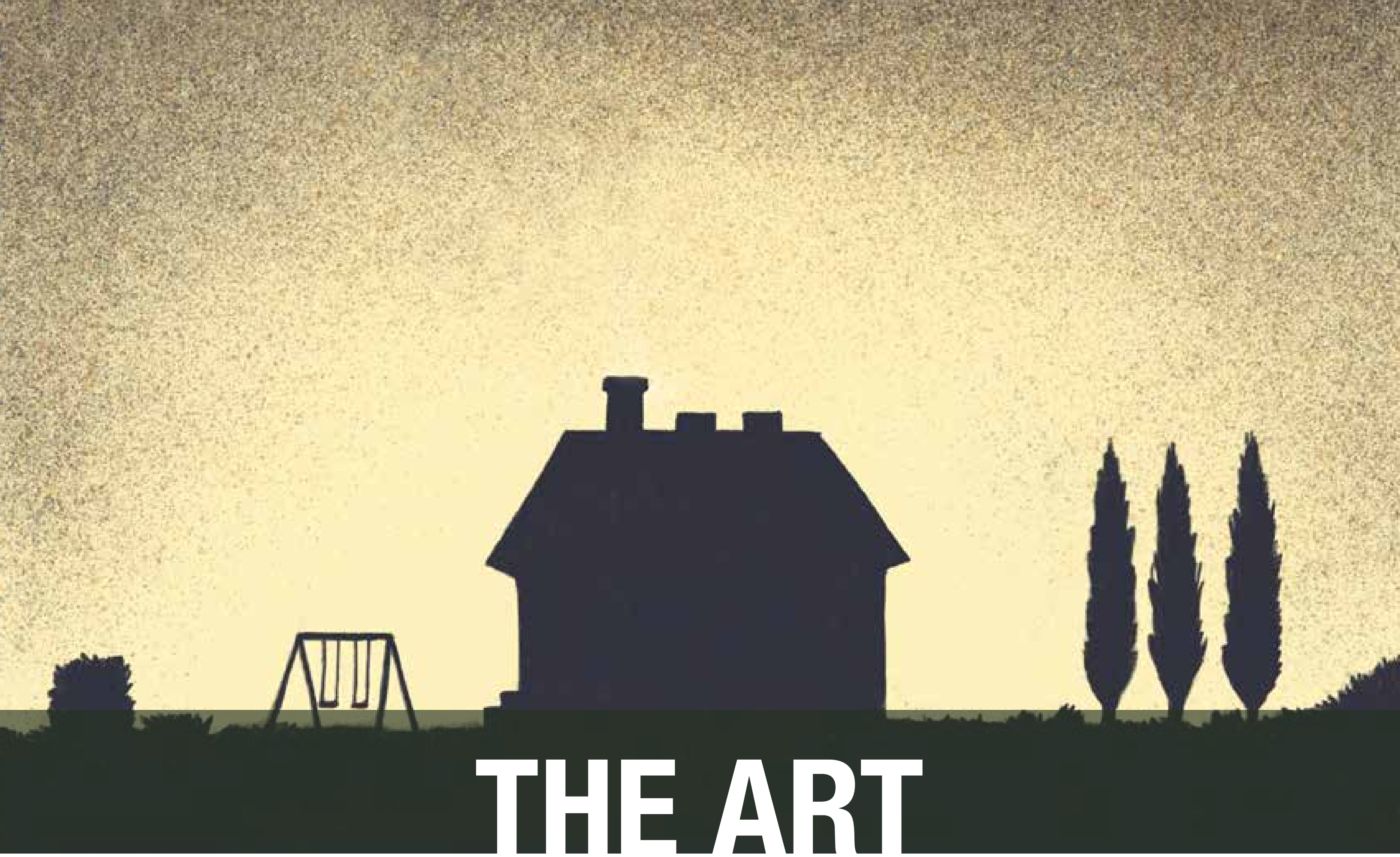


THE ART
of Real Estate Investing

I would like to discuss today some of the principles of the art of real estate investing. To use the lingo of the stock market, real estate investing is fundamentally an activist endeavor. Sure, you'll find buy-and-hold investors now and then and in rare moments of market meltdown you can even invest like a traditional value investor, but by and large, real estate investing is about finding ways to actively add value. This is what really drew me to the space. Psychologically, I had this need for tangibility in my work, the opportunity to touch and feel what I'm investing in and see things manifest in the "real" world. I wasn't getting that from investing in publicly traded securities.

Anyway, before I get into the details of various activist strategies, I want to discuss briefly two really important phenomena: inflation and cyclicality. These two forces are the natural laws of the real estate market. They are always there, operating in the background, and can have a powerful impact on the success or failure of a deal.

Let's start with inflation, one of the most powerful and least understood forces in history. You find it operating in all eras, all civilizations and all systems. It's like a hidden world moving power, driving not only economics but also politics and evolutions in the global order. For all of our sophisticated mathematics and economics, I am convinced that we don't really know anything about inflation and how it works. It's like that background radiation in space that we think comes the Big Bang (but actually have no idea what it is). For our purposes, as investors, we just need to know that it is there, always working in the background, always a threat.

Now, inflation is interesting because it offers real estate investors the opportunity for meaningful passive gains. For certain kinds of property, if you set-up the ownership and finance structure in the right way, you can buy, do almost nothing and still achieve great returns. Before ETF's, this was probably the strategy of the rich for wealth preservation and long-term returns.

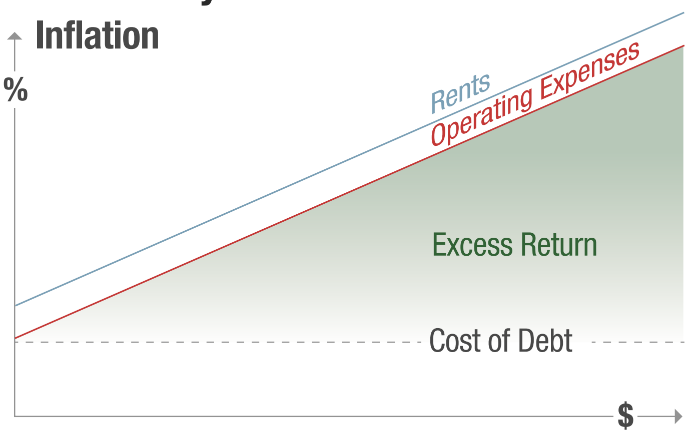
Here's how the inflation strategy works: You first have to find an asset that consistently benefits from inflation. You cannot just buy any old property. You have to find something where the rents will actually keep pace. And the answer to this question has changed throughout history. In the Agrarian Era, you wanted to own big, productive farms close enough to the transportation infrastructure of the day. In the modern Industrial Era, but really throughout history, the most reliable property type has probably been urban residential and multifamily. Once you find the right property, you have to figure out how to own it in the right way. Either you own it outright (i.e., without debt) or you secure debt with a fixed rate that is less than that of inflation.

Interest on Loan < Rate of Inflation

This simple equation is the oldest, most consistent form of financial alchemy in history. To use the lingo of modern finance, with this strategy, you essentially get leveraged equity exposure to an asset with appreciating cash-flow (i.e., rising rents) and fixed expenses (at least in terms of the cost of debt).

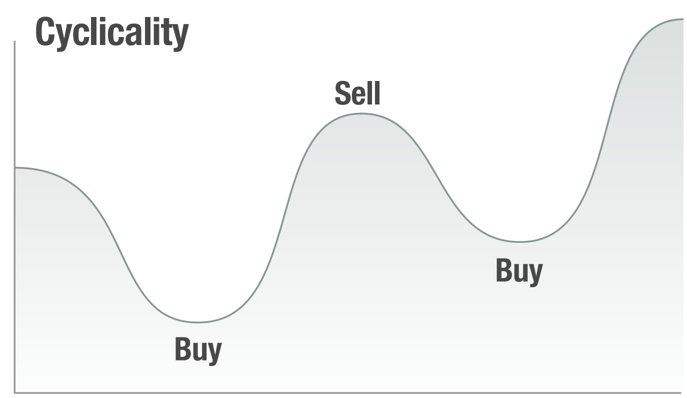
Here's what this financial alchemy looks like in chart form:

The Alchemy of Inflation



With some special assets, like an apartment or condo in a city like Hong Kong, you don't even need the cash-flow for this formula to work. In other words, the inflationary pressure is so strong that what you get from appreciation is enough to offset the operating cost of just owning the asset.

Even with this powerful inflationary force operating consistently in the background, real estate is not immune from volatility and cyclicality. Real estate assets trade up and down like anything else in the market:



Although it often works, you cannot just buy real estate with fixed priced debt and call it a day. The art demands much more of us than that. If you buy at the wrong time in a cycle, you can really get hurt. This is a dangerous (and competitive) game.

One of the interesting things about real estate is that there is this somewhat annoying phenomenon—at least for people like me who do this for a living—where everyone thinks they know something about real estate investing. Just because you played Monopoly as a kid, understand intuitively the meaning of "location, location, location," and bought your first house, doesn't mean you are a real estate investor. This is a serious endeavor. It's interesting because with the stock market, which offers an analogous challenge, people are much more willing to conclude (correctly) that they have no idea what they are doing and should probably consult an expert.

Ok, back to the art of real estate investing. Outside of these big macro forces—inflation and cyclicality—real estate investing is fundamentally an activist game. That is, the way to produce superior returns—to beat the market—involves doing something with the properties you acquire that somehow improves their operating performance or value. There are three main strategies:

1. Do something to physically improve a property. This is the basis, for example, of the house flipping game, which has so captivated our culture. You find an asset that has deteriorated through time in a market that is currently desirable and then fix it up so that it is appealing to a modern buyer.

2. Do something to improve the operational performance of a property. Managing properties, whether they are apartments, offices or retail centers, requires a certain kind of skill and like any endeavor some are better at it than others. Often, you can find properties that are simply mismanaged and by making changes on that front you can improve either the top line (get higher rents or occupancy), the cost (reduce operating expenses) or both.

3. Do something to improve the underlying legal value of a property. Essentially, what this entails is changing the use potential of a property either by taking advantage of a disconnect in existing zoning—for example, in big cities, you'll often find properties where the existing underlying zoning allows you to build much more than what is currently there (e.g. you can build a 10-unit apartment instead of the triplex that exists currently)—or changing the zoning outright (which often produces the biggest returns in the business).

What I love about real estate is that, while the activist strategies themselves are all very simple, they each present in themselves a wide field for creativity. There are many ways to renovate a house, for instance, and some are better than others. You can put your stamp on things and, at the same time, make a difference in your financial returns. The canvas is there for expression.

What I have found over the years is that real estate investing is dominated by five important archetypes:

1. The Trader
This is the "deal person," the person who is hyper-focused on taking advantage of market dislocations, either during big cyclical downturns or as a result of some micro market breakdown. A lot of people fancy themselves to be traders or wish they were but this requires a very specific kind of personality and temperament. You have to be competitive and aggressive and, at the same time, good with people.

2. The Construction Guru
This is the person who just loves the whole process of building. You see this archetype a lot on the real estate TV shows. Construction expertise is a technical skill that can give you a great advantage as a real estate investor. It's the equivalent to the "winning on cost" strategy that you find in business strategy.

3. The Designer
This is one of the more attractive archetypes. Everyone wants to believe they are good at design! At its core, this archetype is all about "winning on quality" and I've found that it's really a powerful strategy. At its core, real estate is a consumption good. It's different obviously than selling a product or service. When you sell space, what you are really selling is a psychological reaction. When you enter a space, you are considering buying or your mind starts to forecast both what you are going to do and how you are going to feel. And a really well-designed space can materially improve the nature of that psychological forecasting. This is why people will often "over-pay" for real estate.

4. The Manager
This archetype is probably the rarest and least exciting but cannot be ignored. Many of the best real estate investment strategies involve property and asset management and like with construction, there's a technical skill involved that can give you a competitive advantage. You have to be good at leasing, dealing with tenants, handling maintenance, accounting …etc. Even though on its face it seems like such simple stuff—"How hard could it be to manage a luxury apartment building in Los Angeles for example? Don't you just have to collect rents and occasionally handle some maintenance requests?"—I have experienced firsthand the massive variability in performance that can come from having good or bad management.

5. The Politician
In some sense this is a niche archetype for it's really only found in strategies that involve development. But it is an important one to understand because those who excel in this area can produce some of the best returns in the entire game. We kind of all know this person already. It's the networker, the individual who understands how to deal in influence and connection, the person who knows how to gain access to the halls of power (and thrives on it!). The development process is confusing, opaque and often corrupt. To successfully and legally get a property rezoned is one of the most difficult feats in the entire real estate game. This is probably why you see so many cases of developers taking the easy route and just paying the bribes that the real politicians keep asking for!

Each one of these approaches requires a certain kind of personality and temperament. Rarely is someone naturally suited for all of them at the same time, but if you can combine a few of these archetypal strategies yourself or build a team that does, you can really set yourself up for success. This is where understanding yourself becomes really important. Maybe you are inclined to see yourself as the Designer but are no good at it (this is very common!) or wish you were a Trader but just aren't built that way (also very common). It's a matter of getting clear with yourself about how you can authentically excel in this art.