

Governance Grows Up

But Not Among Institutional Real Estate Investors, Where it Remains a 98-Pound Weakling

The *Wall Street Journal* recently had a headline titled: Governance Grows Up. The underlying article reported that, despite a spate of recent cases involving certain boards of directors shirking their fiduciary responsibilities, in general the governance of public companies was steadily improving. I wondered if the same could be said of the management of institutional real estate investments?

I fear the answer is: No!

THE SERIOUS, THE SNARKY

After my most recent commentary for this publication urging the use of independent board members or investment committee members (let's call them collectively "Indies"), I received a lot of email comments and questions — some quite serious, others quite snarky, but all interesting and worthy of consideration. The following are some of the questions and my attempts to answer them.

Serious: *Who would appoint the Indies?*

My thought is that the manager/GP would select the Indies. It would be up to them to make the case to their investors that the persons selected were (a) qualified and (b) truly independent. This latter criterion is especially important as the appointment of cronies doesn't work.

LPs have followed up with: *How do I trust the GP to make an appropriate selection?*

My retort is that if you, the LP, have so little trust in the willingness and ability of your GP to act in a fiduciary manner when selecting an Indie, then you should not trust him or her with your money to begin with.

Intuitively and anecdotally, I believe one of the tasks and purposes of independent investment committee members is to mitigate the "deal fever risk," the "distorted incentive fee risk," the "support your colleagues risk," the "let's get the money out before the investment period ends risk."

Another thought is to let a separate account client or, if a fund, the LPs make the appointment. The feedback I've received on that is that (a) most investors don't want to make that decision (their in-house lawyers may even prohibit it), and (b) if it's a fund format, the LPs would never reach agreement on selecting an Indie.

Serious: *Is there any hard evidence that good governance/best practices actually produce superior performance?*

Great question! To some degree, it's like proving a negative. I know of no documented evidence and doubt that there will ever be firm proof to back up my case. However, intuitively and anecdotally, I believe that one of the tasks and purposes of Indies is to mitigate the "deal fever risk," the "distorted incentive fee risk," the "support your colleagues risk," the "let's get the money out

before the investment period ends risk," and other risks that all too often infect even the best managers. If I am correct, in the long run it should produce better performance by preventing poor investments from being made. But it's admittedly difficult to track the rejection of "bad deals." Few firms keep those kinds of records.

DON'T BE GROSS

Snarky (from a friend): *Bill Gross doesn't have Indies. Why should I?*

Snarky answer: You ain't no Bill Gross!

Also, I've been told that he does have Indies on his various fund boards that approve strategies. That alone makes his governance structure superior to that of close to all real estate investment structures.

Serious: *What has the experience been of GPs actually using some form of Indie structure? Happy with it? Regret it?*

The all-too-few that I am familiar with tell me they believe it does indeed make them a better, more thoughtful investor. Each of these has, in my personal view, true Indies on their boards/committees, and the role of the Indies is taken very seriously. The GPs view the function of their Indies as a risk mitigator.

In addition, these GPs have found that their LPs are impressed by their commitment to good governance. In fact, one of the GPs informs me that they can directly tie their recent award of a major mandate to their commitment to using an Indie.

Humorous: *What is the difference between an Indie and a Crony?*

You don't play golf or go skiing with your Indie; keep the relationship at arms-length and as business-like as humanly possible.

Serious: *How do you get the industry to buy into and even push the Indie concept?*

Just as the Big Dog public funds were the drivers for better governance in public companies, I believe this change will need their strong backing to succeed in the private equity real estate arena. I find it ironic that some of these Big Dogs fire off letters to public companies about some governance issue when they may have a stock holding of \$50 million to \$100 million, but will give a real estate manager \$500 million with little or, usually, no say in the governance of that program. The pressure — and that is what it will take as the GP side of the industry is likely not going to volunteer — has to come from the Big Dogs as they have the leverage with their large allocations. Small- to medium-size LPs just do not have the clout to reform the system.

Serious follow-up: *Why don't LPs require better governance?*

I just don't understand it. I would personally think that after their recent experience with major losses, the LPs would be searching for methods and systems to protect their future investments. My guess is that the LPs get intimidated by the GPs' resistance to such changes and continue to rely on old structures such as LP advisory committees, which have proven to be of limited, if any, worth. In addition, the consultants have not, as far as I know, bought into the concept and thus are not encouraging their clients to take the necessary steps. And given the fact that some of the more prominent consultants are becoming GPs, they are increasingly unlikely to want to reform the system.

FANGS, PLEASE

Serious (I think): *Aren't you being too harsh on the role and effectiveness of LP Advisory Committees?*

No way! As I mentioned in my previous commentary, the advisory committees are "toothless tigers." More importantly, the advisory committees are not involved in actual investment decisions. Nor should they be for a boatload of reasons. It is at the investment committee level that the rubber meets the road. It is where the expenditure of the LPs' money is actually vetted and decided upon. It is where whatever risks may exist are analyzed and hopefully mitigated. That is

precisely why I advocate the use of qualified Indies at that level.

I've been told by a lawyer who works on a lot of fund agreements that the LPs seem to be more worried about who their fellow LPs will be in a fund than about their own fund's rights and obligations vis-à-vis the GP. They seem to be missing the important lessons they should have learned from the recent cycle.

P.S. If advisory committees are such a great good governance device, why don't we see them in the best-run public companies?

Serious: *What is the typical Indie profile, and what does it cost?*

The Indies I am familiar with are usually retired or semi-retired men or women who have an excellent record of performance and proven good judgment. They usually, but not always, have some mix of real estate and investment experience. But to me, it's the "proven good judgment" that is the key ingredient. After all, what we all do is not rocket science!

The Indies I am familiar with are usually paid \$100,000 to \$150,000, depending on the number and frequency of meetings and the personal time commitment required. This is not atypical for the role. That may sound high to some smaller investors, but it's a relatively inexpensive way to avoid mistakes of a far greater magnitude.

Snarky/humorous: *Are you tilting at Indie windmills?*

Probably, but it's worth trying. Using Indies is clearly not a panacea, but it is an easily implemented risk management tool for an industry that has not really focused on true risk management.

P.S. The day I wrote this another article appeared in *The Wall Street Journal* headlined: Push for More Independent Directors.

It's coming to our world — just probably later than sooner! ♦

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