

REAL ESTATE INVESTMENT GUIDELINES AND RANGES

The Montana Real Estate Pool (MTRP) was created to permit the nine Montana Retirement Systems to participate in a diversified real estate portfolio, consisting of commercial real estate and timberland. Real estate investments in the MTRP shall be consistent with the following guidelines.

a. **Allocation Size**

The target allocation range for real estate shall be 4.0 percent to 10.0 percent of the total Retirement Systems’ assets, with the Timberland allocation subject to a maximum upper limit of 2.0 percent of total Retirement System assets. The real estate target range is long-term in nature, and the allocation percentage will fluctuate according to the relative values among real estate and the other asset classes of the Retirement Systems.

b. **Permissible Investment Structures/Vehicles and Public/Private Allocations**

Investment Structures/Vehicles. The MTRP will include real estate investments, consisting of both open-end and closed-end pooled funds, the advantages and disadvantages of which are described in the following table.

VEHICLE	ADVANTAGES	DISADVANTAGES	LIQUIDITY
Open-Ended Fund	<ol style="list-style-type: none"> Property type diversification. Geographic diversification. Existing investment portfolio to evaluate. Existing manager and fund performance record. Infinite life. Can redeem units in fund. 	<ol style="list-style-type: none"> Passive investor. Cannot replace manager. Cannot influence manager decisions regarding acquisitions, financings, and sales. Fee level and structures lack alignment of interests. Lack of manager co-investment. Historically have not sold assets to harvest gains. 	Typically within 90 days unless there is an investor queue.
Closed-Ended Fund	<ol style="list-style-type: none"> Skilled value-added/opportunistic management. Manager organizations and track records. Manager co-investment. Manager-investor enhanced alignment of interests. Asset liquidations by end of term of fund. 	<ol style="list-style-type: none"> Illiquid-specified term. Typically blind pools. Cannot redeem interest. Passive investor. Cannot influence manager decisions regarding acquisitions, financings, and sales. 	Typically 7 to 10 year terms.

Open-end Commingled Funds. The MTRP portfolio may have a significant exposure to open-end commingled funds. The open-end fund investments shall be made primarily to provide (1) timely access to large existing, well-diversified portfolios, (2) reasonable property type and geographic diversification, (3) exposure to larger properties (i.e., over \$50 mil.), and (4) reasonable liquidity (i.e., ability to purchase or redeem within 90 days unless there is an investor queue). Reasonable due diligence shall be completed to evaluate open-end commingled funds consistent with these objectives.

Closed-end Commingled Funds. The MTRP portfolio may have a significant exposure to closed-end commingled funds. The closed-end fund investments may be made to obtain exposure to timberland and value-added and opportunistic real estate investments. Reasonable due diligence shall be completed prior to selecting closed-end fund investments.

Liquidity. The table below describes different levels of liquidity of real estate investments.

PORTFOLIO LIQUIDITY RANGES	
	Investment Type
LIQUID (i.e., can redeem within 30 days if no queue exists)	Select Open-End Funds
MODERATE LIQUIDITY (i.e., can redeem within 90 to 120 days if no queue exists)	Open-End Funds
ILLIQUID (i.e., liquidity is subject to GP discretion until fund termination.)	Closed-End Funds

c. **Expected Investments.**

The categories utilized to classify MTRP real estate investments are: Timberland, Core, Value-Added, and Opportunistic. With the exception of Timberland, the categories are differentiated primarily by risk/return attributes rather than by property type. A description of each category follows.

Timberland. Equity investment in land that is populated with or is intended to produce commercially harvestable timber. Net inflation-adjusted returns are expected to be 5.0 percent to 7.0 percent. Proceeds from the sale of timber and ancillary revenue opportunities, such as recreational leases, will account for the majority of the real return, while land appreciation is expected to approximate the rate of inflation.

Core. Equity investment in operating and substantially-leased institutional quality real estate in the traditional property types (apartment, office, retail, industrial and hotel). Net returns historically have been in the 4.0 percent to 6.0 percent range (inflation-adjusted and net of fees) and are typically comprised of greater levels of income (i.e., 67.0 percent of total returns) with appreciation matching or exceeding inflation.

Value-Added. Equity or debt interests in assets requiring rehabilitation, redevelopment, development, lease-up or repositioning. Net returns historically have been in the 8%-10% range (inflation-adjusted and net of fees). Value-added investments frequently involve the repositioning of distressed assets (i.e., not fully leased and operating). For example, a value-added investment may be an office building that is 40.0 percent vacant and needs significant capital to rehabilitate and reposition the property. Investment may also include non-traditional property types (e.g., manufactured housing) which may contain greater risk. Value-added investments typically are expected to generate above-core returns through the leasing-up of a property, which increases the end value by increasing in place income and, in many cases, decreasing the capitalization rate used in selling the asset due to the reduced asset risk resulting from stabilized occupancy. Value-added returns are typically more

dependent than core on appreciation returns with purchase prices based on income in place or asset replacement cost (i.e., at a discount to replacement cost).

Opportunistic. Equity or debt investment in real estate properties, operating companies, and other investment vehicles involving significant investment risk. Risk may include real estate, financial restructuring, and non-real estate risk. Net returns have been in the 12.0 percent or higher range (inflation-adjusted and net of fees). Opportunistic investing includes distressed assets, financial restructurings, and/or financial engineering opportunities (e.g., foreclosing on a mortgage and selling the equity interest) and potentially the purchase of REITs or REOCs. Investment may also be made in non-traditional property types (e.g., self-storage) which typically contain greater risk. Opportunistic returns typically require even greater appreciation returns than value-added (e.g., 50.0 percent of total returns) and in many cases are originated with minimal income in place.

d. Policy Constraints.

Policy range targets for MTRP will be reviewed and adjusted periodically going forward with respect to MTRP exposures. Policy range targets include those dealing with investment category (see below), property type (Section f. 1.), geography (Section f. 2.), and leverage (Section g. 1.). With the exception of the leverage policy range target, policy ranges will be measured based on the net asset value of MTRP holdings. Targets may be adjusted on an annual basis and will be reflected in the MTRP quarterly performance reports. Because MTRP investments have limited liquidity, it will typically be impractical to correct deviations from policy range targets through the purchase or sale of assets. Therefore, if actual portfolio holdings should fall outside of policy guidelines, the MTRP shall refrain from investing in funds that would be expected to increase the deviation from policy ranges.

The following table sets forth the long-term investment category policy ranges for the portfolio.

INVESTMENT AND PORTFOLIO RISK/RETURN RANGES		
Risk/Return	Nominal Return (Net)*	Policy Range
Core plus Timberland	6-8%	35%-65%
Value-Added	10-12%	20%-45%
Opportunistic	13-15%	10%-30%

* Assumes 2.5% inflation overall and 100 basis points core management fee, 200 basis points value-added and timberland management and incentive fees, and 300 basis points opportunistic management and incentive fees.

e. Income and Appreciation Return Mix.

Real estate investments, depending on their risk/return level, offer varying proportions of expected income/cash yield and appreciation returns. Investments providing higher income/cash yield returns typically will be preferred among investments of comparable expected total returns since income/cash yield returns provide greater return certainty

and therefore lower risk. In addition, investments providing preferred or senior income/cash yield returns typically will be preferred among investments providing comparable returns because such features enhance the certainty of return.

f. **Diversification.**

The MTRP portfolio diversification is important in reducing portfolio risk and accomplishing superior risk-adjusted returns. The impact of investments on portfolio diversification, portfolio risk, and risk-adjusted returns shall be considered when evaluating prospective investments. Additionally, the portfolio may have over-weighted exposure in select property types or regions as desired.

1. **Property Type.** Property type diversification is one of the most important diversification features in terms of impact on returns. The property types have historically performed differently during economic cycles. Residential and industrial investments have historically outperformed the other property types during economic downturns. Office has historically underperformed during economic downturns, as reduced tenant demand results in lower rents, higher owner operating and build-out costs, and reduced income and cash flow. Hotels historically also have underperformed during economic downturns.

Diversification ranges are based on the universe of available real estate investments and institutional investor portfolio information. The following table provides a guideline range with respect to the MTRP property type diversification.

PROPERTY TYPE DIVERSIFICATION RANGES	
Property Type	Policy Range
Timberland	0%-35%
Office	15%-45%
Retail	10%-40%
Industrial	5%-35%
Residential	10%-40%
Hotel/Other	5%-25%

2. **Region/Location.** The importance of location to the long-term value of real estate is based on the economic fundamentals and the other risk attributes (e.g., weather, earthquake and local government impact) of U.S. and international regions. The distribution of real estate investments by geographic region shall be monitored for compliance with the broad ranges set forth in the table below. Policy range targets with respect to regional exposures may be established and adjusted on an annual basis.

REGIONAL DIVERSIFICATION RANGES	
Regions	Policy Range

West	20%-45%
South	10%-40%
Midwest	5%-25%
East	20%-45%
International	0%-30%

Because domestic commercial timberland is primarily concentrated in the South and the Pacific Northwest, the preceding regional diversification ranges shall apply only to non-timberland real estate holdings. Timberland holdings shall be managed such that, upon maturity of the timberland strategy, no more than 50% of timberland holdings will be concentrated in a single timber-growing region.

3. **Other.** In addition to property type and regional diversification, there are other real estate factors that impact the portfolio risk which may be reduced through diversification. These portfolio factors may include, but are not limited to, the following:
 - a. **Investment Structure.** Equity, preferred equity, first mortgage debt or mezzanine equity. **Investments in public CMBS and REITs are not preferred.**
 - b. **Life Cycle.** Land, development/redevelopment, leasing (i.e., less than 90% leased) and operating (i.e., over 90% leased).
 - c. **Investment Size.** \$0-\$10 mil., \$10-\$20 mil., \$20-\$50 mil., \$50-\$100 mil., \$100 mil.+.

While no formal diversification ranges are set forth for the above portfolio risk factors, these and other factors may be monitored in assessing overall portfolio risk and expected return.

g. **Other Risk Factors.**

1. **Leverage.** Leverage is a significant risk factor. Its importance is magnified during an economic downturn when decreasing property values and stricter lending terms can lead to unexpected increased leverage levels. It may be the case that the leverage level increases as market conditions worsen.

On an individual fund basis, the leverage level can range up to 75.0 percent. Leverage consists of the combined borrowing at the property level and the fund level. On a select basis, the leverage may exceed 75.0 percent for a given investment, if it is determined to be reasonable to do so. Leverage shall be monitored on an individual fund level, and new investments shall be made with the intention that the total MTRP portfolio leverage shall not exceed 60.0 percent.

LEVERAGE RANGES	
Risk	Range
Timberland	0%-30%
Core	0%-50%
Non-Core	0%-75%
Total Real Estate Portfolio	0%-60%

2. **Monitoring and Control.** All investments will be made through investment vehicles providing full discretion to investment managers.
3. **Manager Concentrations.** The MTRP exposure to each manager shall be reviewed regularly to determine the reasonableness of each. No manager shall have under management more than 25.0 percent of the MTRP's net asset value, unless specifically approved by the Board.
4. **Benchmark.** The MTRP benchmark shall be the NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE), reasonably adjusted to provide comparable risk/return with the MTRP portfolio given the level of non-core exposure. Because MTRP's underlying funds typically report their returns 30-60 days after quarter-end, the benchmark will be compared on a one-quarter lagged basis. Benchmarking of the Pool should emphasize the comparison of longer-term performance data, ideally a period of time sufficient to encompass an entire real estate market cycle.