OPPORTUNISTIC
PRIVATE INVESTMENT PROGRAM
STRATEGIC PLAN

BOARD APPROVED: 02/18/2011

ARIZONA STATE RETIREMENT SYSTEM

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INTRODUCTION

In the summer of 2010, the Arizona State Retirement System board adopted an initiative for an investment program in opportunistic private investments ("OPI") in order to better capture the potential benefit of private market investment opportunities. The thematic investment areas encompassed by OPIs and their comparative and competitive justification are discussed herein. This strategic plan also describes the relationship of the OPI allocation to existing private markets activities in real estate and private equity, governance issues and performance evaluation.

INVESTMENT PHILOSOPHY

Mission Statement

The mission of the ASRS Opportunistic Private Investment (OPI) Program is to invest opportunistically in select private equity and real estate investment opportunities that are not otherwise pursued through the ASRS' Private Equity and Real Estate Programs due to their tactical nature or need for specialized due diligence. The ASRS has established a 0%-3% target range for the OPI Program.

The ASRS expects that the Opportunistic Private Investment Program, over time, will generate enhanced returns for the overall ASRS investment program. The ASRS recognizes that the OPI Program may add further diversification to the ASRS program, but such diversification benefits are not a primary objective. The OPI Program is expected to produce other benefits, including improved terms, lower cost, better alignment of interests, and enhanced control, stemming from direct or co-investment and customized investment structures.

Investment Themes and Considerations

First and foremost, opportunistic investments are not strategic investments. During the strategic asset allocation process, ASRS identifies strategic assets that the ASRS intends to own across market cycles and that the ASRS expects will withstand shorter term market fluctuations. Opportunistic investing is tactical in nature, and is the opposite of strategic investing in that it seeks to capitalize on short-term market dislocations or unique situations that are not expected to persist. Many of these assets will have marked illiquidity, with few bids and high spreads. In certain cases the ASRS will attempt to find situations where economic downturns negatively impact industries, eliminating or reducing competition for products still needed by consumers, albeit in quantities smaller than previously supplied. The ASRS will also attempt to capitalize on steep discounts on assets previously supplied to excess when there is adequate evidence of demand for these products on market recovery. In addition, the ASRS will pursue opportunities where it believes a contrarian perspective may provide attractive opportunities in areas out of favor with conventional wisdom. The ASRS will exit as opportunities close, though in some real property cases involving successful turnarounds, the exit may involve re-designating the assets as part of the broader real estate portfolio.

Opportunistic private market investment investments will be sourced through non-traditional proprietary channels based on information flows available to the ASRS staff, trustees and consultants. Since the announcement of the program, ASRS staff in collaboration with referrals from trustees and consultants has been developing an investment pipeline. As a means of illustrating the types of investments and investment themes that will be considered in the OPI program, a series of "case studies" reflecting elements of the pipeline as of November, 2010 are presented in Appendix "A."

Opportunistic private market investments are investments in businesses or real property that are not registered as securities. Investments may be made in debt, equity or hybrid elements of the capital structure of the target firm or property. OPI investments exist on a continuum with our existing real estate and private equity investments. In some cases, it may be a judgment call whether a particular investment is "opportunistic" or fits into our "standard" program. For example, purchasing a limited partnership interest in a private equity partnership where the ASRS already is a partner has exactly the same risk characteristics as the interest already owned and would not be considered opportunistic. Similarly, a "co-investment" in a portfolio company owned by a partnership in which we are invested possesses many of the same investment characteristics as the partnership interest itself, and would not necessarily be considered opportunistic. On the other hand, a co-investment in a company which is part of a partnership in which the ASRS is not a partner would likely be considered opportunistic.

The following four thematic areas constitute the universe of investments that will be pursued through the OPI Program:

1. Emerging Firms with Experienced Personnel

   Emerging firms are entities that do not have significant tenure in their current form, but nonetheless consist of individuals that have relevant backgrounds, significant experience, and robust domain knowledge. These firms are often overlooked by the institutional marketplace for a number of reasons, including limited capacity, additional due diligence requirements, and herd mentality. As a result, there are often emerging firms that could offer advantages including local knowledge, specific skills, better terms, and so forth.

2. Direct and Co-Investments

   Opportunities exist to invest directly in equity and debt securities of private companies and properties outside of a typical limited partnership structure. There are several potential advantages to such investments, including lower fees, increased transparency, improved governance, and reduced competition. Many institutional investors do not pursue such investments due to the large capital outlays necessary, the specialized due diligence required, and limited resources to source and review such investments. This dynamic creates the potential for the ASRS to access attractive investment opportunities that are not as aggressively pursued and competed for by other institutional investors.

3. Regional Opportunities

   The ASRS staff, trustees, and consultants may possess unique regional market insights that could provide a competitive advantage in sourcing and reviewing investment opportunities. Other entities may prefer to partner with a local fund such as the ASRS, or the ASRS may determine that opportunities exist in markets where it has specific knowledge.

4. Direct Partnership Structures

   The ASRS may pursue direct partnership structures with entities possessing significant skills or capital. These entities could include domestic and/or international pension funds, endowment funds, foundations, and operating partners. Each entity would offer some degree of competitive advantage, such as local market expertise and information flows, effective investment sourcing, operational skill, etc. The ASRS advantage would include capital availability, mobility of capital, decision-making fluidity, and regional and non-regional expertise.

OBJECTIVES

This section outlines the broad return objectives and risk mitigation considerations of the ASRS Opportunistic Private Investment Program.

Return Objectives

There will be two types of benchmarks employed within the OPI area, one related to each individual investment made, and one relating to the program as a whole.

Because each OPI investment is likely to be unique in character, the performance benchmark for each individual investment will be determined at the time of investment by the relevant asset class committee approving the investment. The benchmark may be an absolute return, or may be relative to a publicized index. Additionally, the portfolio from which the funding for the investment is drawn (fixed income or equities) will be identified with each investment based on the characteristics of the investment and the performance of the investment will be compared to its funding source, thus reflecting the opportunity cost of the investment. The benchmark and funding will be identified and approved by the committee as part of the investment decision. Importantly, the benchmark will, as closely as possible, reflect the risk and return characteristics of the investment itself.

Since the alternative to conducting OPI transactions is investing in other more traditional investments of the ASRS, the performance benchmark for the entire OPI program (program benchmark) will be the return of the overall ASRS Fund.

Given the illiquidity inherent in the private markets, both the individual OPI investments and the aggregate program will be judged over an appropriately long time period of a rolling 10 years, on a net of fees basis.

Risk Mitigation

The OPI Program will be structured to mitigate risks in a variety of ways. The ASRS will implement the program through partnership or equivalent structures with managing partners with a high degree of expertise and experience managing the type of asset or business involved in the investment. The ASRS will favor custom negotiated partnership structures with fees and manager co-investment structured to align interest, compensate manager accomplishments that add value and discourage unintended risks. As discussed further below, focus will be placed on degree of discretion granted to managers in negotiating partnership structures.

Each investment will be subjected to multiple layers of due diligence investigation commensurate with industry standards for such transactions. This will include underwriting by the general partner, consultants retained by the general partner, internal underwriting efforts based on the particular skills and experience of the ASRS staff, and additional consultants retained by the ASRS as deemed appropriate by the committee assigned to the investment. The relevant asset class committee will provide oversight to assess the adequacy of due diligence efforts.
In addition to utilizing prudent underwriting standards, the OPI Program as a whole will be diversified to mitigate investment-specific risks. While the nature of this opportunistic Program does not allow for traditional diversification criteria, the ASRS will take diversification into account when allocating capital to investments and the OPI investments collective will reflect multiple industries, locations and property types.

Below is a list of the types of risks associated with the OPI Program. The ASRS will consider these risks and the degree to which they are mitigated when making OPI investment decisions.

Pricing Risk (entry/exit risks): Because the OPI Program is tactical, decisions are required with respect to both the timing and price of the entry and exit of each investment. Due to economic cycles, credit cycles, and a myriad of investment-specific factors, the pricing of any individual asset can differ significantly from year to year. Well-timed entry in less liquid markets is a fundamental goal of the program and a potential weakness if not well implemented. The ASRS will prefer investment structures in which it has control or some significant input in entry and exit decisions for assets.

Economic Risk: The OPI Program will have economic risk related to the specific assets selected and the economy in general. The success of the investment program will depend, to a certain degree, on national and regional economic performance. This risk may be mitigated through senior positioning in the capital structure, low entry price or other downside protection. Nevertheless, if the economy fails to perform as contemplated in an original investment thesis, or enters a recessionary period, the return to an OPI Program investment will likely be negatively impacted.

Operating Risks: The OPI Program is subject to risk that weak management of an asset will result in a failure to achieve the full return potential of the asset or business. The ASRS will seek to mitigate this risk by selection of managers with a high degree of experience and expertise in the type of asset or business involved. Moreover, the ASRS will favor structures where there are no unreasonable barriers to the removal of a non-performing managing partner.

Financial Leverage: Because the OPI program may involve investments in businesses or properties which have unstable cash flows, inappropriate use of leverage could create a significant risk of loss of capital. Leverage and control over leverage will be a central part of all negotiations with prospective managing partners and the ASRS will favor investments where it has control or some significant input in leverage decisions.

GOVERNANCE STRUCTURE

The OPI Program will be governed through the traditional investment channels within the ASRS. The following section details the roles of various decision-making bodies at the ASRS. These roles are substantially similar to those used for governing decisions regarding all other investment decisions of the ASRS, but have been enhanced to reflect the unique requirements of the OPI program.

Because the OPI Program will include investments considered either "real estate like" or "private equity like," the CIO will make a determination during due diligence about which ASRS asset class committee is best suited to review each investment. Consequently, OPI Program investments will be reviewed, and corresponding investment decisions will be made, by either the Real Estate Committee or the Private Equity Committee, depending on the nature of the investment itself. Because of the unique character of investments which will be considered for the OPI program, OPI will not have a single, dedicated consultant. Rather consultants will be selected and receive assignments at the discretion of the committee to which a particular investment is assigned.

Investment due diligence will be conducted by staff with asset class committee oversight. It is anticipated that diligence will be performed by sponsoring operating partners, staff and third party consultants. For each investment, staff will review investment memoranda and diligence materials provided by sponsors in order to prepare a diligence plan indicating what confirmatory and additional diligence will be needed. Staff will then recommend the diligence plan for review and approval by the CIO. In reviewing the diligence plan for adequacy, the CIO will consider the size and complexity of the investment, the experience and reputation of the sponsor and the need for independent information sources to prudently judge an investment. In most cases, an independent party will investigate the expertise, reputation and track record of a sponsoring entity, although this requirement can be waived in the case of co-investments with large, public sector institutional investors or other cases where the CIO and asset class committee deem it is appropriate to do so.

It is anticipated that investments will often be presented to the asset class committee over two meetings, allowing a review of preliminary diligence, the diligence plan and investment analysis in an initial meeting providing an opportunity for committee suggestions. Such a two-step process will be encouraged when time permits, but is not a requirement for investment approval.

Staff will provide to the relevant committee periodic reports on each investment, its progress in relation to its business plan, changes in market conditions and considerations related to exits and dispositions.

DEFINED ROLES FOR DECISION-MAKING BODIES

The ASRS OPI Program shall be planned, implemented, and monitored through the coordinated efforts of the Board, Investment Committee (IC), Real Estate Committee or Private Equity Committee (the "Committee"), Director, CIO, and Investment Management Division staff (Staff), and consultants selected by the committee for an investment (Consultant). The IMD RE Staff will be primarily responsible for implementing the investment decisions of the REC, the IC and the Board. Set forth below is the delegation of the major responsibilities of each participant.

Duties of the Board

- Establish the allocation to and role of OPI investments to the ASRS.
- Approve the OPI Program Strategic Plan and any changes and modifications to same.
- Formally review the OPI portfolio on an annual basis.

Duties of the Investment Committee (IC)

- Recommend to the Board the OPI Program Strategic Plan and any changes and modifications to same.
- Provide expert advice to the Board and the Asset Class Committee

Duties of the Asset Class Committee

- Final decision making authority on an OPI investment recommended by staff, subject to referral to IC in accordance with Board procedures. *
- Review due diligence completed by sponsors, staff and third parties. The Committee may recommend to the Director, CIO and Staff areas where additional diligence or analysis will be required to approve an investment.

  *Decisions require the consensus of the Director and CIO.

Duties of the Director

- Member of the Committee. No investments made without concurrence of the Director.
- Approve the selection, retention and termination of consultants performing work on OPI investments.

<u>Duties of the CIO</u>

- Member of the Committee. No investments made without concurrence of the CIO.
- Execute the decisions made by the Committee.

<u>Duties of Staff</u>

- Prepare the strategic plan and updates thereto.
- Review potential investments and make investment recommendations to the Director, CIO and Committee.
- Perform due diligence activities, negotiate partnership agreements and coordinate due diligence activities of managing partners and third party consultants retained by the ASRS.
- Oversee the day-to-day operational activities of the OPI Program.

<u>Duties of Consultants</u>

- Perform diligence and analytical activities as requested by the Asset Class Committee and staff and advise the Committee and staff on the results of such work.

APPENDIX A - CASE STUDIES

The following case studies are intended to provide examples of the types of investments that might be pursued through the OPI Program. As the program is intended to be tactical and opportunistic in nature, investment opportunities will likely arise that are not represented by the case studies below. The case studies are not intended to be a comprehensive representation of the types of opportunities that are likely to be reviewed through the OPI Program.

Case Study #1 - Senior Lien in Illiquid Market

We may have the opportunity to provide financing for the acquisition and completion of a partially constructed condominium building. The building is well located and appears to have potential for demand if offered for rental or sale at the right price. There is a complete absence of debt financing for this type of project resulting in very low "all equity" asset pricing. One financial structure we might pursue for this type of investment would be to provide a combination of senior and mezzanine debt. Given the absence of competition, we would price this loan to achieve double digit annual returns. The risk of the transaction is reduced by the lien position and low entry price as a result of illiquidity in the market.

In searching for opportunities that are "priced wide" the reason for the favorable pricing may come from multiple sources. One example is dislocation in the market as a result of prior firms either disappearing or exiting their historic activities. This creates an opportunity for new entrants or re-entrants to operate essentially without competition while they gain market share.

Case Study #2 - Specialty Finance

A portfolio company in one of our private equity partnerships is a chain retailer built on a franchise model. We have learned from our partner that this business is constrained not by lack of consumer demand for their products, but by the absence of capital for their franchisees. This loan demand used to be met by institutions like GE Capital and other non-bank firms with franchise finance specialty arms. Most of them have either gone out of business or exited the market. As it happens, a team of highly experienced franchise finance operators happens to reside in Phoenix and they are considering a re-entry into the market. This is a potentially substantial transaction. Our portfolio company alone projects that they could annually provide $300 million of loan production to a franchise finance operator. We are in early stage discussions with this team to explore investing with them to launch this company. We have the potential to be first in the field to re-enter, creating the opportunity to rapidly gain market share at favorable pricing. An exit from the investment would be possible through IPO or to a strategic buyer. The synergy with our other portfolio companies is a side benefit.

Case Study #3 - Out of Favor Investment Opportunity

You could hardly find a sector in deeper distress at the moment than home construction. Yet, people continue to buy 300,000 new homes per year. Around half of those homes are built by privately held builders who have to work on all equity terms or with "hard money" lenders. A highly experienced team with national contacts among privately held builders is looking to re-launch a lending business. They have sourced invetmentss at 80% loan to cost with yields including "kickers" in the mid-teens for senior lien collateral consisting of "pre-sold" homes. This is either a self liquidating business or could provide an exit to a strategic buyer.

Case Study #4 - Deep Value Investments at Discount to Reproduction Cost

Investments without current cash flow have few bids because they do not fit the structures typically pursued by institutional investors, and, therefore, trade at deep discounts. We have had preliminary discussion with a local manager with skill and deep analytical capability in dealing with this type of asset. While he has been approached by name brand institutional money sources, he has turned them down because of the arbitrary exit requirements that do not fit the natural cycle of the investment. By negotiating a structure with terms more intelligently structured around the actual opportunities, we can invest directly with a highly competent local operator with the potential for higher returns for all parties.

Case Study #5 - Wider Spreads on Smaller Investments in Smaller Markets

A respected local apartment investor and manager has arranged for the acquisition of 1,100 apartment units in a town of 140,000 people northwest of Nashville. This town has a self-contained economy with a state university campus, a military base, the seat of county government and a new $1 billion solar panel manufacturing facility about to open. At the top of the market, these apartments qualified for a $58 million loan. Now they are being acquired for $18 million. With fix-up costs of around $5,000 per unit, the total cost for the acquisition will be at approximately a two-thirds discount to replacement cost. The stabilized yield on the investment is estimated at 11% on an unlevered basis. The unlevered return is priced about 500 to 600 basis points wider than trophy quality investments.

Case Study #6 - Difficult-to-Categorize Investments

A brand name investment management firm is organizing to invest in the management platform of established, institutional-grade hedge funds each with more than $1.5 billion under management. Hedge fund managers have limited options for liquidity based on the value of their business operation. This fund seeks to take advantage of that illiquidity and lack of competition to create a structure for investors to participate in the management and incentive fee income. The structure is advantageously priced, in part, because it doesn’t fit a standard category. It’s an investment in a business, but it isn’t traditional private equity. It’s related to hedge funds, but isn’t a hedge fund. The investment is projected to have limited “j-curve” characteristics, high cash yields, and high outsized total returns.

Case Study #7 - Secondary Limited Partner Interests

In a recent meeting with one of our secondary market private equity managers, we learned that their preferred acquisition method often comes in the form of packages of limited partner interests. As it happens, it often is the case that the package includes non-private equity interests, usually real estate. They seek to dispose of the non-PE interests in order to maintain purity to their private equity mission. We could be a strategic partner to their private equity activities by providing a market for the non-PE components of their acquisitions.

Case Study #8 - Emerging Managers

A leading search firm that helps the private equity industry source investments from among the many thousands of privately held firms in North America is trying to get in the fund business with a “co-invest” fund. Their firm is well established in the search business and they established relationships with thousands of privately held firms and maintain a data base of information on those firms. Similarly, they maintain contacts in the fund industry and conduct searches for firms with particular attributes in order to meet fund acquisition criteria. Because of their success in building their search franchise, they are now able to command as a premium for their search service a co-investment right in companies they place with funds. They have an early look at investment flow, are privy to diligence outcomes and are in a position to know which investments pass diligence with the best investment characteristics, allowing them selective access to investments. They are attempting to organize a fund to invest in these co-invest opportunities. As a first time fund, they are having difficulty raising capital and we have the opportunity as an early adopter to invest on favorable terms.

These examples are intended to illustrate the types of investments that we might further investigate for possible inclusion in our opportunistic portfolio. In general we seek wide pricing and favorable terms. In order to obtain this favorable pricing, we will demonstrate creativity and flexibility in investing in ideas and categories that are out of favor, off the beaten path, and for whatever reason are mispriced in the market.

Each of these case studies was an actual opportunities which was available for review in late 2010, though some have since closed and are no longer available. They reflect what seem like promising ideas among what has crossed our path in just the first few weeks since we have started trying to build this program. Not all will be pursued and certainly not all will be implemented. More themes and opportunities will emerge as we move forward.