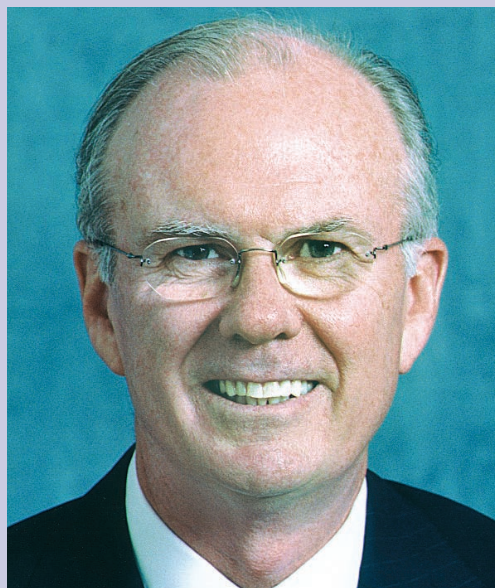
Survival skills for managers

Only those investment managers that succeed in regaining investor confidence will survive into the 'next era', says **Ted Leary**

Most institutional investors are unhappy with their real estate returns and are frustrated with many of their managers. They paid out big fees during the 'hot years' but are now reporting enormous losses in real estate portfolios. So investors are starting to reassess the whole framework of the business: fees, incentive structures, 'alignment', governance, co-investment, vehicles, strategies, fiduciary conduct and more.

As these issues get sorted out, the economics of investment management will change – probably for the worse. Many firms will disappear – maybe 30% of them. 'Consolidation' in the business will more likely be the 'elimination of firms and the consolidation of assets'.



Ted Leary is president of Crosswater Realty Advisors

I ask clients who are thinking about terminating a manager what – when virtually every manager has lost lots of money – has triggered that decision? The answer is almost invariably: "We've lost confidence in their ability to serve us".

I've then found that the lack of confidence can be tied to many factors including very poor returns, poor strategies, poor fiduciary conduct, poor attitude, staff losses and organisational disarray.

One regular complaint concerns managers that placed capital at the market high. That perception involves 20-20 hindsight – but not all managers behaved that way. Some firms exercised much greater investment discipline than others. When an investor has that kind of comparison available, some firms naturally look better than others and some a lot worse. The conclusion investors often arrive at is that the more aggressive managers were driven by a short-term fee mentality.

One of my particular concerns, when reviewing a manager's investment recommendations, is the frequent lack of true risk analysis. You see the 'base case' at a 14% return and the 'downside case' at a 10% return. Well, life isn't that fair and balanced. Stuff happens. Particularly in a market where deals were 'priced to perfection' and there was no margin for error.

I don't have a simple solution to the risk management issue but I sense that investors are going to want a lot more attention paid to it – possibly even requiring managers to have some sort of strong risk management function staff in their firms. And I mean investment risk, not insurance risk.

The problems created by the lack of true risk analysis and management were exacerbated by cheap and readily obtainable leverage. We've seen the disastrous consequences of that in the single-family housing sector and in the supposedly more sophisticated commercial markets. I think that most investors will want to de-leverage existing portfolios and use far less leverage in future. This will reduce returns and, in turn, managers' fees.

So what other changes can we expect to see?

Fees: I suspect that 'power' will shift to the large institutional investors and away from the managers. Fees are sure to come down as investors assert that managers didn't deliver the goods. The aggressive approach of private equity investors is likely to be adopted by real estate investors. Stand-by or commitment fees will likely be cut or reduced. Asset management fees will also be cut or reconfigured. The performance fees hurdle will be higher. I have observed, though, that in many cases high hurdles drove managers to take bigger and bigger risks. So an argument might be made that lowering hurdles might be a safer investment strategy. Furthermore the idea that everybody can beat certain hurdles is naïve. It's the real estate equivalent of Lake Wobegon, where everybody is above average.

Mid-term or uncrossed incentive fees will be eliminated. If a manager does want a mid-term fee then clawbacks – enforceable and bankable – will be needed. To avoid clawbacks, managers will have to wait until their fund is completed and the client's capital has been totally returned.

Governance: Many institutional investors will be unwilling to enter into partnership agreements where they don't have a much stronger voice in the investment process. We are already seeing the use of 'shadow managers' who represent the investor in overseeing managers. As their use grows, their role could become longer term. Investors might ask for representation on a manager's investment committee through independent members, akin to independent directors in a public company. There are limits to what the investors can do within their limited partner remit, but it's reasonable to expect LPs to be more assertive. For example, instead of investors requiring a super-majority to remove a manager, the hurdle will likely drop to 51%.

Co-investment: I have yet to see convincing evidence that co-investment make a better manager. I've observed managers with no or minimal co-investment doing well and others with significant co-investment doing abysmally. But at a minimum, the investors want to make sure the manager as well as the investor 'hurts' if a deal goes bad. This could penalise younger, smaller firms that lack the requisite capital, leaving only bigger firms at a time when bigger has not necessarily meant better.

Manager organisations: And is bigger better? I am beginning to think it's not. There has been a tendency to invest with the larger, big-name firms.It was easier for the investors' staff and the consultants to make this decision. But many of the biggest losses are coming from the biggest firms. That's partly because no-one, no firm, is good at everything. Local knowledge and skills are crucial to real estate. They are hard to expand/replicate globally.

A friend in London believes that once a big firm gets 'humungous', growth in assets under management – not necessarily performance – becomes the true economic driver of the business. This motivates the big firms to raise more money and to invest it as fast as they can. I ran this by a friend in the investment business – not real estate, but with $50 billion in AUM. His response: "Aha! You just stumbled upon the secret of the business!"

So what is my advice to managers?

- Develop a true risk management role that an investor can believe in;
- Figure out how to motivate your team when profits and thus bonuses are in decline;
- Restructure your organisation to keep overheads low. But don't cut into your core competency;
- Most of all be open with your investors about your assets, your organisation and any other issues you may be facing.

Those firms that figure out how to retain their investors' confidence - even in this difficult market – and position themselves for the 'next era', will be the winners when the cycle finally turns for the better.