

## Errors: Portals of Discovery

Sunday, September 20, 1964, 31 years to the day that the Pittsburgh Steelers were soundly defeated in their first ever football game by the New York Giants, the Steelers were still seeking revenge. By the second quarter of the game, the Giants had stormed to a 14 - 0 lead. New York had the ball deep in its own territory when legendary Hall of Fame quarterback Y. A. Tittle dropped back to pass. At the moment when Tittle was about to release the pass, John Baker, Pittsburgh's 6-7, 280-pound defensive end, drilled Tittle's right side, knocking Tittle's helmet off, cracking his sternum, pulling his rib-cage muscles and causing a concussion. The ball floated aimlessly into the arms of Steelers' tackle Chuck Hinton, who waltzed into the end zone from eight yards out.

As the Steelers were celebrating their defensive touchdown, Morris Berman, a Pittsburgh Post-Gazette photographer, captured the bruised and battered Tittle kneeling in the end zone, helmet off and blood trickling down from his famously-bald head. That play turned the game around - the Steelers won 27 - 24.

The picture reminds us of the look (or at least the feel) of most real estate investment managers today. While the last period looked fairly good, the current turn of events is not so pretty: values are down, lenders want their loans repaid, tenants have all the leverage and equity partners no longer cut any slack.

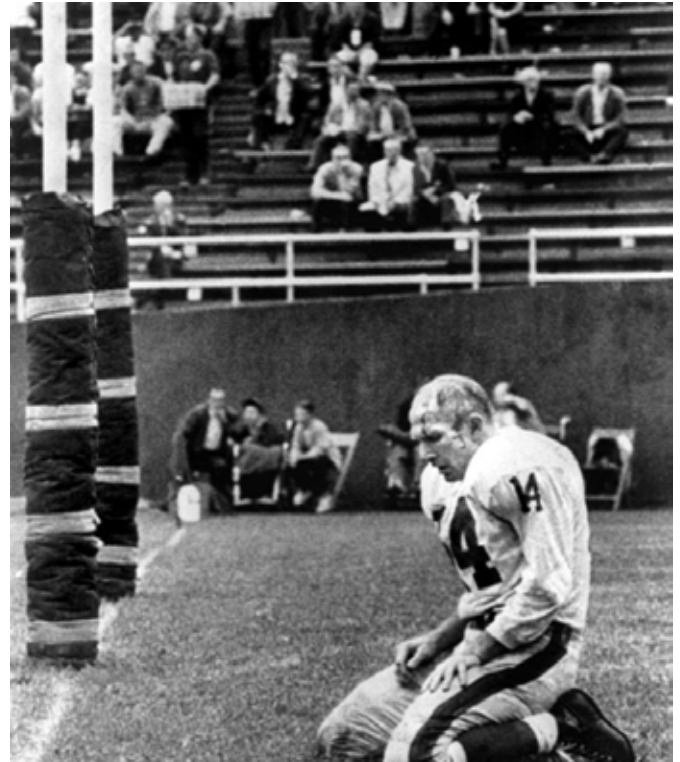
Then again, there is much to learn in defeat, if we can summon the will and courage to look within.

In this quarter's Our View, we first lend you our seats to review a few quotes we've excerpted from the second quarter reports of fund managers we are invested in, so you can read, without interpretation, a bit of what our underlying managers are saying. Second, we focus in on a few key take-aways from the current downturn that may lead to greater risk mitigation going forward.

## Who needs commentary?

NBC made history with the first announcer-less telecast of a National Football League game between the New York Jets and Miami Dolphins on December 20, 1980. As we reviewed this quarter's financial reports of real estate private equity funds worldwide, it occurred to us that letting you sit in our field-level seats, without embellishment or analysis, might provide more information than any commentary on the state of the commercial real estate markets that we might provide.

In the spirit of the announcer-less game, the quotes below (transcribed without source to ensure confidentiality) should allow



you to feel the game, up close and personal. We believe that real estate managers are finally coming to the realization that the markets have changed and that the work required to recover value will be intense. Please note that these quotes are not meant to be comprehensive but rather to convey a sense of the tone of the market.

- "Values have dropped to 1997/1998 levels in many markets. This is 30-40% below 2008 values."
- "Rising vacancies, falling rents and capital constraints are expected to have a significant impact on U.S. commercial delinquency rates."
- "Tighter underwriting standards, declining cash flow and plummeting asset values mean that many of the loans coming due will be impossible to refinance without 'substantial equity injections.'"
- "While we believed the [last quarter's] write down was conservative, we are making an additional write down this quarter due to further deterioration in market conditions including increased space availability, anemic demand, continuing rental rate compression, and tenant distress."

- "...world economies continue to struggle with the effects of the banking collapse. These effects manifest themselves in geometric fashion in the real estate industry. Not only is the effect felt from reduced demand for space from corporate users whose businesses are stressed, but the property industry itself, which is so capital intensive, suffers further from the combined effects of the banking turmoil, Wall Street/CMBS disappearance, and the lack of liquidity in the marketplace."
- "The debt markets have not improved, but thankfully they have not worsened either. In fact, banks are making motions of being back in business. We take these overtures lightly because bank executives would rather have their "street" lenders talking about being back in business than really being back in business."
- "Either in conjunction with what you have read or despite what you have read, the demand for space has not been this poor in nearly 20 years. While historically industrial assets have had only modest decreases in vacancy and rents, this recession is a notable and unwelcome exception."
- "The CMBS process takes a bit longer and more uncertain considering the agents who manage the securitizations make more money from the fees than the recovery of their first loss debt."
- "Significantly weakened operating results beginning in the second half of 2008 which have extended into 2009, together with tight liquidity at [the Company], resulted in the Company's decision not to make certain interest payments due on unsecured notes of the Company beginning in February 2009."
- "During the quarter ended March 31, 2009, a member of a lending syndicate defaulted on its obligation to fund the remainder of its share of a syndicated construction loan to finance the ... development being undertaken by a joint venture in which the Partnership is a significant partner."
- "No new assets were added this quarter, in recognition of management's interest in caution."
- "No assets [mezzanine loans] paid off in the first quarter."
- "As you know, we have maintained a bearish outlook in this sector for some time. The consumer slow down we have been expecting appears to be in full swing. To reiterate our strategy here, we look to strictly limit retail and to invest only in "necessity retail" or retail in the primary shopping projects in a given sub-market."

You get the point...real estate investment performance in 2009 has been extremely poor on all levels. In particular, strategies dependent on high leverage or a robust consumer appetite (retail, hotels, condos, land for homebuilding, etc.) are suffering badly. Even historically defensive sectors (rental apartments and warehouse industrial) have been hurt, although to a lesser extent.

## Let's go to the video tape ...

Overall, as of mid 2009, the market has gotten the better of many in the industry. What we find, however, is that, as in most endeavors other than sports, losses are not absolute but are instead relative. In many cases, the investments with the most massive losses resulted from aggressive operating and/or financing strategies.

As portfolios are reviewed, we believe that the most value add from this year's challenging environment may result from frankly assessing past investment decisions. While our investor meetings lead us to believe that many are taking stock of their portfolios by assessing damage and considering alternatives, we wonder how many are stepping back far enough to see the source of some of today's problem.

For example, today, all too often, performance reviews seems to focus on what real estate managers did wrong or why investment structures failed. We wonder, however, if such reviews perhaps overlook the fact that some investment strategies were themselves fundamentally flawed. Similarly, at the market's recent peak, assessments of why investment performance had been so strong were often glossed over (hint: tons of leverage and declining capitalization rates, both of which were unsustainable). Going forward, we believe that focusing on return attribution is essential.

In our view, reviews of past investment decisions should be comprehensive, which we believe often includes, but should not be limited to, discussion on the following three potential root causes of poor investment performance: (1) appropriately define the investment decision task, (2) allocating sufficient resources to the task and (3) not relying on ineffective oversight.

## Defining the investment decision task

Volumes have been written about investment analysis, and yet, investors often define investment analysis as conducting due diligence, which is defined as follows:

**Due Diligence:** 1. An investigation or audit of a potential investment. Due diligence serves to confirm all material facts in regards to a sale. 2. Generally, due diligence refers to the care a reasonable person should take before entering into an agreement or a transaction with another party.

All too often, what's left out of due diligence is any **actual analysis**. Typically, lists of questions are sent out to potential managers, track records reviewed, and team member biographies compiled. A meeting with a manager may be held and then a memo is written and investment commitments are made.

We view the analytical mission of due diligence as having three key components that involve many interrelated and probing areas of inquiry, which ultimately facilitate judgment. Just as these components can be applied prospectively, they can also be applied retrospectively:

## 1. Did the investment strategy make sense in light of the current economic environment?

Successful long-term investing involves risking capital in strategies that have a high probability of providing an attractive return given a macroeconomic environment that can reasonably be expected to play out. In particular, investors should be wary of strategies having exhausted tenant demand or having attracted so much capital as to be priced unattractively at this point. While none of us has a crystal ball, we must take a stand and position portfolios as we see appropriate.

Given the extraordinary events of the recent past, we should all be reviewing our investment memos from 2005 to 2008 including our assumptions on the macro-economic environment. While none of us are immune from investment mistakes and it can be painful to check the files, the learning experience is well worth the effort.

## 2. Was the manager/operator capable of executing the desired strategy in this environment?

Understanding a manager's capabilities is no easy task; luck and talent are often confused. In 2007, virtually every manager that came calling had a wonderfully successful track record. So what. Understanding how returns were generated and assessing cautiously whether given strategies are repeatable is imperative. But attribution of past returns requires digging, asking for data, visiting properties, reference checking, etc. This information simply can't be found in any standard questionnaire.

A manager's expertise must also be match the current environment and strategy being pursued. Today's investment negotiations involve investment professionals representing lenders (primarily banks, insurance companies and CMBS special servicers), institutional investors and real estate operators. They are negotiating values, cash distribution priorities and default provisions – a far cry from the time when zoning, construction and project management were at the forefront of every deal. Understanding who really is sufficiently experienced and strategically positioned to undertake the next round of value creation is critical.

## 3. Was the investment structure appropriate (including decision-making responsibility, liquidity provisions, fees, legal, tax, etc.)?

Today, many are questioning whether they should continue investing in commingled fund structures, wondering instead whether joint ventures or "club" deals would have resulted in better investment performance. This is where the videotape review should be most helpful. We believe that careful review may yield that the problems did not arise from fund structures but rather from investment strategies that didn't fully contemplate global macro-imbalances. Perhaps the structures didn't kill the investments; perhaps the strategic investment decisions did. Review the tapes carefully!

## Allocating sufficient resources to the investment task

In reviewing the videotape, we suggest taking a wide-angle view in order to capture all the action. It may be the case that there were far too few resources allocated to investment decision making. Why do we say this? Because it's difficult to understand how one investment professional can implement and manage 20+ investment strategies and relationships.

Institutional investors are finding themselves increasingly constrained due to decreased budgets and increasing demands on existing staff. We wonder how Boards of Trustees agree to commit only a few people (sometimes only one!) to the entire real estate asset class (or sometimes all alternatives) when selecting and managing investments is such an extremely complex task.

In hindsight, the abundance of fundraising over the past five years raises a concern about how much analysis went into decision making. With valuations approaching all time highs, economic recovery well advanced and significant global imbalances, why were so many aggressive investments made?

## Over-reliance on ineffective oversight

Related to the resource issue, one area where we think funds could use significant improvement is the use of advisory boards. We're beginning to wonder if advisory boards are failing their purpose – partially because many board members are burdened with an overwhelming number of board memberships and other investment and management tasks, making them unable to stay up to date with fund developments and fully understand the issues.

In some cases fund advisory boards may be worse than no board at all, as fund managers may use the presence of an inactive board as a crutch while smaller investors are relying on the larger ones to lead the way

## Recommendation

From reviews of our own videotape and discussions with many others in the industry, we have three clear recommendations that we believe should be considered to improve investment performance.

**Defining the Investment Task** – Thoughtful investment decisions are rarely the result of having asked the "killer" due diligence question. They result from careful analysis and consideration of an opportunity's risk and return attributes, which takes extensive time and effort. A reexamination of our investment processes and augmentation of independent analysis, considering macro-economic, organizational, strategic, value and structural elements are likely to improve long-term results.

**Resource Allocation** – Boards of Trustees should seriously consider whether they have allocated sufficient human capital to undertake the analysis required of complex investment decisions. Options include pursuing a less ambitious investment policy, augmenting internal staff and outsourcing investment decisions beyond the in-house team's experience or capacity.

*"The quality of a person's life is in direct proportion to their commitment to excellence, regardless of their chosen field of endeavor."*

Vince Lombardi

**Advisory Boards** – Serious consideration should be given to either (a) designating a lead advisory board member who will commit to focus on the issues for the benefit of all, or (b) institute an independent (and paid) board structure.

## Conclusion

Like Y. A. Tittle and the New York Giants of 1964, commercial real estate investors are on the losing end this year. The quotes above tell how the game is playing out world-wide. Managers who accept their defeats and own their decisions tend to grow from their experiences – as Tittle did when he created Tittle Insurance and Financial Services, where he proudly displays the famous photograph.

In the near term, investors and managers should conduct forensic analysis to understand thoroughly where portfolios did well and where they didn't. Little is learned in bull markets – much is learned at times like these. We are active in this task and look forward to exchanging ideas with many of you. The lessons are out there – let's hope we all pay attention. If we do, future investment performance may improve as a result.

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