Lessons LPs should have learned

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Having attended several industry conferences recently and talked with real estate institutional investors, fund managers and consultants I am not convinced that we, as an industry, have learned as much as we should have from our common experiences of the last few years. I am fearful that we will soon repeat many of our past mistakes – and, most likely – manage to create some totally new ones. As Mark Twain allegedly said: “History doesn’t repeat itself, but it does rhyme”. Thus, I offer from my experience working with LPs on evaluating and restructuring troubled portfolios, a few lessons LPs should have learned. In no particular order, they are:

1. LPs are almost by definition macro-allocators who invest in strategies and the fund managers of those strategies. To me that means LP staff should spend their time and energy focusing on the macro trends that will impact their investment goals and the strategies needed to achieve those goals instead of focusing on the micro. When I hear LPs, as I have all too often, opine on retail cap rates in Houston or office rents in Los Angeles or apartment absorption in Washington DC – I just roll my eyes. LPs should focus on larger, broader movements and issues that impact the role of real estate in the global economy, such as demographics, technology, interest rates, currencies and capital flows. Once they are comfortable with their findings then they should establish their strategies to take advantage of those trends, only then should they find the right managers to execute those strategies and, finally, get out of the manager’s way. The job of the LPs is to design strategies on their own, not just to accept them from managers.

I would recommend that LPs throw away all those micro-research reports they have been receiving. Let your manager read them. Instead LPs should subscribe to – and actually read – publications like The Economist, Financial Times, Wall Street Journal, New York Times and sign up for some of the more thought-provoking economic blogs such as Simon Johnson’s or Nouriel Roubini’s. You don’t have to necessarily agree with these commentators, but they will make you think! By engaging in this level of research LPs will be far more likely to pick up on the big trends that will impact the global real estate markets and to avoid poorly conceived manager pitches, thus ultimately improve upon the prospects of their portfolios.

2. When selecting new managers LPs should focus on the character – the 'soul' – of the manager. Performance is important, but it can be, as we saw in 2005 through 2008, highly ephemeral. My experience from working on a wide variety of workout assignments over the past few years is that in the long run personal and firm character counts the most. The managers who truly understand and live up to the fiduciary role protected their clients' interest on the downside and ultimately produced superior returns.

3. The lesson in #2 will require LPs to delve deeper into a manager's personnel, culture, organisation, ethics and corporate soul than has been done in the past by either the LPs, or their consultants or advisers. LPs need to be prepared to spend the time and money to dig deep. Due diligence is key. Don't be penny-wise and millions-foolish!

4. Don't try to execute a tactical investing programme through fund vehicles. By definition being tactical requires nimbleness, manoeuvrability and control. The challenge for LPs is that the markets, and thus creative investment opportunities, shift and morph much faster and sooner than can be executed in a particular fund's strategy. Funds with the typical very limited LP control provisions and 7 to 10 year lives are therefore simply not tactical vehicles.

If an LP feels that because of its size it has no choice but to invest in commingled funds, that LP needs to ensure that it has control rights to curtail or redirect the programme, if the markets move against the fund or the manager appears to be incapable of executing the fund's strategy. If such control rights are unobtainable, try to make sure that the 'tactic' you are investing in is not a trendy one and will likely stand the test of time and cycles.

5. Don't fall into the trap of believing that co-investment makes a manager a better investor. I have asked clients and consultants ad nauseam whether there is any demonstrable evidence that manager co-investment improves performance. There isn't! My own anecdotal experience from the workouts I been involved with over the past few years is that some of the biggest losses have been generated by managers with the largest co-investments. On the other hand, some of the top performers had little or no co-investment. Manager co-investment may comfort an LP, but don't turn it into a crutch or use it to make a final decision on investing in a particular manager.

6. Grill your existing and potential managers about their risk management philosophies and systems. For far too long 'real estate risk management' has been an oxymoron in our industry. LPs need to begin to force the issue and really dig into this subject. Ask your existing managers with poor results, “What went wrong?” I did that one day last year with the senior team of a top-ten manager only to get catatonic stares in response. They could not explain what caused their massive investment losses. I reminded them that if they couldn’t answer that question, they were bound to repeat their poor performance.

7. Don’t blame everything on the managers. The LPs and the consultant community (and maybe even the placement agents) were willing participants in our industry’s recent disastrous performance. Every sector of the industry needs to take a hard look in the mirror – even the LPs. Maybe especially the LPs! As for the consultants and advisers, LPs need to go back and look at their reports on strategies and managers and their recommendations from the last cycle to try to uncover how prescient, naïve or just plain wrong they were.

8. Be very, very careful what you incentivise! Financial incentives actually work and can seriously – for better or for worse – impact manager conduct. My recent workout experience is that fee structures overweighted to back-end incentive payments all too often led managers to make bigger and bigger bets using increasing amounts of leverage. Incentive fees are fine, but make sure you design a balanced programme that doesn’t cause the manager to constantly swing for the home run because when he/she strikes out the LP is the big loser.

9. Leverage kills! What more do I need to say. Leverage does not make an investment a better investment. It merely increases the potential rewards and, now we realise, the risks as well. Leverage has a role in real estate investing, but use it sparingly and skillfully. Don’t get lured again to the investment rocks by ‘the Lorelei of leverage’.

10. Don’t diversify just for diversification sake. I am bemused when I hear of investors who with a 5 to 10 percent allocation to real estate go off and invest in 25 to 50 funds (that is, strategies). Do they really think that such micro slicing and dicing will move their performance needle or hedge their risks? No way! One of my friends in the business calls that “deworsification”. Instead investors should restrict their investing to asset categories and strategies they deeply understand and feel comfortable with. Then they should increase their allocations to those strategies. The ‘throw lots of darts at the wall’ style so many investors followed in the last cycle just didn’t work very well.

11. Beware of yield compression – especially across styles. When I entered the business in 1989 there was a healthy spread between investment styles: core, value-add and opportunistic. By 2005 or so those spreads had dangerously narrowed while leverage increased across all styles. As we now know that was a recipe for disaster. Investors need to set a floor on expected returns from a particular strategy and exhibit more discipline by just saying 'no' to managers who pitch products that would not meet these expectations.

12. Beware of weaknesses inherent in the allocator model. I observed during my workout assignments that several LPs have been burned by not focusing on the third level of the allocator model: the operator. LPs rightly focus on their level of control and other rights in their direct agreements with their fund managers. But when their manager inks an agreement with an entrepreneurial operator the manager often – consciously or unconsciously – gives away many of those important rights. When the market turned against the LPs or mistakes were made they soon found that they had limited ways and means to mitigate their problems.

13. If you insist on being on an LP advisory committee, be proactive. My experience representing LP clients on some of these committees is that the other LP representatives are often far too passive and sometimes downright ill-informed. (I know several LPs who are building lists of LPs they will no longer invest alongside as those LPs were either un-cooperative in solving problems or appeared to be captives of the GP.) As a former manager, I was never bothered by clients asking tough, thoughtful questions – after all it was their money I was managing. I don't think managers who have a 'fiduciary soul' and are confident in their firm's performance will be offended by tough questions. If an LP is not prepared to do the homework necessary to be an effective committee member and is not willing to be an active participant, let another more assertive and knowledgeable LP take its place. Remember, LPs as well as managers have a fiduciary duty.

A summary 'to do' list

1. Think about big, global, macro trends. Don't sweat the small stuff. That's for your managers to do.

2. Read everything you can get your hands on to help you better understand those trends.

3. Focus on the 'fiduciary soul' of prospective managers as well as their performance numbers. It will pay off for you in the long run.

4. Learn how to conduct due diligence on prospective managers' 'real' performance numbers – find out what they really delivered to their investors. As Ronald Reagan once said: "Trust, but verify".

5. Don't automatically re-up with a manager's next offering, even if they have delivered good returns to you. Markets change. Teams change. Organisations change. So dig as deeply into a follow-on offering as you did (hopefully) the first time.

6. Have courage of your convictions. Invest through fewer managers and vehicles that you are highly comfortable with the strategy and believe that your managers understand the meaning of being a fiduciary.

7. Try to get as much control over governance issues as you can, but don't meddle in a manager's operations. If the manager doesn't work out, get a new and improved one.

8. If you sit on an LP advisory committee, be a prepared, thoughtful, energetic, problem-solving oriented participant.

9. Cool it on the use of leverage.

10. Oh, and hope that our colleagues in the business learn these lessons as well.

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