

December 14, 2007

MEMORANDUM TO: State Investment Council

FROM: William G. Clark, Director  
O. Ike Michaels, Jr., Deputy Director

SUBJECT: **Proposed Real Estate Investment in AEW Core Open-End Fund**

This due diligence memorandum is presented to the State Investment Council (the "Council") pursuant to N.J.A.C. 17:16-69.9 to report on a proposed real estate investment of an additional \$100 million in the AEW Core Open-End Fund ("ACF").

Please note that this investment will be authorized pursuant to Articles 69 and 71 of the Council's regulations, which became effective on June 20, 2005. The ACF investment will be considered "core real estate" as defined under N.J.A.C. 17:16-71.1.

The Alternative Investments Procedures adopted by the Council on January 20, 2005 require any potential alternative investment opportunities to be identified and initially evaluated by the Head of Alternative Investments of the Division (Bill Clark in an acting capacity) and the applicable Asset Class Consultant (The Townsend Group for Real Estate, or "Townsend") in coordination with the DOI Investment Committee (Bill Clark and Ike Michaels).

As a result of internal and external sourcing, the DOI Investment Committee identified the proposed investment, and Townsend and Division staff proceeded to undertake extensive due diligence on the proposed investment. We completed the same due diligence process as with all the other alternative investment opportunities presented to the Council.

Based on this due diligence, the Division has determined that the proposed investment meets the criteria for investments set forth in the Alternate Investment Procedures.

AEW Core Open-End Fund ("ACF") is a recently-formed open-end commingled fund ("OECF") sponsored by AEW Capital Management LP ("AEW") that initially raised \$800 million of seed capital in early-2007 from a select group of investors ("Seed Investors") including \$100 million from the Division. ACF is structured as a perpetual life vehicle, open to investors for quarterly contributions and redemptions of capital. AEW is utilizing Seed Investor's capital to build an attractive well-diversified portfolio of assets by property type and geographic location. In return for providing seed capital, AEW offered Seed Investors an attractive incentive in the form of a substantial reduction in the base asset management fee on the initial commitment amount inclusive of future appreciation in value and reinvestment of operating dividends. This fee reduction will also apply to this additional investment.

AEW is a large investment manager that is based in North America, with affiliated operations in Europe and Asia. Headquartered in Boston, it currently employs over 150 investment professionals and manages in excess of \$20 billion in private and public real estate. AEW operates three separate and distinct functional lines of business including public real estate securities, opportunistic private equity partnerships and direct equity investments. Firm-wide strategic direction and operations are overseen by the AEW Management Committee. Jeffrey Furber, CEO and Managing Partner, Pamela Herbst, Head of Direct Investments, and Steven Corkin, Head of Client Service and Marketing Group, make up the three-person Management Committee. Together the three have an average tenure with AEW of about 18 years.

The Division desires to increase its core real estate investments either by seeding new core funds or making additional commitments to our existing core investments. While the probability of recession has increased for the economy as a whole, fundamentals in the commercial real estate class are currently in tact and rents are being pushed. Nonetheless, existing core funds may be subject to price depreciation on certain assets to reflect higher cap rates over the next nine months (appraisal lag) whereas AEW will be acquiring a new portfolio at current market prices over the next 2 years. Accordingly, we believe ACF may benefit by purchasing assets in a soft market environment. ACF will employ a core strategy primarily focused on the four main property types (retail, multifamily, office and industrial) with the ability to engage in a modest amount (up to a maximum of 15%) of value added investment strategies. Leverage will be capped at 30% loan-to-value, consistent with the majority of OECFs in the marketplace. Investments will be limited to U.S. domestic opportunities.

All the legal and economic terms associated with this Fund are fair and consistent with market standards.

A formal written due diligence report for the proposed investment and all other information obtained by the Division on the investment was sent to each member of the Investment Policy Committee of the Council on Friday, December 7, 2007, and the Committee held a meeting on December 12, 2007 to review the due diligence report prepared by Townsend and Division staff and other information for the proposed investment.

After review of the extensive due diligence referenced above, the Investment Policy Committee of the Council has decided to report on the proposed investment to the full Council pursuant to Step 4 of the Alternative Investments Procedures. Under these procedures, the Council may adopt or otherwise act on this report.

State Investment Council

Page 3

December 14, 2007

We will work with representatives of the Division of Law and outside counsel to review and negotiate specific terms of the legal documents to govern this investment. In addition, the proposed investment must comply with the Council's "pay to play" regulation (N.J.A.C. 17:16-4). While we are confident that we will work through these issues, the potential exists that a successful resolution may not be reached with the general partners.

We look forward to discussing the proposed real estate investment at the Council's December 20, 2007 meeting.