Everyone wants to be in show biz

Institutional investors have two fundamental roles, and they should stick to them

by Ted Leary

In the September issue of *The Institutional Real Estate Letter – Americas,* Nori Gerardo Leitz wrote a column challenging our good friend Geoffrey Dohrmann over the question of which managers were better: Big or small? Local or global? It was a fun read, and I admit that I tend to side with Nori on most of the issues discussed.

I dare not jump into the middle of a Nori-Geoff kerfuffle, but I do have a few comments relevant to the manager selection debate.

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Everybody wants to be in show biz. That is why all our waiters, trainers, valet parkers, etc., are "actors," but most have never set foot on a sound stage or movie lot.

My observations come from 10 years in the asset and organizational workout business, the 20-plus years running an investment management team, and the past five doing workouts and manager restructurings for several very large public pension funds.

As a general matter, I believe smaller, highly focused managers offer the best chance for investment success. With just a couple of exceptions, I have seen little evidence that the multi-property-type global managers produce the best returns. However, I and my fellow senior (aka old) advisers have concluded that the main issue is not whether *big* is better than *small,* or *local* better than *global,* or *core* better than *value-add* or *opportunistic*. In each group there are truly talented managers with interesting strategies. But there are, sadly, also a great many untalented managers and poorly designed and executed strategies. This should not be a surprise as it is what "makes a market." To us *old folks* at Crosswater, the fundamental issue is: How can investors' staff best differentiate and underwrite potential managers?

During the past five years we have worked with several large pension funds to address this issue. The result has been multiple manager terminations and multiple additional commitments to excellent performers. What was it that led some managers to all-too-often egregiously underperform (a polite term for losing all or most of their clients' money), while others had excellent performances right through The Crash? And, most importantly, how can institutional investors comfortably determine which managers are most likely to achieve their clients' goals?

As each real estate manager is, like a snowflake, different, often quite different, there is no single cause for failure or success. Institutional investors need to really undertake a *deep dive* into a manager to try to get beyond the numbers and uncover their core strengths and weaknesses — characteristics that we believe are far better indicators of long-term performance than past performance alone. Our observation is that such manager analysis was not done nearly as well as it should have been done in the hot years leading up to The Crash.

We have concluded that institutional investors have two fundamental roles:

1. Design the appropriate strategy for their entity.
2. Find a manager capable of executing that strategy.

That sounds simple, but it is very hard to do successfully, as proven by the past cycle. There is no third step. If investors handle these two roles well, they have done their job. However, because manager selection mistakes will inevitably be made, investors must have some ability to pull the plug on a manager who goes astray. This is not easy, especially in a commingled fund. But if an investor cannot obtain some reasonable level of protection against manager incompetence, it should avoid the investment.

There is no perfect vetting process for managers. We would, however, like to pass on a few insights we have gained from our recent work. These are in no special order.

- As managers can be highly "creative" in writing their pitch books, PPMs and quarterly/annual reports, investor staff needs to review them carefully. We have been amazed how inaccurate some of the reports have been that we have reviewed.
- To help avoid surprises, investors need to design and implement systems that promote transparent performance reporting on the part of managers.
- Whether a manager is "in the money" or "out of the money" can dramatically affect their behavior — especially their concept of, and attitude toward, risk.

- If a manager is raising money for a new fund, it may affect the decisions it makes about existing investments.
- Managers too often fail to sell their losers and end up carrying them long term to the detriment of investors.
- You can learn a great deal about a manager's culture and dynamics by spending time with mid-level and even junior staff.
- Incentive fee formulas can produce rude surprises not understood when originally designed.
- While it is quite difficult to get into a manager's compensation system, try your best to ensure that its internal compensation drivers match your investment goals. We have seen too many incentive fee structures that work against the investor.
- True alignment of interest is more a function of human behavior than mathematical formulas.
- There is scarce evidence that manager co-investment produces superior results.
- The larger the manager, the further the founders are removed from daily activity, and valuable institutional memory is all too often lost.
- The larger the manager, the greater the need for sophisticated strategic planning and disciplined operational methodologies.
- Confirming the true track record of emerging managers is quite difficult.
- High value-add and opportunistic performance is the most difficult to predict or verify as there are so many variables at play.
- Investors must have the discipline not to ask managers to take on projects or solve problems outside their core competencies. The further investors or managers drift from their core competencies, the greater the chance of error.
- Use of a truly independent board or investment committee member can be a powerful risk mitigator. (It is a lot easier to prevent a mistake than to fix it after it happens.)
- Performance numbers are obviously important, but real estate is a difficult asset class to evaluate on numbers alone. Investment and holding periods tend to be long, often crossing multiple economic cycles. Early-term successes can be wiped out by late-term mistakes. It is a business dependent on individuals and organizations, as the assets need to be actively managed.

Probably the most important task facing investor staff is to understand whether a manager's touted success is due to prudent underwriting and skilled management, financial engineering or, as we have often seen lately, good luck in the vagaries of the capital markets?

As part of our most recent manager evaluations, we have gone in and looked at original underwriting of both successes and failures to determine if the manager hit its numbers, projections and hurdles along the way. Recently, we have seen several "successes" where the ultimate IRR appeared to be attractive, but if you dug into the original investment recommendation, you saw that the items the manager was able to theoretically control (absorption of space, costs, rental increases, etc.) were way off their marks. In each instance, the manager was saved by exogenous factors, such as substantial cap rate compression, which the manager never contemplated as part of its original recommendation when it decided to commit millions of its clients' dollars. We are not sure that should be considered a successful investment — merely a lucky one.

As we say in Los Angeles (aka Tinseltown): Everybody wants to be in show biz. That is why all our waiters, trainers, valet parkers, etc., are "actors," but most have never set foot on a sound stage or movie lot. (Years ago there was a great Ray-Ban sunglasses billboard on Sunset Boulevard showing a picture of "cool shades" and no other visuals. The tagline read: "How to look like an actor without having to wait on tables.")

Well, it is not the job of institutional investor staff to "be in show biz." That is what managers do. Staff's job is to find the very best managers and, as recent history has proven all too clearly, that is a daunting enough task. ❖

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