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Ted Leary's Observations From 2010 and Predictions for 2011

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Over the past month or so I've been carrying around a pad of paper to jot down some ideas for this letter, trying – without much success – to find some central theme that would wrap up 2010. In blogland the trendy term is "meme"; an idea or concept that spreads quickly from blog to blog. PIMCO's phrase "the New Normal" was a "meme" quoted quite a lot during 2010, but – as the FT recently pointed out – may already be past its prime. If I was still managing money my "meme" would probably be something Sam Zell-like such as "Thank Heaven I Made It To Eleven". So instead of waiting until I lock onto that evasive "meme" (which may never occur) I offer some very brief, rambling observations and predictions. These are based primarily on the workout and restructuring tasks I've handled over the past year.

Openness Pays

Institutional investors appreciate and value managers who were open with them about problems in their portfolios, took early and aggressive write-downs and even adjusted their fees to reflect any losses in values. As we all well know, most – but definitely not all – managers had significant losses over the past few years. Unfortunately not all managers were forthright about their losses and often the concomitant problems those losses created within their firms. My experience has been that managers who were open and honest have been given "the benefit of the doubt" by their investor clients, while managers who "hid the ball" will pay a serious price for their behavior and have trouble raising new funds in a recovering market.

Manager Co-Investment

I continue to see no demonstrable evidence that manager co-investment makes a manager a better investor. In fact, some of the most dramatic loss situations I dealt with involved very significant co-investment by the manager. On the other hand, several of the most successful programs I observed had minimal manager co-investment. I must admit I have not won this argument with my clients and certainly not with the consultant community. While most of them acknowledge that they cannot produce any evidence that co-investment

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works, they maintain it makes them feel a whole lot better when, if a loss occurs, the manager involved also suffers. So I guess that as manager coinvestment "doesn't hurt" (although I've seen situations where , when an investment goes bad, managers appear to be protecting their own interests first), there is no harm in asking for it. Just don't consider it as a meaningful, let alone foolproof, way to generate manager investment success.

Ted Leary

Alignment of Interests / Character Counts

"Alignment" was the most overused buzz word in our industry over the past couple of years. It sounds great, but nobody has, to my knowledge, produced a clear definition of what it really means Often -- all too often -- manager co-investment, was supposed to create it, but as I mentioned above I don't buy that argument.

My observation, based on spending a lot of time with both failed managers and successful managers, is that the optimal way to create alignment of interest is through the character of the manager. Character does actually count! If a manager truly knows what being a fiduciary means, then it doesn't matter how many supposed alignment structuring devices are used. They act appropriately. At the same time, if a manager doesn't know what being a fiduciary entails, no structural devices will ultimately prevent that manager from acting in its own – and not its clients – best interest. If there is one thing I think we can all agree on is that all too many managers have shown that they know how to "game the system" quite well. The problem is that digging into a firm's character and fiduciary mind-set is very difficult. It certainly can't be discovered in your typical consultant RFP response form.

My personal belief is that it can only be done by doing a "deep dive" into a manager's organization and leadership. This requires lots of time and the skill of men and women who know

how to underwrite organizational character. If you don't know the important questions to ask, you won't get meaningful answers. The irony is that now is the optimal time to undertake such deep dives as there is nothing like the stress of a terrible market to bring out the best ---AND the worst – in firms and people. Until the business – and especially the investor community – learns how to deal with character underwriting, it will continue to have to rely on often ineffective alignment structures.

The *Power Pendulum*

PERE News had a recent interesting commentary on the "power pendulum" that swings back and forth between managers and investors. The commentary argued that "power" had shifted back to the investor community for the time being and thus those investors were now being more selective with new commitments and more demanding on fees and control issues.

My observation is that there is instead a "performance pendulum". Investors don't really care about "power" as much as they care about performance. Their ideal is giving pretty broad discretion to a manager who actually delivers. Firms that consistently deliver superior returns maintain better personal and economic relationships with their investors. Firms that have erratic, if not downright disastrous, performance will eventually suffer in its client relationships and ultimately in its economics.

It amazes me that the real estate investment management business, which is peopled by seemingly pretty smart men and women – who supposedly believe in the capitalist concept of "the market" – should have such a difficult time grasping the fact that poor performance should not be rewarded.

There is an almost near hysteria in the business and the business press that some managers won't survive this truly disastrous cycle. Isn't that how "the markets'" are supposed to work? The best managers will not only survive, but will continue to raise new funds from satisfied clients ---- and the very poor managers won't!

Fees / Rebalancing the Risks & Rewards

One area where the so-called "power pendulum" concept is valid and appropriate is manager compensation. Over the past several years I've seen managers receive (note I am not using the term "earn") enormous compensation to "manage" incredibly poor investments, while their clients lost millions, and in some cases, billions of dollars. I have not seen any indication that investors don't want their managers to earn very attractive fees. They just want to pay those attractive fees only when the manager has delivered on their side of the bargain – through performance. As one of the earliest adopters (in the late 1980s) of a fee structure heavily weighted toward performance, I must

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confess this is one alignment device that does seem to work -- if carefully structured. If a manager is getting rich just off commitment and asset management fees, performance fees become less important and the alignment is lost. Astute investors are getting wise to this and are moving to more performance weighted compensation systems. I call it "rebalancing the risks and rewards". This will involve more cost-based commitment and asset management fees plus performance fees that are paid only after the full recovery of an investor's funds. I have argued to clients that, as part of such reforms, they should make sure they don't improperly incentivize their managers to "swing for the fences", but also be willing to increase performance rewards, if the manager actually delivers.

Bifurcation

I sense that the investor world may be heading toward a bifurcated structure. The very large funds, The Big Dogs: very large public funds and sovereign wealth funds -- have been deeply disappointed in the commingled fund vehicle. Unless they held a majority position in a fund – and in some case even if they did -- they have learned that commingled vehicles don't provide them with sufficient flexibility to determine their own destiny. As their size allows them to pursue large separate accounts where they have more control -- especially if performance turns out to be poor – I think we are going to see these Big Dogs create a new, improved version of separate accounts – with very large commitments. The ones I have seen so far have, in my view, a good balance of control and compensation structures and the managers involved seem quite content with this latest version of the separate account. At the same time small and mid-sized investors will likely continue to utilize a commingled fund structure. The issue is going to be whether these mid and small size investors will have the inclination and the ability to "rebalance" the control and compensation systems in a way that mimics what the Big Dogs are doing. Only time will tell.

Wrap Up

Since I am having trouble being particularly original, I will end with a quote from Oaktree's Howard Marks' latest newsletter: "the indispensable elements [for investment success] are now risk control, selectivity, discernment, discipline and patience." I couldn't have said it better myself and wish I had!

Have a healthy and successful 2011. ◆◆