ROCKSTREET
PARTNERS

In this Issue

Rockstreet discusses why its standards will sometimes force it to transact less; what those standards are; and why it believes its approach will ultimately be rewarded.

A Client Memorandum from Rockstreet Partners

A Down Payment on Trust

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By John L. Turner Jr.

One of the core beliefs Travis and I hold is the importance of delivering consistent returns to our limited partners. An investor who entrusts his or her capital to Rockstreet deserves steady investment performance regardless of the economic environment. Being consistent, however, does not mean your track record is built around wildly gyrating returns—with poorly performing years offset by periods of outsized gains—but on a steady accumulation of above-average results. **Our goal is consistency, not a polarity of extremes.**

Consistent performance is best delivered through the steady adherence to investment principles that elevate investment performance over asset gathering--even if that means there are times when you are less active than your competitors. In his excellent book *Against the Gods: The Remarkable Story of Risk, economist* Peter Bernstein pointed out that "**time matters most when decisions are irreversible**". In other words, once an investment is made you're always somewhat captive to circumstances. For Rockstreet, there may be periods of time with fewer investments, but there will never be a time when our investors are captive to one that doesn't carry the firm's full and complete confidence.

Managers focused more on generating consistent volume of transactions (and increasing their fee income in the process) may balk at this concept, but it almost always will enter the minds of those whose first concern is generating reliable, above-average investment returns. Travis and I count ourselves among the latter. So if we are temporarily not finding new opportunities with risk-return parameters we like, then we will wait until we do.

This approach can be frustrating in the short-run. Our investors count on Rockstreet to uncover opportunity throughout the market cycle. And while Travis and I take that responsibility very seriously, we also believe that our patience will be rewarded in the long-run. **Sometimes, the investments you do not make turn out to be more important than the ones you do**.

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Implicit in this is something important for our investors to know: **Rockstreet will never lower its standards to generate new business.** Travis and I are not among those managers who believe their mission is to deliver the best returns available at the moment; our investment standards are objective for all time, not subject to the times. We would rather abstain from new investments than risk jeopardizing our investors' trust because we stretched to justify an investment. **Transacting less today is our down payment on your trust.**

When the Market Cooperates, and Doesn't

Clearly our belief is that it is better to patiently work towards uncovering a great opportunity than to rationalize investing in an average one. Rockstreet has a very simple conception of what distinguishes great from average, and it informs our entire selection process: we want investments where the price represents a clear and present value proposition backed up by a business plan capable of fully unlocking that value in any economic climate.

Prices move in the opposite direction from the perception of risk. If people are more optimistic about the future they tend to pay more, less when they are pessimistic. As I wrote in *Lessons Learned*, February 2014, great investments usually happen when risk is over-valued:

> Given the human character of [the economic] process, one can easily see why far greater fortunes are made buying after a market reset than predicting one before they happen. The essence of any investment is a balancing of risk and return, and it is in those rare moments when the market has so greatly overpriced risk that the rational investor can find his greatest reward.

The point I was trying to make was not so much about market timing, but when risk tends to be most over-valued (and price under-valued). In truth, this mistake is made all the time, it just happens with more frequency at market bottoms than tops.

Rockstreet's Standards

Theoretics aside, a great opportunity for Rockstreet is one where either: (1) the returns are attractive even if performance is worse than expected, or (2) the returns are above-average even if less than all our operating assumptions prove correct. The chart below sums up our target return based on how we execute on our business plan:

Business Execution	Investment Returns
Poor. Most operating assumptions are not achieved.	*Average.* Full return of capital with a modest overall return.
Good. Some, but not all, operating assumptions are achieved.	*Above-average.* Full return of capital with a mid to high teens level of return.
Best. Most, but not all, operating assumptions are achieved.	*Superior.* Full return of capital, opportunistic-like return.

Hopefully, a few items may have caught your attention in the chart. First, in each of the scenarios you find that the returns do better than the execution would suggest: A deal that performs poorly, maybe because rents or occupancy (or both) are worse than expected, still protects invested capital and delivers a modest level of return; likewise, a far better than expected return is delivered if the deal performs just slightly better than expected; and, in the middle, where most but not everything goes as planned, the return is solidly above-average. The reason for this has much to do with the price we pay.

But investment success isn't just about price. It is also about execution of a sound business plan. The second component of our standards deals with this. Specifically, each of the scenarios in the chart focuses more on the downside than the upside. Like life, investments don't always go as expected, so the ability to overcome obstacles is critical. To account for this, **our underwriting standards demand that above-average returns be achievable when only some—not all—of our operating assumptions prove correct.** While missing on underwriting assumptions is certainly not our aim, Travis and I draw comfort in

knowing that our investments are selected on their basis to best withstand setbacks--including economic shocks, capital market fluctuations and plain human error. This is the only way to approach things if you're investing in the real world.

76 Months and Counting

Competition for investment returns is intense, and windows of opportunity for superior returns close quickly. Early in a cycle, as the economy begins to grow, is when the best investments are most readily available; however, **the deeper into a market cycle we travel, alpha can only be generated through keen market insights backed by sound business plans.** Capital tends to flow wherever there has been strong recent performance, making above-average returns harder to achieve within sectors that previously outperformed.

The current expansion began in June 2009 and is now at month 76 and counting. This fact, alone, is not an invitation to stop the search; even in the latter stages of a cycle, superior investment opportunities exist and it is this firm's responsibility to uncover them. The difference now, however, is that **generating new investments capable of meeting our standards requires greater patience, new strategies and the discipline not to compromise our standards**. The best returns aren't usually available wherever capital was previously or is now being directed. With over six years of growth behind us, ever more opportunistic corners of the market have been priced away. This also means business execution becomes far more important to investment success--usually you can't miss on *any* assumptions, let alone hit only some of them, and expect to achieve quality results. Since Rockstreet's standards won't adjust to suit that approach, we are finding fewer deals that merit the seal of its brand.

Back to Consistency

Travis and I believe our results are (and will continue to be) consistent precisely because of the approach I've outlined here. It is simply a tall order for a deal to surpass these hurdles--and harder still when the market is beset by a generally optimistic mindset. And since we cannot control the environment, sometimes the best thing we can do is seek to understand what is happening, and respond wisely.

Our best guidance to you is to remain patient with us. Charlie Munger once noted how remarkable the long-term advantage he and Warren Buffett had achieved "by trying to be consistently not stupid, instead of trying to be very intelligent." No brilliance is required to see that today is a difficult market in which to find bargains, but it does require discipline to avoid being seduced by its siren song. This time is not different, and by staying the course I've outlined here, Rockstreet and our investors can be the beneficiaries of others who think it is.

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