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In this Memo

Risk controls appear to be waning. What causes this, and how should investors think about it?

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A Client Memorandum from Rockstreet Partners

The Extended State

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By John Turner

Rarely do we hear investors use fishing metaphors to diagnose markets. Most seem to prefer the analogy of a baseball game. We find this unfortunate, because **investing is lot like fly fishing**. The process through which a trout is landed can be influenced by many things—by weather, fly selection and even randomness. But it never amounts to much more than one successful cast into a vast flowing river. **Superior investors have a better sense of what's happening *inside the river*, and thus whether its worth casting in any certain spot—or even wading out in the first place**. Still, even they cannot know if they correctly judged the situation until a cast is made. Less skilled investors often don't appreciate the subtleties of life beneath the surface, preferring to cast into the water in search of a bite.

While it is not our place to proclaim ourselves superior investors, we at Rockstreet certainly have that as our aim. We believe it so much, that one of the firm's slogans is *Investment Performance Over Asset Gathering*. To use the previous analogy, **we are not going to cast until we think we fully understand what's happening in the river**.

Setting aside our personal feelings as to which analogy is better, we must admit to hearing the "what inning are we in?" question with growing frequency. But how should one answer the question? In response to that question, Oaktree's Howard Marks recently wrote:

> Perhaps no one can say just want it is that will ring the bell on today's positive trends, but people still want to know how advanced we are in the process, and thus when it will end. . . rather than "what inning," I'd suggest investors ask whether things are or are not in an extended state. Is psychology depressed, average or euphoric? Is the capital market shut tight, normal

> or unthinkingly generous? These are questions that can be answered in a helpful way, not how close the game is to over. No one knows the answer to the second.

The observation begs many questions. What are the conditions of an Extended State? What causes an Extended State? Do investment conditions today show the hallmarks of being in such a state? If we are in an Extended State, how much longer will it last? These are the questions with which we've been wrestling, and our best attempts at answering them are the subjects of this memo.

WHAT IS AN EXTENDED STATE?

We suppose the best place to start is with a review of market behavior. At its most extremes, market behavior tends see things as either flawless or hopeless. The reality, on the other hand, tends to be somewhere between two lesser extremes—things are, in fact, generally good or not so good. Markets, however, can overreact because investors are people who experience fear and greed, especially when it comes to money! The two rarest of situations are:

- First, markets can act as if things are hopeless, when they are actually pretty good. Think of the guy who walks past a $20 bill and doesn't pick it up, because, well, if it were really a $20 bill it wouldn't be on the street.

- On the other side, markets can act positively euphoric when the reality is quite the opposite. Here, the guy picks up the $20 bill and then continues walking the streets looking for others.

In each case, the protagonist failed to properly appraise risk. Our walker who doesn't collect the $20 failed to see the lack of risk in bending over to see if it was real; while in the other scenario he fails to appreciate that $20 laying on the sidewalk is a rare occurrence.

Now, let's change the scenario a bit. Suppose our protagonist pockets his $20 and then tells his friends. These people, in a burst of excitement, take to the street in droves to locate other twenties. After a couple of hours, a few report finding some smaller bills—no $20's but a couple $5's and even a $10. Word spreads, and the next day there are more people searching. And they now have help—a few "experts" who've looked at the previous day's data claim to have identified patterns and locations for optimal success. Some of the advice pays off (most doesn't), and soon word is spreading further still. Eventually, it reaches the ears of some sage financiers who set up a derivatives market for currency searchers. With this innovation, the money hunters can now leverage their success! In this ridiculous example, the ad hoc market is acting euphoric when the situation is anything but.

The absurdity of the example, however, illustrates the important point to our first question: **The Extended State is a market condition were participants continue to act as if conditions are flawless when they are, in fact, not so good.** Like our currency hunters, investors in an Extended State fail to fully control for the risks—i.e., the range of possible outcomes—some good, some not so good—that could impact investment performance. Safer investments have a pretty small range of negative possible outcomes; riskier investments have more. We expect to make more from risky assets than safe ones so long as none of the possible negative outcomes occur. The problem comes when we fail to give proper thought to what can go wrong. **The Extended State involves a pretty widespread failure to understand, recognize and control for risk. If markets in this state perceive conditions to be favorable, when it fact that are not, then the obvious definition of an Extended State is a market where risk controls are waning.**

BEWARE CHEAP CAPITAL

If you're in the business of making fly fishing rods, the best method of growing your revenues is to make a better rod. A new rod with better casting distance and accuracy always attracts attention. Sure, you will certainly spend money on advertising, but that only works if your rod lives up to its billing. If your product can be differentiated from your competitors, then "building a better mousetrap" is the most effective strategy for capturing market share.

But what if your product isn't unique? What if you offer a commodity product, such as aluminum or oil? You cannot truly differentiate your product from your competitors—after all, you're both offering the same thing. If your business trades in one of these products, then about the only thing you can do to gain market share is to offer a lower price.

Capital is another commodity. Money is merely a means of exchange, and your customers don't gain any appreciable advantage from using your money to transact versus that of your competitors; a given amount of debt financing provides the same purchasing power, regardless of who the lender is. Capital providers—lenders and private equity investors—who want to move more of their money must make it cheaper than their competitors. Like any other commodity, the surest way for a capital provider to grow market share is by offering the lowest price.

There are several ways for a capital provider to lower the price of its money:

- If they are a lender, the most obvious is by lowering their interest rate. Lenders can also weaken covenants, provide greater leverage or offer extended periods of "interest only" payments.

- If they provide equity capital, the means are a touch subtler but no less dangerous. Private equity investors can, for example, agree to weaker deal structures that "prices" their money cheaper because it gives a greater share of proceeds to the recipients. They can also agree to finance projects being acquired at higher prices.

What these capital providers are doing is simple: they are lowering the cost of their product—capital—to do deals. Ultimately, **capital providers who "discount" their product also reduce their prospective investment return. The only way to cheapen your capital is by lowering your return targets.** In short, superior investment returns never begin with discounting your product.

Capital providers who cheapen their product play a large role in the creation of an Extended State. Think of investment conditions early in a cycle, when most are still reeling from losses incurred during the downturn. Some are willing to act, but many are not—they take the wait and see approach. As those first movers rack up superior returns, others move in. Gradually, the sea of superior opportunity turns into a lake, then a pond. Only pockets of opportunity remain; and those pockets require far smaller amounts of capital than stands ready for deployment. Capital providers have two choices at this point: they can either hold firm to their standards and transact less, or they can choose to discount their returns and transact more. Those deals done with "cheaper" money further compress returns, extending an investment cycle into an Extended State. **To revisit our fishing analogy, they care more about casting, less about what is happening in the water.**

SELLING MARGIN OF SAFETY

If you believe, as we do, that valuation is an imprecise art, then the only way to invest is with a margin of safety. Such safety entails a lot of things, but at it most basic it requires a reasonable price, good deal structure and investment returns that can be achieved when things don't go exactly as planned. The opposite of margin of safety is "priced for perfection"—a condition where everything must go exactly according to plan to achieve the desired outcome.

Ultimately, **investors who want to get more money out will require less safety—to generate the new "investment products" that drive fee revenue, they accept the risks that others don't.** It's the easiest, and least obvious, way to continue generating new business long after the best deals have been done. The sacrifice comes in many forms; underwriting more aggressive reversion sales (lower cap rates), adding a few more basis points to rent growth, or running vacancy a bit lower than you should. **Instead of underwriting for the unpredictable, they underwrite to the flawless.**

For these investors, investment performance takes a back seat to the objective of asset gathering. Superior

investments are rare; and finding transactions that are priced right, with strong deal structures and the right business plan is no easy task. Against this, **it is far easier for the ambitious private equity manager to "beat the drum" that raises the most capital.** "Sell what sells", so the saying goes, which usually means at the latter points of a cycle pursuing strategies where there is broad acceptance of the underlying rationale, strong recent performance and an optimistic forecast—in short, the sorts of deals with the greatest risks of suffering the deepest corrections.

Naysayers who refuse to take this path pay a price. He may be ridiculed as a curmudgeon; his transaction volume will certainly be lower and his returns may even lag those of his drum-beating peers. Nobody will know who got it right until the final investment returns are tabulated. It may not be fair, but nothing ever is. We all have to wait after sunset, when everyone is off the water, to know who fished the river best.

SOME OBSERVATIONS

So how are things today? The short answer is we see a fair number of things that raise our eyebrows, but we cannot say whether they are going to correct today or tomorrow, or even never. What we can say with some confidence is there is ample evidence that now is a time for moderation, selectivity and agility. Here are a few reasons:

- **Cap rate compression** that is narrowing spreads over interest rates to within 100 bps across a range of property types. Assets underwritten four years ago to sell today at, say, 6% cap rates now routinely trade hands below 5%. The old saying that "well bought is half sold" finds no home in a market with those features. Investors buying on such spreads are betting solely on rent growth and/or further cap rate compression to generate their return. The risk in this approach is obvious.

- **The return of "financial engineering" to make deals pencil.** Lenders are getting generous again. Among these are up to five years of interest-only payments on senior acquisition financing, a growing reliance on floating rate financing and a return of CMBS.

- **Weakening Deal Structures.** The terms on which a JV investment is today structured differ markedly from those of just a few years ago. Sponsors expect to command more favorable profit splits, and sometimes this will even include new guaranteed fees that more rapidly bring the sponsor "into the money". Many years of positive results, not to mention an influx of investment capital eager to access real estate, are tilting the balance of power away from the equity investor.

- **Proliferation of "Direct" Investing.** More private equity real estate managers are opting to ditch their traditional joint venture structure and invest directly for their own account. When traditional equity partners move into the sponsor's seat, they do so for a simple reason: there isn't enough upside at today's prices for both the manager and a JV operating sponsor. Many of these managers are sitting on substantial amounts of dry powder in the form of uncalled closed-end fund commitments. In most cases, the capital for those funds were raised on return expectations that are no longer available in a JV structure. The solution for some (not all) is to simply take on full responsibility itself; whereas it used to rely on a JV operating sponsor for critical day to day management, the manager eliminates that level and brings it in house.

- **Lower Overall Returns.** Even with all the efforts taken, today's pro forma returns are still lower relative to a few years ago. Compared against other fixed income, real estate still provides great yields. To access those higher yields (but lower than they were in the past) many are overlooking the risk of low spreads, floating rate debt and weak deal structures.

These observations add up to one thing: investors appear to be accepting less safety. Does this mean we are in an Extended State? The frustrating answer is: not necessarily. The evidence is certainly ample

that we are; but the truth is nobody knows until all results are in. The way this cycle has progressed is not unusual; from a deep bottom things have gradually improved, transaction volume has grown and returns have compressed. About the only outlier this time is the duration—now at 8 years and counting. In our opinion, there is no riddle to how this eventually turns out, but only time will tell.

Difficult as it may be, Rockstreet is willing to bear the label of curmudgeon if it means saving our track record and preserving our investors' capital. Experience shows that the corrections following periods of lax underwriting impose painful losses. Is it possible to not happen this time around? Sure, but Rockstreet isn't about to bet our reputation and capital that it won't. **We will continue to do what it has always done: value investment performance over asset gathering.**

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