and procedures, develops the quarterly performance measurement report, assists in developing Investment Manager selection criteria, conducts due diligence with regard to Investment Managers, coordinates Investment Manager searches, , monitors Investment Manager performance in conjunction with Investment Manager financial reporting, works with Staff on special projects, and is available to administer required portfolio level control and monitoring systems. Should a separate account vehicle be employed, the consultant is also responsible for overseeing the implementation of the Tactical Plan process.

4. **Legal Counsel** - Internal counsel or external legal counsel retained by the Board 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 legal documentation.

5. **Investment Manager** - Qualified real estate organizations, registered as Investment Advisors under the 1940 Act that provide institutional real estate investment management services to the System are preferred. However, if Investment Managers are not registered it is preferred that they have an investor base that includes institutional plan sponsors.

Responsibilities - The Investment Manager, acting as a fiduciary on behalf of the System acquires, manages and disposes of real estate properties in accordance with the stated objective of the commingled fund. The Investment Manager retains appropriate property management expertise, including independent appraisers. The Investment Manager provides reporting as required by these guidelines.

C. INVESTMENTS AND RISK MANAGEMENT

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

1. **Institutional Quality** - All assets must be of institutional investment quality as evidenced by a precedent 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 Manager's style to the extent that an adversity affecting any one particular area will not impact a disproportionate share of the total portfolio. The long-term real estate strategy is for each System's real estate portfolio to be diversified by geographic regions and property type. No more than 20% of "committed funds" may be invested in any one property or investment. This limit will not be in effect when the investment is in its acquisition phase. "Committed funds" means the aggregate of all funds committed to investment by all investors and shall not include any non-recourse debt used to acquire, refinance, or improve portfolio property. Debt used to acquire, refinance, or improve portfolio property secured by other assets or funds shall be added to the numerator of this "committed funds" calculation.
3. **Ownership Structure** The ownership structure of the System's private real estate investment will primarily consist of interest in a limited liability entity or commingled fund units. Wherever possible, the System will retain the right to freely transfer its ownership interest to another qualified investor.
4. **Leverage** - Leverage may be utilized in a constrained manner in order to enhance yields of the various investments and/or facilitate the diversification of the private real

estate portfolio. Leverage is limited to non-recourse debt secured solely by the property being acquired, refinanced or improved with such debt. Additionally, lines of credit secured by and limited to the System's subscription agreement for investment in that fund during the fund's commitment period may be utilized. For core investments, total portfolio debt should be limited to forty percent (40%). Additionally, leverage should be limited to "positive leverage" where cash flow is in excess of debt service. For specialty investments portfolio debt should be limited to 75%. For timber investments portfolio debt should be limited to 25%.

D. PORTFOLIO COMPOSITION

The equity real estate program may be comprised of three complimentary components – core, specialty, and timber. The following definitions and real return objectives apply to each component.

1. **Core Portfolio** - Core investments include existing, substantially-leased, income-producing properties located principally in metropolitan areas that exhibit reasonable economic diversification. Core properties, therefore, should have most of the following characteristics:

- Existing 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 a economically diversified metropolitan area;
- Credit quality tenants and a staggered lease maturity schedule;
- Quality construction and design features;
- Reasonable assurance as to a broad pool of potential purchasers upon disposition; and,
- Properties requiring quality asset and portfolio management but not requiring specialized operating expertise which is not readily available in the market.

Core properties can be further classified as:

- Trophy
- Commodity

Trophy properties represent dominant and unique properties that cannot easily be 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 represent those core properties without trophy characteristics but yet offer nearly similar economic, financial and operating expectations. Typically,

commodity properties should have a competitive advantage in its immediate marketplace by virtue of its size, location, tenant base and/or design features.

2. **Specialty**- Specialty or specialized investments represent 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 have greater associated volatility compared to core investments and as such provide expected yields higher than those associated with core investments. Specific return targets for specialty investments should be instituted upon the consummation of a specialized investment program and/or investment, but broad return objectives are outlined below.

a. **Private Real Estate Investments**: Up to 25% of a specialty investment portfolio may be comprised of real estate –related, non –real property investments such as securitized interests of mezzanine debt and domestic and international global real estate securities.. Specialty real property investments typically exhibit the following characteristics:

- Properties located in secondary and tertiary markets, which are not economically diversified and may have accompanying susceptibility to imbalances of demand and supply;
- Property types including hotels, motels, senior housing, residential housing which require specialized management skills focusing primarily on operating business expertise rather than pure real estate management expertise;
- Properties which are considered to be in a “work out” mode;
- Properties involving significant appreciation, development, lease-up, development and/or re-development risks; and,
- Financing or investment structures that impact cash flows and/or require additional administrative expertise.

b. **Public Real Estate Securities (REITS): approved/restricted investments**:

- Permitted investments/securities are:
 - √ Cash – bank deposits, 24 hour accounts and bank bills;
 - √ Securities of Benchmark and non-Benchmark constituents traded on a recognized stock exchange - ordinary shares, units, preference shares, warrants, convertible preferred and debt securities and other similar publicly traded securities subject to the Restrictions below.
- Investment in unlisted pooled vehicles, whether internal or external, is not permitted.
- Cash limitations should be within industry norms.
- The holding of Benchmark securities in the Managed Fund should be within industry norms.
- Regional exposures should be managed within industry norms.

- Investment in non-benchmark securities should be within industry norms.
- Short selling is not permitted.
- Borrowing is not permitted.
- The global real estate securities portfolio should be diversified by geography and property type.

3. **Timber** - Timber investments involve the privately negotiated purchase and, to a lesser degree, leasing, of forestland tracts, upon which trees are grown for commercial sale. Investments in timber will be made through a commingled fund or limited partnership managed by a qualified timberland asset manager.

Commingled funds or limited partnerships managed by a qualified timberland asset manager which provide funding for the purchase and development of timber land and provide for resource asset management are appropriate investment vehicles and may be considered by the Systems. These investments shall be governed by their accompanying investment documents, but will be held to the same reporting standards as real estate commingled funds. The funds selected by the Systems shall attempt to be diversified by:

- regional geographical location (South, Northeast, West, Other, and International);
- non-contiguous tract and parcel locations;
- type and species of tree (e.g., softwood/ "conifer," such as pine, fir redwood, etc., and hardwood/ "deciduous," such as oak, maple, etc.);
- end-use market of forest product (building and construction, pulp and paper, furniture and decorative wood);
- potential purchasers of inventory (mills and processing plants); and,
- stage of tree growth (seedling through mature).

4. **Allocation Among Core, Specialized, and Timber** - The System may allocate its real estate portfolio between core investments and specialized investments pursuant to its discretion.

5. **Core, Specialty, and Timber Return Objectives**

Core – Consistent with the System's total real estate portfolio return objectives, the core portion of the portfolio is expected to provide real returns in excess of 6%.

Specialty – The specialty portion of the portfolio is expected to provide returns above an 8% real return commensurate to the additional risk associated with these types of investments and/or strategies.

Timber - Over rolling 5-year periods, the total timber portfolio is expected to generate a minimum total real time-weighted rate of return of 6%, net of all investment management fees and expenses. The inflation benchmark employed to

measure the real rate of return calculation will be CPI-U. The timber portfolio's rate of return is expected to be generated substantially from the following sources:

- A primary component of return on the portfolio will be from the biological growth of the timber.
- A material component of return attributable to the portfolio is expected to result from an element of moderate cash income from the sale of timber inventory.
- Long-term, a component of return will result from capital gains through active management, both in improving property values and opportunistic purchases and sales of properties.
- The manager will also exploit other opportunities for garnering rate of return, such as usage leases and easements, and other active management techniques.

The portfolio will be compared to an appropriate timber index (such as the NCREIF Timberland Index), or other relevant proxies as appropriate. In any event, the 6% minimum real rate of return hurdle will apply.

III. REAL ESTATE INVESTMENT PROCESS

- A. Selection Criteria** - In an effort to maintain simplicity and ensure appropriate underwriting of investment management organizations, the System should utilize only real estate investment management firms selected by the Board in a formalized search process for the acquisition, asset management and disposition of property. Selection criteria should include minimally conflicted fee structures and maximum investor controls.
- B. Evaluation and Monitoring** - In private 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 of interest contributes to the lower volatility associated with the asset class but also creates a need for a higher oversight standard by the System. The Board should be notified by the Staff and the Consultant of manager reporting problems, significant organizational changes such as mergers, and prolonged underperformance. Investment Managers performing below expectations in any of the aforementioned areas should be placed on the "watch list" as outlined in Section IV A2. All of a System's Investment Managers should be subject to an annual review by the Board and may also be called in by the Staff or Board for a special review.
- C. Reporting** - Investment Managers must report as outlined in Section IV. and, upon request, must provide such information to the Consultant, Staff, or any member of the Board. In addition, each Investment Manager shall provide to the Board, Consultant, and Staff quarterly and annual reports setting forth for the reporting period an overview of the fund's acquisitions and dispositions, the fund's investment returns, the substance of the fund's strategic plan for each year, quarterly financial information, and annual audited financial statements.

- D. **Environmental Protections** -- In the event that an Investment Manager acquires a property with environmental violations, the fund's Investment Manager and legal counsel must establish sufficient protections to shield the fund from liability.

IV. ***CONTROL AND MONITORING SYSTEMS***

A. **ANNUAL REPORTING REQUIREMENTS**

1. **Investment Manager Reviews** - At least annually, or more often as determined by the Board, the Staff and Consultant shall coordinate an Investment Manager review presentation for the System. Each Review is required to discuss how the investments managed on behalf of the System have met the previous year's plan as well as the program objectives of the System. The Investment Manager's organization is also reviewed. This monitoring system is designed to assist the System in identifying troubled investments and changes at the organizational level that may suggest additional monitoring is required.
2. **Watch List** - The performance of the System's Investment Managers will be monitored on an ongoing basis. Upon recommendation and/or consultation of the Consultant, Investment Managers may be placed on a "Watch List" or terminated. Investment Managers may be terminated or placed on a "Watch List" for a variety of reasons: personnel changes, violation of policy and investment guidelines, style deviations, underperformance and asset allocation changes. The System 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. There are various factors that should be taken into account when considering placing a manager on a "Watch List" or the termination of a manager. These can be separated into two broad categories - qualitative and quantitative factors. The former focuses on personnel, organizational and legal issues while the latter address performance.
3. **Investment Manager Fees** - Recognizing an inherent conflict of interest, Investment Manager compensation may be based on a percentage of portfolio market value, or, alternatively, may instead be calculated as a portion of cost, asset book value, or cash flow. On an annual basis, the Investment Manager shall certify, by letter of its legal counsel or compliance officer, compliance with any most-favored nation clause in its Investment Management Agreement.

B. QUARTERLY REPORTING

1. **Performance Data** - Within 45 days of the quarter close, the Investment Manager is required to submit to the Consultant performance figures for use in the calculation of System-wide performance figures for that period.
2. **Operations Report** - 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.
3. **MBE/WBE Compliance Report and Client Retention** - The Investment Manager will provide to the Board quarterly and annually written reports, as appropriate, that present, at a minimum, the following information:
 - dealings with minority and woman -owned businesses - quarterly
 - minority and majority property management firms used - quarterly
 - minority and majority appraisal firms used - quarterly
 - firm composition specifying majority, minority, and women personnel by management category - annually
 - changes in personnel or firm composition (specifying changes in minority/women personnel) - annually
 - clients gained or lost - quarterly
4. **Performance Reporting** –
 - a. **Content** - Reports consisting of performance information and a list of holdings is to be provided to the Board on a monthly, quarterly, and annual basis. Fiscal year to date performance information must also be included in each report. The System's fiscal year ends 6/30. In addition, narrative discussion of the portfolio's performance as well as current market conditions is to be included in the quarterly and annual reports.
 - b. **Mailing** - Each written report is to be mailed directly to the members of the Board, the System Executive Director, the System Deputy Director, and the Accounting Manager. The System will supply each Investment Manager with current mailing lists. When necessary, revised lists will be sent to each Investment Manager. In a month when an Investment Manager is scheduled to personally appear before the Board, the written quarterly reports are to be mailed directly to the members of the Board, the Administrator, the Deputy

Administrator, and the Accounting Manager at least one week in advance of the appearance date. Ten (10) additional copies of the reports should also be mailed to the System one week prior to the appearance date. If the additional copies cannot be delivered in this manner, then the reports can be personally delivered on the appearance date. The additional copies are only required for review meetings with the Board and are not required any other time.

5. **Periodic Review** - It is the Board's intention to formally review Investment Manager performance on a periodic basis. Investment Managers are expected to personally appear annually, or at the Board's request, at regular monthly or special meetings of the Board to discuss performance results, economic outlook, investment strategy, organizational changes, and other pertinent matters.

C. IMMEDIATE NOTIFICATION

Immediate telephone and/or letter advice should be forthcoming from the Investment Manager when information of an important nature, such as unusual market activity (oil embargo, monetary crisis, etc.) may have a material impact on the Systems' assets. Major changes in personnel and organizational structure should also be communicated to the Systems, in writing.

D. Private Real Estate PROPERTY VALUATIONS

1. **Appraisals** - The selection of independent appraisers is left to the discretion of the Investment Manager. Appraisals shall be conducted in accordance with the System-approved investment management agreements. Staff, on behalf of the System, reserves the right to obtain and review the list of appraisers and their qualifications. This review is only for monitoring purposes; the System may not veto an Investment Manager's choice of appraiser. The Investment Manager may use its discretion to select and rotate qualified appraisal firms. . See Appendix A for specific guidelines for separate accounts.

Investment Managers sponsoring commingled fund vehicles in which the System 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 criteria may be relaxed in the specific case where the cost of appraisal is greater than the benefit received by the participants. If the commingled fund documents provide that performance or similar incentive fees are payable based on actual sales of assets, not market valuations, then annual independent MAI appraisals will not be required. However, if fees are paid based on "market value" of an investment, then in no case should annual independent MAI appraisals be waived.

2. **Performance Measurement** - For performance measurement purposes, both the MAI appraiser's and the Investment Manager's interim internal re-valuations 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** Commingled account Investment Managers are not obligated to provide these reports provided that they include information regarding property valuations in the fund's quarterly and/or annual reports (if quarterly valuations are not required). See the appendix for separate account reporting.

E. Private Real Estate SUBCONTRACTORS

1. **Property Management** - The selection of property management is left to the discretion of the Investment Manager. It is expected and required that the Investment Manager will retain the highest caliber, market-rate property management service either 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, from time to time, by the 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 the System's interests. Prior to terminating a property management assignment, an Investment Manager must inform the Staff and the Consultant in writing of the release, and designate the new firm to be retained.
3. **Bonding** - It is preferred that all property managers employed by an Investment Manager be bonded. The level of bonding and implementation is left to the discretion of the Investment Manager. The Investment Manager shall employ the highest standards of care in this matter. To the extent that property managers employed by an Investment Manager are not bonded, the fund Investment Manager must substitute the bonding with an appropriate amount of fidelity insurance. In the case of a separate account investment, all property managers employed must be bonded.
4. **MBE/WBE Participation**

Baltimore City has a policy of encouraging the equitable utilization of minority-owned businesses and women-owned businesses. The Investment Manager shall agree to make good faith efforts to utilize the services of minority business enterprises (MBEs) and women's business enterprises (WBEs). In identifying available MBEs and WBEs, the Investment Manager is encouraged to use the MBE/WBE Directory published by the City's Minority and Women's Business Opportunity Office, 410-396-4355.

In keeping with the spirit of Baltimore City's policy, the Investment Manager's efforts to utilize MBEs and WBEs and minority professionals in the real estate investment industry may include, without limitation: utilization of services by MBEs and WBEs relative to this Agreement, such as real estate brokerage, printing, appraisal, property management, or real estate investment research services; hiring and training of minority professionals with the goal of placing minority professionals in all managerial levels of the Investment Manager's organization; and promoting the education training and hiring of minority professionals and the development of minority and women-owned businesses within the real estate investment industry.

In order to assist the Board in monitoring compliance with this section, the Investment Manager shall provide the Board with an annual report showing the composition of its workforce relative to minorities and women, as well as the minority- and women-owned businesses with which the Investment Manager does business.

F. AUDIT PROCESS

On an annual basis, the Investment Manager will provide the System with a combined audited financial statement for the total portfolio. This is to be prepared by a nationally recognized audit firm approved by the Staff. The auditor shall complete an income statement, balance sheet and changes in cash position analysis, and any other supporting schedule which is necessary.

G. ACCOUNTING AND CASH MANAGEMENT

1. **Accounting Policies** - All accounting data shall be computed using current value accounting, not historical cost accounting. Therefore, the carrying value of real estate assets shall be adjusted annually to reflect the most recent appraised value and will not be carried at historical cost values. The accrual basis of accounting should be used to recognize revenues and expenses in 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 a prudent manner. Cash balances should be swept to an account in compliance with a previously agreed-upon schedule and in accordance with maximum balance restrictions.

H. INSURANCE COVERAGE

1. **Required Coverage** - The Investment Manager should effect insurance for the physical properties and assets under its investment management control in accordance with the any terms set forth in the investment management agreement 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; business interruption coverage, comprehensive general liability; and title insurance.

V. GUIDELINE REVISIONS

All guidelines are approved and implemented under direction of the Board. If at any time these objectives cannot be met, or these guidelines constrict performance, the Board should be notified in writing. The Investment Manager is encouraged to suggest changes to these guidelines at any time.

VI. ACCEPTANCE

By signing and continuing acceptance of these Investment Objectives and Guidelines, the Investment Manager concurs with the provisions of this document.

Accepted by:

Name & Title

Firm

Date