

# Word Cloud or Fog of Words?

## Managers Need to Positively Differentiate Themselves from the Competition

Over the past couple of quiet holiday weeks, I made an effort to clean up my messy office. I had piles on piles of presentation pitch books friends and even strangers had sent me asking that I review them and provide comments, suggestions, criticisms, etc. As I remember fondly the help “veterans” gave me when I started out in the investment management business, I try my best to respond to such requests. In addition, I often find them quite interesting to read as it gives me a window on who is out there and what they are doing.

Before filing the pitch books away, I again flipped through about 20 to 25 of them. I quickly realized that they all look an awful lot alike, that it was truly difficult to differentiate one presentation from another. They all blended together after an hour or two of reading.

Having prepared scores of these pitch books for more than 20 years and having struggled with ways to differentiate — in a positive way — our firm from others, I know full well what a struggle it could be. I was and am totally

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sympathetic with the authors of these pitch books.

There is a new concept of a “word cloud” that I see more and more often on the Internet. It’s a visual attempt to show how many words are used in a presentation/pitch book/article/speech/whatever and compare that to clouds from other sources. The more a word is used, the larger the font in the cloud.

It’s a clever device. (See the sample word cloud from President Obama’s 2011 State of the Union Speech.)

Not being digitally clever myself, I tried to write down on a yellow pad the most popular words used in the 20 to 25 pitch books I reviewed. As you can imagine they were: “leading,” “value-add,” “team,” “research,” “discipline,” “risk-adjusted,” “high returns,” “fiduciary,” “core-plus,” “unique strategy,” “lessons learned” (but never “mistakes made”!), “proprietary deal flow” and more.

If I was capable of creating a Word Cloud for each presentation, I think I would have seen that most of the “clouds” for the real estate offerings looked very similar.

When my former partners at Lowe Enterprises and I entered the institutional investment management business in the mid- to late 1980s, we were competing against maybe 20 to 25 firms for attention and investment allocations. Now, I have been told that there may be 400, or even many more, offerings in the marketplace. I can’t imagine how difficult it must be to differentiate your firm (obviously in a positive way) in a market that is hyper-competitive. Interestingly, from my personal perspective, of the 20 to 25 pitch books I reviewed, only a small handful succeeded in achieving that goal.

This issue reminds me of a scene in the famous 1950s Broadway musical (and later movie) *Gypsy* about Gypsy Rose Lee, the famous burlesque “artist” (aka stripper). When young Gypsy visits the artists’ dressing room for the first time, her fellow, but far more experienced, artists sing to her “Gypsy, You Got to Have a Gimmick.” Now, of course, I don’t want to compare serious real estate investment managers to bur-



lesque artists, but the three veterans who sing the song have a serious message: *In a highly competitive environment, you have to*

*be able to positively differentiate yourself from the competition.*

For me, the prime differentiator is “corporate soul.”

During the past three or so years, I have been able to review the track records and decision-making processes of many real

## Manifesting the “Corporate Soul”

Ted Leary artfully describes what it means to have a “corporate soul” in our business and important ways to verify its existence. The corporate soul is our guiding light and is the essence of accepting and implementing the role of fiduciary every hour of every day. It not only means putting your client’s interests above your own, but structuring your company and culture in a manner where that happens as a natural course of business. Ted wisely offers that evidence of a corporate soul can be found in how managers allocated capital during “hot” markets and how they assessed and reacted to risk before, during and after the financial crisis.

I agree with Ted on all points, but suggest we need to go further. Much further.

Looking at history is instructive, but a corporate soul is more importantly in evidence based on how a manager views the current environment, anticipates the future and communicates all this clearly and powerfully to investors. And investors have their role to play. They should be asking questions borne of the hard lessons learned in the recent downturn. Investors — and their consultants — should push their managers to explore and explain how their thesis or strategy responds to different potential outcomes. Risk management is how you handle negative surprises. This means you must have a mechanism to monitor, report and respond to various scenarios. Risk management also means taking responsibility for your actions and acknowledging mistakes and making that part of the dialog between managers and investors.

The one thing we should know in our bones by now is that financial markets connect and lever. The issues in subprime and single-family housing were clearly identified in 2005. A single chart said it all: homeownership rates soared to unprecedented levels. Yet, the vast network of connections and leverage was not fully appreciated until it was revealed as it broke down. This is true, I believe, even for those who saw it coming. The Network is mostly transparent until it fails. This is the major takeaway lesson of the last crisis and the one that most defines how we must adapt and create a culture of true risk management.

Real estate investment and the ethos of real estate research have mostly come about in a decades-long environment of positive and increasing leverage and demand growth. Up until 2007, cycles were primarily defined by excess supply. In hindsight the errors of excess supply were usually cured in a few years by new growth. For 40 years the virtuous cycle of a growing network of financial connections and expanding leverage — at the consumer, corporate, banking, shadow banking and sovereign levels — have nurtured and protected real estate investors. I know at times it did not feel that way, but the long-term performance was mostly very good with less risk than other asset classes. The Network was there for us up until it began to unwind in 2007. Total employment growth for the prior 10 years before the crisis was virtually flat, but the Network made up for it in cap rate compression and financial innovation.

We are in a new era. The world is no longer leveraging, we are de-levering, particularly at the consumer and sovereign levels. Corporations are de-levering by reducing head count. We can see that today the Network is no longer completely virtuous and could — and likely will — be the source of frequent surprise. History shows that the process of de-levering plays out for a very long time. There are few if any “V” recoveries and new waves of price discovery are the norm.

This means that U.S. real estate investment underwriting requires a much more comprehensive understanding of the timing and resolution of U.S. loan maturities as well as a global view on growth. I’m not talking about forecasts (which are mostly useless). What works best are concrete scenarios that relate to very real potential outcomes that could materially impact return expectations, pricing or the viability of an investment thesis.

For example, one scenario is that some areas of the commercial real estate market have not yet cleared. This scenario assumes pricing is not yet reflective of the capital required to meet loan maturities when the can is no longer kicked down the road. As one example of this scenario, German banks (and others), which have been accommodating, may be forced virtually overnight to become very aggressive in monetizing and enforcing maturities. When the Network works against you, small breaks often precipitate big breaks. These risks produce opportunities as well for those who have the flexibility and capital to pivot and respond. What are the signposts along the way that linkages are breaking down? What tools are managers using to define and monitor risk here? How will their strategies react under different outcomes? How can trillions of pending maturities not matter? Quantitative approaches to risk that rely on old price relationships that defined the prior era are far less useful than the more difficult task of thinking through scenarios that challenge your preferred investment thesis.

Another example: in a virtually zero-interest rate environment where the only big move will be up, it is important to remember that the Fed does not set market rates. Bond buyers do. There will be an endgame on rates. How will managers know the game is changing? How will they react? Where are the opportunities going to emerge? Who will lose the most and who will gain?

Lastly, the conventional LP approach often works against the “new era” requirement for flexibility. Funds that prescribe a specific strategy over a pre-defined time horizon lock in a thesis that cannot change when the world changes. Yet, many investors have built their own habits, models and structures (the LP Corporate Soul?) around these fixed investment agreements.

So, if we wish to manifest the corporate soul and truly be a fiduciary, we must begin to understand and anticipate the once transparent network of linkages and leverage that has massively benefited our industry and now poses as many new risks as new opportunities.

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estate advisory firms. My conclusion is that the firms who performed the best in 2007–2009 made the correct but hard decisions to:

- Sell assets
- Trim leverage
- Slow down or even stop investing

They saw danger ahead and took a defensive posture, which allowed them to mitigate losses in a turbulent market and even make some attractive returns.

Just like in theology, “soul” is hard to define, but I think I know it when I see it. Just recently I was reading a submission that was describing how their firm picked operating partners to invest with. They said they sought out firms “with an identifiable pattern of responsible decision making.” I would edit that slightly to say “firms with identifiable *and verifiable* patterns of responsible decision making.”

That may on first blush sound like a lot of firms, but that hasn’t been my experience. But it’s not an impossible task to test firms to see whether they had that “soul.”

First look at a manager’s track record in “hot” markets. Did they keep pumping money out when just about everybody knew the markets were way overheated? For me, the concept of “due diligence is for sissies” and 14-day start-to-finish \$100 million deals were clear signs from on high that a crash was coming.

You should ask to read firms’ internal investment recommendations from those years to see if they were even thinking about the risks in an overheated market. Did they recognize it and try to mitigate such risks? Everybody makes investment mistakes, but people/firms that don’t even consider or recognize or try to mitigate risks are bound to make more and bigger mistakes. Look at their “hold-sell” analyses in 2007–2008. Did they have any sense that danger was lurking?

Talk to their younger staff — not just the Big Cheese Bosses — in a one-on-one, casual setting. You will be surprised how much you can learn about a firm’s values, culture and processes by having lunch or coffee with mid-management staff

— without a “boss” lurking around. It’s the old “out of the mouths of babes” theory of research. My pet question is asking them how their firm’s “risk management” process works and seeing if they steer you to their insurance person.

One of my concerns recently has been increased restrictions on investor staff’s ability to interact with managers. If all investors can do is sit across a table from teams of bright, articulate presenters in nice suits, they are never going to get to the soul of an organization. There is a reason for social interaction with other business people, whether it be at conferences, dinners or — god forbid! — the golf course.

In these social settings you may get to see a side of a person or firm that you will never see in a highly choreographed one-hour presentation. People just naturally let their guard down in social settings, and you will possibly see the side of a person or firm you would like to consider in your decision making. While there is no doubt some of the “socializing” in the past has probably been overused or even abused, I would hate to see investor staffs “sent to the convent.” That will not lead to optimal decision making.

The “gatekeeper” consultants are supposed to help with this vetting, but they are also time and cost constrained. And do they have the staff to do the “soul” check? Good question! (I might also add that, if one did a word cloud of consultant RFPs, you would find a similar clustering of words and phrases.)

So back to my pile of submissions. I wish I could give clearer advice to all the people who sent them to me. You can’t just state: “we have a fiduciary soul.” That won’t resonate! If you want to differentiate your firm, you must somehow prove that over the past cycle you were cognizant of the issues and risks involved, that you tried to mitigate those risks without totally throwing in the towel, and that you tried your level best to make investment decisions that were verifiably in the best interests of your investors.

Not everyone will be able to do that.

As for investors, my advice is to just follow the old Ronald Reagan rule: “trust, but verify.” ♦

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