MARKET PERSPECTIVE

by Ted Leary

Parades and Charades

Starting this issue, the Market Perspective column will be authored by a rotating panel of four industry experts — Ted Leary, president of Crosswater Realty Advisors; Nori Gerardo Lietz, founding partner of Areté Capital; Randy Zisler, CEO of Zisler Capital Associates; and Stephen Roulac, founder of Roulac Global Places. We trust that you will find these articles to be insightful and thought-provoking. As always, your comments and feedback are encouraged. Send them to me at m.consol@irei.com. We kick things off with Ted Leary. Enjoy the read. — Ed.

My old boss, U.S. Sen. Abe Ribicoff, used to love riding in convertibles in holiday parades in small Connecticut towns. He said the best polling he could ever do on what were the most important issues facing his constituents was listening to their comments as he rode along the parade route. Well, going to industry conferences, big and small, is our industry's version of the parade ride. Every year there seems to be one, two and maybe three "hot issues" in our industry — usually to be replaced within a year or two by new "hot" issues. (Who will ever forget the seemingly endless cacophony over "the four quadrants" years ago?)

This year the "buzz" seems to be about "alignment" and "best practices." As usual "performance" seems to be missing from the chatter.

"Alignment" is all the rage. My simple definition of it is "acting in the best interests of your client." That would seem to be pretty easy to understand — acting like a fiduciary — but, as usual, our industry overcomplicates it. It sounds like such a basic concept for people in the investment management business, but the past cycle and the billions of dollars in losses revealed that it apparently wasn't understood. Managers kept pumping the money out well after the market had peaked, avoided write-downs that would have meant revenue reductions, and gamed the system to emasculate many of the checks and balances investors thought they could rely upon. This may sound awfully cynical, but I have seen far too much of this behavior during the past several years.

> ***As for manager co-investment I remain a skeptic. I still have not seen any evidence that manager (either personal or corporate) co-investment produces superior results. I've asked a number of the major consultants and research people whether such evidence exists, and they all say, "No!"***

Alignment should not be that difficult to achieve: choose managers with true fiduciary character. But doing that will require digging into the soul of a manager, a challenge which few investors or consultants seem to want to or be able to take on. Because it is (seemingly) so hard the industry reverts to mechanical devices such as co-investment and cleverly structured incentive fee systems.

As for manager co-investment I remain a skeptic. I still have not seen any evidence that manager (either personal or corporate) co-investment produces superior results. I've asked a number of the major consultants and research people whether such evidence exists and they all say "No!" The one so-called "improvement" in the co-investment theory is that the LPs have finally realized that "house money" co-investment from the big firms had no impact on behavior or performance and that it was essentially a way for the big firms to buy investor comfort and thus the business. If you believe that personal co-investment produces a more careful — but not necessarily better — investment manager, requiring an individual to put up his or her personal funds makes more sense than relying on house money. We probably need a full cycle with heavy personal co-investment to determine whether it actually works. In the meantime I would encourage the LP community to work on ways to improve their ability to underwrite the "fiduciary soul" of their prospective managers, as I believe that will actually yield positive results.

"Best practices" is another hot topic. You hear a lot about it these days, but there doesn't appear to be a consistent definition. Mine would be: adopting the governance systems and transparency practices that are used in the very best public companies. I find it fascinating that so many of the big, activist LPs, who push the public companies they invest in for improved "best practices," seem to be quite relaxed about how their private equity and real estate managers run their businesses and their investment processes. This laissez-faire attitude may be changing, ironically not because LPs are asking for it, but because certain GPs believe it is the right thing to do and will eventually result in improved investment and corporate performance.

For example, CBRE Global Investors has created an independent investment committee position for all its U.S. assignments. As I know the person in that role — an old partner of mine at Lowe Enterprises — I know he is very independent and beholden to no one except CBRE's investors. In Canada, Bentall Kennedy has an independent investment committee composed of sophisticated outsiders. No Bentall Kennedy staffer votes on the final investment decisions. What is fascinating is that both of these firms have decided that these "best practices" have helped them in running their firms and making their investment decisions. Additionally, their clients' reactions have been very positive. There may well already be other firms that have adopted similar governance improvements. Hopefully others will follow.

It is puzzling to me that LPs don't ask all of their GPs for similar governance changes. After all, one of the simplest tests of a fiduciary manager is to create a governance system that best protects the interests of the LP.

While we are on this subject, isn't it time to eliminate LP

LP advisory committees are a charade. Eliminate them!

advisory committees? They are a charade. As we all saw clearly in the depth of the last cycle, the LPs on such committees have little ability to impact anything — assuming they want to — even when managers are performing or behaving badly. These committees are the classic Toothless Tigers that recent history has shown managers know how to manipulate.

They sound formidable on paper, but they do not function as intended. Relying upon powerless, ineffectual advisory committees to protect LP interests is certainly not a "best practice."

The LP community would be much better served by dropping these advisory committees and pushing for independent directors — by which I mean truly independent men and women, not cronies of the managers. Precisely because they are not reliant on the manager for a salary or bonus, they are much more likely to protect the interests of the LPs — most particularly in times of stress. ❖

Ted Leary (tleary@crosswateradvisors.com) is president of **Crosswater Realty Advisors.**