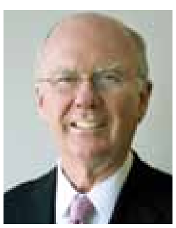
Drift and discipline

What I wish I had understood 25 years ago

by Ted Leary

I have spent the past four years not in the leisurely retirement I had planned, but right in the middle of the action at one of the nation's largest institutional investors — a major public fund. It has been amazing how much I have learned about the way a major investor thinks and operates — a level of knowledge I wish I had when I founded my old investment management firm more than 25 years ago.

I used to visit potential clients armed to the teeth with all the persuasive (I believed) information I could share about our firm and our strategies. But looking back, I realize just how little I really knew about the potential client and its strategies and ways of doing things. In the late 1980s and early 1990s, we were a first mover in investing in hotels, which we operated directly. It was, in my not so humble view, a very good strategy that matched our particular organization, our experience and market opportunities. The potential clients I visited around the country generally said they were impressed, but time after time they then said, "It's a great strategy, but it just doesn't fit our asset allocation model."



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End of meeting!

My unspoken reaction usually was: "What idiots. Why don't they get it?"

What I failed to understand is that most institutional investors (or at least many of them) are not deal junkies; they seriously try to adhere to their overall asset allocation process and resist the "brilliant idea of the week." I think that discipline was not well adhered to in the Hot Oughts, which led to many of the disasters in which institutional investors were involved.

I get the sense from friends and colleagues that asset allocation discipline is coming back. Until recently, I did not realize how seriously most (but not all) investors take their asset allocation process and results. I also came to realize that each investor has a different — and sometimes dramatically different — asset allocation approach. No two pension funds are alike in the ways they look at their investment goals and choices. Some funds like real estate for its cash flow. Others want real estate to produce high returns, usually at the back end. Some will only invest in funds. Others will only invest in separate accounts. Some will invest only in the United States, while others want to explore real estate opportunities around the globe. There are investors who hate vertically integrated managers, while others prefer them. I must confess that this pretty simple insight (that only took me 30 years to get) would have saved me a lot of time, money and frustration.

Marketing is a very expensive proposition, and the more highly focused a program is the greater the likelihood of success. I look back on all the long, costly and frustrating marketing trips I took over the years to absolutely no avail because what I was presenting was not an easy fit with the prospective client's asset allocation strategy. Admittedly, it is not always easy to get the particulars of an investor's likes and dislikes. Sometimes you just have to sit down with them and dig it out. But I have noticed that as we go through several cycles, the investor community is getting better at describing their strategies. After all, they do not want to listen to someone pitch hotels when there is no way their model will allow it. A friend on the investor side told me: "It makes a powerful impression on us when a manager knows about our strategic plan and has tried their level best to adjust to it."

Learning the hard way

I suspect that one reason investors have hardened their asset allocation discipline is that they got burned during the recent financial crisis by "allocation drift" of their own making. If investors lost their shirts in, say, single-family land development or emerging markets investments, they will be a hard sell on new programs with that focus. If you visit an investor and pitch something there is no way they will pursue, the investor is probably thinking: "Doesn't this person get it? Is he or she even listening?"

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I have seen this play out time and again during the past few years when my major client — which has a well-documented and well-known strong preference for U.S. core in a separate account format — is visited by a firm that pitches (often quite strongly) the brilliance of the high-yield, emerging markets commingled fund they are offering.

The managers often look shocked by my client's reaction and inevitably go away wondering: "Why did I fly all the way here?" If they had done their homework instead of being dazzled by the dollar size of the potential client, they might have spent their time and energy researching and finding an investor who wants the very program they have, as the British say, "on offer." As one client said after such a meeting: "If they don't know how to thoughtfully invest their time and resources, why would I trust them to invest our money in real estate?"

While I have never been a big fan of placement agents, the more successful ones provide an important service as they generally have a deeper knowledge of the preferences of target investors and thus can save their own clients a lot of otherwise wasted time and money. Although one of my investor colleagues thinks the reverse may be true, as "placement agents like to show their manager clients they can get them in to see certain mega-funds." There is probably a grain of truth in both positions.

Because of the research and program design I did on real estate emerging managers, I get a lot of calls from these new, hungry firms and generally meet with them to offer them some "senior advice." I spend a lot of time helping them understand the cost side of the institutional investment management business — including the considerable time and money they will have to devote to understand the client's preferences before they hop on a plane. Of course, like all of us when we started our firms many years ago, they do not really understand this and believe they have a "secret sauce" that will have investors champing at the bit to give them money regardless of their asset allocation model and strategies.

They soon learn! ❖

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