RISK MANAGEMENT

by Ted Leary

Real Estate Risk Management

An Oxymoron or an Achievable Goal?

This past February, *The Economist* magazine had one of its periodic special inserts titled: "The Gods Strike Back." While it focused on the lack of risk management in the financial services industry in general, it contained a number of lessons we in the real estate investment management business can and need to learn. It struck a particular chord with me as over the past 18 months or so I have been helping several large institutional investors work through their "challenged" real estate investments. The thrust of *The Economist* article is how very few financial managers really had a risk management culture or function or, even if they did, how even fewer executed it correctly.

My recent experience, which has involved digging deeply into the decisions of many sophisticated real estate investment managers, convinced me that, as an industry, we really haven't learned how to analyze and manage investment risk. Yes, there were a small handful of managers who, by either good luck or great foresight, anticipated the collapse and took their chips off the table. But far too many firms plowed doggedly ahead only to lose hundreds of millions, if not billions, of dollars of their clients' and their own money. And, along with that, they lost their reputations as well. How did our industry manage (if that is the correct word?) to mess it up so badly? And it wasn't only the investment managers. I don't recall any of the consultants or the research firms predicting a collapse in the markets, even a fraction of what actually occurred or even offering particularly sage warnings of an overpriced, overleveraged market.

Executive Summary

- **Few investment managers had a risk management culture or employed a risk management function.**
- **Often investment managers don't have an incentive to stop investing or to sell; they are focused on building their asset base.**
- **An independent investment committee member could serve as an effective risk manager.**

The Economist wisely points out that risk management is not just a metric-based exercise, but it also requires (in my view more importantly) good old-fashioned judgment. There is a natural conflict of interest in the investment management business: the managers are in the business of investing, not disinvesting. Logically, if managers truly believed a crash was coming, they would sell all their assets — and possibly thus collapse their firm. Well, that's easier said than done. As a former investment manager who used to wake up at 3 a.m. worrying about our firm's growth, its profitability, and our ability to attract and retain talented men and women, I recognize the pressure to grow assets under management.

A firm that shrinks its asset base, no matter how wisely, is likely going to get punished by the consultants and the investors who want to see growth and performance — even if it's ephemeral. As one manager I have been working with — and one for whom I have great respect as he has shown discipline and has produced excellent performance — confessed to me: "Look, I have to feed the beast. If I stop and shrink my assets, my organization could die." That's a conundrum I don't have a clever solution for. As opposed to some other asset classes, we don't have a really effective way to "short" our markets if we see problems ahead. There is a tiny derivatives market now, and maybe clever people will make it grow as we try to work our way out of the current mess.

In Michael Lewis' new book, *The Big Short,* even the people who insightfully spotted the coming collapse of the residential mortgage market had to create new devices to short the market — and many of their investors thought they were nuts. In the meantime, without some sophisticated "shorting" mechanism, our industry will have to rely on good, solid, experience-driven judgment to manage our investment risks.

But that isn't easy. We are by nature optimists and sincerely believe that what we are investing in is prudent and will produce the returns desired by our investors. How does a firm full of optimists create a culture and a position where it is acceptable to say: No! Stop! Sell! Being the voice of caution is not the path to leadership and riches in most entrepreneurial firms. Too often it is viewed as "being negative."

I have been surprised in my recent work how rarely managers had in their investment recommendations a genuine, thorough

analysis of the risks involved in a given investment. All too often the "downside" returns were a couple of hundred basis points below

While the independent committee member is not a perfect risk management tool, it's a substantial improvement over what we now have (or don't have) in our industry.

the "base" case. Very few people contemplated events even close to what we are now experiencing. In some cases there has been essentially no risk analysis — as if the managers thought the deal was a "sure thing." If there are no magic metrics-based solutions to this problem, what can be done? Or are we forever doomed to periodically crash and burn? The same *Economist* article quotes the head of the Bank of England's financial stability group who calls this phenomenon "disaster myopia," where financial investors are like drivers who pass a road accident and naturally slow down but then quickly speed up again. Will real estate investors have a similar myopia and charge boldly ahead again ignoring all the lessons we should be learning from our own crash?

As I accept as reality the difficulty of creating an internal risk management role in an entrepreneurial organization, I've come to believe that the much-needed risk management function may have to come from outside the firm. But I also believe that, in general, neither the investors nor the consultants want to get too intimately involved in actual investment decisions — nor do the managers want them involved. I've recently served as one of three independent directors of a small public company. A number of important and tricky issues arose, and the independent directors got deeply involved in the decision making and truly acted in an independent manner looking out for the interests of all shareholders. That experience, brief as it was, convinced me that there may be a role for "independent directors" — or in our industry parlance, independent investment committee members — to serve as effective risk managers.

Of course, to be effective an "independent" committee member needs to be actually and truly independent. They can't be just a crony of the manager, but instead should be a person who doesn't "need" the job and is not reliant on the manager for their income. This person could be a retired executive with successful investment experience, as the manager certainly will not want "Dr. No" sitting on his committee. The independent committee member should have sufficient deal experience to appreciate both the rewards and risks of investing. Even with an independent committee member, there is no guarantee that investment mistakes won't be made. Everybody makes them. The hope is that the independent committee member will bring lessons learned from their own mistakes to head off possible mistakes by the investment manager in the heat of deal fever.

As *The Economist* article points out, the role of a board or investment committee member, most especially an independent member, should be as a skeptic, not an enabler. While the independent committee member is not a perfect risk management tool, it's a substantial improvement over what we now have (or don't have) in our industry. There is an additional advantage in this role as it may soothe the fears of the investor that the manager is only interested in its own best interest, not the investor's. I have heard several investors, when reviewing a particularly disastrous investment, ask: "I wonder who was at the table worrying about us. Who was providing the balance to the deal people? The voice of caution?" A truly independent committee member could play that role.

In a separate account it should be relatively easy to devise and fill this role; there are only two parties — the manager and the investor — who must work out the mechanisms for appointing such a person. Commingled funds are another story. If there is one lesson we all should have learned from the crash and the response to it, it is that so-called investor advisory committees are all too often toothless herds of cats who are usually unwilling and/or unable to take a unified stand and assert their rights. That "herd" may find it difficult to agree on who should be appointed as an independent committee member and/or on what this person's role should be. If they can't work that out with the fund manager, it will be proof — at least to me — that the commingled vehicle is fundamentally flawed.

As* The Economist *article points out, the role of a board or investment committee member, most especially an independent member, should be as a skeptic, not an enabler.

I believe it would be a great test for all concerned to see whether they have learned anything from the past few years and are able to adjust to prevent the same mistakes from being repeated. In my view, smart, forward-thinking, fiduciary-oriented investment managers should embrace some version of this idea — and, in fact, several major managers are doing it at the moment, and searches for independent committee members are picking up steam. They recognize, as *The Economist* article's last line states, "In finance the gods always find a way to strike back." ❖

Ted Leary is president of **Crosswater Realty Advisors,** a Los Angeles–based real estate workout firm.