

### 07.11.08

After I read this week's very interesting Forbes magazine article on real estate opportunity funds (if you haven't seen it, you can find it on Forbes.com) I also read a commentary in the FT entitled "Sometimes Write Downs Aren't All Bad". The latter was on technical accounting issues in the UK, but it triggered in my mind a concern that our industry may not remember some of the important lessons we learned in the last serious real estate downturn. Those of us who were around those days remember that some of the leading investment managers tried to argue that assets owned by "long term holders such as pension funds did not have to mark their assets to (tumbling) current market values". If I recall, they were plugging something like "investment value" or a similar term. Well, that argument didn't catch on as the market continued to tumble and clients saw it as a way for managers to protect their high, asset value-based fees. It also caused a lot of clients to develop a deep distrust of real estate and real estate managers. Fortunately when the market turned, investment vehicles and formats changed – and we embarked on what looks like a 15 or so year successful run -- we were as an industry able to earn back the confidence of the investors. I am worried now that with the passage of time and the dynamic of the new formats (high fee opportunity funds) we may be about to forget and then repeat - albeit in a different form -- those past mistakes.

We work in a cyclical business. A lot of people seemed to believe the great run would last forever, but it never does. Sooner or later any asset class develops problems and write-downs are necessary. How investors and managers in that particular sector handle that inevitable downturn usually is the key to the future of further investment in that sector – and who the future trusted managers will be. The new industry model is based on commingled funds where performance fees are a very important component of the managers' compensation -- although the base fees being charged today look pretty healthy on their own. But the clients, consultants and the managers have all agreed that linking part of managers' compensation to performance creates the proper incentives -- The famous " Congruency of Interests". Successful managers now have a series of funds. If their first fund appears to be doing well, then they launch a follow-on fund. Generally follow-on funds are launched before the finally tally is in on the success of the previous fund – or maybe one even earlier. Some managers are into their 4th-5th- & more fund. But we are now entering a market environment where values may be dropping – moderately to considerably – and those drops in values create real problems for managers. This is especially true of funds invested over the last 24-36 months when the market was over-heated. I don't believe it's a disaster – unless, as some appear to have done, you grossly over-paid and then over-leveraged. We aren't seeing spec-churches in Houston or see-through office buildings like we did in the 80s. With few transactions occurring and

the usual lag in appraisals, its still early in the correction, but every active player I speak to in the business acknowledges that values are falling. If you are a manager out marketing a follow-on fund, do you really want to know – and if you do know – do you really want to tell your existing and targeted investors that your most recent fund won't be hitting its predicted numbers – let alone may lose serious equity? Humans being human, the answer is likely to be -- No! But that is where the dilemma arises. If we, as an industry, are not open about valuations and true fund performance we could once again damage, let alone destroy, our credibility. One of my former clients told me that he sees what is going on and is keeping a list of when his managers come in to tell him they have problems. This client has been in the business 20 plus years and knows cycles are inevitable. He is now testing his managers to see who is forthright about the situation they are in. He said "I will obviously be disappointed in sub-par performance, but I will be furious if managers try to hide their problems. If they do, they will be gone." The next few months – more likely the next few years -- will be an interesting, if not downright challenging, time for our industry and the participants in it. We – and by that I mean, client investment staff, consultants and managers -- have built up the real estate investment business into a huge force involving huge numbers. We all have a stake in its continued success and viability – and its natural that none of those players want to admit that we may be entering a problem period.

In the broader financial services business we are seeing – on an almost daily basis – stories of firms that run into trouble over valuations - some disappear almost overnight. In other asset classes investors can pull their money out very quickly, queues to pull money out can develop within hours. I don't see that happening in the real estate business as we are not very liquid, but apparently queues are building up in the open-end fund business -- probably more out of concern than real facts. But that phenomenon illustrates that investment clients want to be kept current on valuations and want their managers to be very frank with them.

Confidence – in an industry or a firm – can be lost very quickly and is hard to recover - so the key is to not lose it in the first place. My old boss in the US Senate, Abe Ribicoff, had a great line during the Watergate years. We were discussing that particular day's revelations in the Washington Post about the Nixon White House - one which didn't seem to me to be that serious, so I said, "Senator, they can explain that one away". He replied, "Ted, Rule # 1 -- if you have to explain it, you are already dead". It was a good lesson for politics and real estate investing.

Ted (I think this is enough preaching for this week – although at the pace of stories like Fannie & Freddie's problems, I just might be back next week)