Where's the post-crisis self analysis?

The argument that 'we were caught in a bad market' is given short shrift by Ted Leary, who says discipline and good judgement based on experience is the way forward

So just what are those big investors thinking the days?

First and foremost, they have come to realise that their managers are certainly not the 'masters of the real estate universe' they once held themselves out to be. And that their managers are not nearly as smart and clever as the investors thought they were.

As a result, the knowledge and experience edge managers once seemed to have had over investor staff is long gone and may never return.

Second, investors have concluded that the commingled fund structure is deeply flawed: fees were far too high and possibly created the wrong incentives; discretionary boxes were too big, too loose and even then too often quickly breached; fund governance favours the managers far too much; and, concomitantly, the investor advisory committee structure simply hasn't worked effectively.

Interestingly, and very importantly, a number of managers actually pulled back from the peak , if not out of the market entirely and thus minimised – if not eliminated – their own and their clients' losses.

When you dig deeply into the decision making processes of those particularly successful managers you discover some very serious thinking about the markets and the risks involved. That revelation obviously raises the question: "If those firms could recognise that the market was grossly overheated, why didn't my other managers? Why didn't others show the same level of discipline?

> 'I've observed that some of the biggest losses have come from managers with the largest co-investments '

My observation is that there was an almost total absence of any real risk management culture or function in those firms. There was a lack of investment discipline and serious style drift – drift well outside the core competencies of the manager which almost inevitably led to failure.

Far too many firms raised vast sums of money and then invested it late in the cycle, if not well after the market had turned. Too many firms thought that leverage could make an investment
better when, in fact, all it did was increase the possible rewards and also the risks – but without the necessary analysis of those risks.

The argument currently being espoused by some managers and – shockingly – by some investors, that "we were caught in a bad market" is ridiculous. Investment managers are supposed to be fiduciaries using good judgment based on experience, not lemmings heading to and then over the market cliffs.

The large global multi-strategy investors seem to have the biggest problems. It looks to me like they were more focused on AUM revenue than performance and thus raised money like mad and pushed it out the same way.

I have observed that the smaller, more nimble, more focused players did the best. Maybe they were closer to the real market dynamics and maybe they were more focused on performance and the fees that come with it.

Finally, I am amazed by how little genuine post-crash self analysis is being done by the managers, the consultants or even many of the investors. I am a great believer in 'brutal introspection'. In doing a serious 'mistakes made, lessons learned' exercise – on an annual basis. As Mark Twain once famously said: "History doesn't repeat itself, but it does rhyme"

So what does this mean for the future? If possible, investors should avoid commingled funds – as governance will always be problematic. Invest through separate accounts where the investor will have more control, with much easier termination provisions.

Fees are certainly coming down – lots of managers are volunteering to cut them right now. Asset management fees will be more cost-based. Performance fees will be much more back-end weighted. ie, they won't be paid until the investor gets all of its money back.

Co-investment will be a key ingredient. I don't believe co-investment makes a manager a better investor. In fact, I've observed that some of the biggest losses have come from managers with the largest co-investments. There is simply no evidence co-investment produced superior performance.

There needs to be a greater use of independent directors and investment committee members. Not cronies of the managers, but truly independent and experienced executives who represent the interests of the investors.

Investors now want a voice and even a vote at the investment committee table. As a result of all the changes, there is going to be – quite rightly – a serious fall out in the number of managers. But also new firms will emerge from the rubble.

A former US Army Chief of Staff once said: "If you don't like change, you will like irrelevance even less."

Ted Leary is president, Crosswater Realty Advisors