The Pinkard Fund

Investor Update — October 2016

Market Update — For Q3 2016

With a little more than one week before Election Day we are more than ready for this particular election to be behind us, yet the truth is the results really matter. While political risk is always a factor in the real estate investment world, and particularly in Washington, DC, investors will continue to wrestle with the same issues post-election that have proved challenging over the past couple of years. Where does one invest late in the cycle, when all asset classes seem fully priced and interest rates are at historic lows? Many sophisticated investors have made the choice to invest in real estate in this environment, and it seems that an equal number have avoided the asset class. Disappointing performance by hedge funds, a lackluster equity market, and low expectations for bond performance have helped make real estate look attractive by comparison. On the other side of the coin the fear of an impending recession and the potential for rising interest rates signals caution. What should the prudent investor do? The simple answer is: be diversified because there is no right answer. In our view there is another approach which guides the way we invest. Invest where you have some control of the outcome.

We see four major areas where value can be created at the asset level with varying levels of control on the part of the investor. The four areas are: buy the asset at a below market price, strategically change the asset to be more competitive in the current climate, have the fundamentals of supply and demand for the product shift in your favor during the hold period, experience falling interest rates or cap rates during the hold period. It is rare that you get all of these factors to work in your favor on a given investment, but sometimes the stars align. The key is to control what you can.

Buying Below Market - This is really hard to do on a consistent basis. We work a lot on off-market deals. While we have made some good buys, it always seems that someone is waiting in the wings if we stumble. Most of these transactions clear at something close to the market price. However, focusing in this area does avoid the buying frenzy and resulting overpayment on sought after, marketed properties.

Changing The Asset - This is the activity where asset value can be improved regardless of unpredictable cyclical dynamics. The concept is to improve the capacity of the asset to produce cash flow. Turn a B asset into an A. Turn a piece of land into a building. Solve a problem which is holding back the asset's ability to produce cash flow. Creating asset value is the area where the real estate owner exhibits the most control. Value is created both by having a vision and through efficient execution of that vision.

Anticipating Market Fundamentals - Being on the right side of property fundamentals can make all the difference in creating value. In our last quarterly report we showed a JLL chart that suggested the Washington office market had bottomed. We have been talking about that for some time in this report. There is no sure signal for the bottoming of the market, but serious attention to the details and the dynamics of markets and submarkets will yield positive timing more often than not. On the other hand, all of the value creation in the apartment market locally is the result of cap rate compression as rental rate increases trail projections due to continued additions to the supply.

Falling Cap Rates - Falling cap rates have created a lot of value for real estate owners over the last few years, but this is the least controllable area of value creation. Back in 2008 many top economists were predicting higher interest rates due to quantitative easing which was supposed to be highly inflationary. It made sense at the time, and year after year projections for rising interest rates were made by virtually all of the top economists. It has not happened, and here we are eight years later. We don't spend a lot of time in this area because it is not within our control or really knowable with any degree of certainty.

The approach is simple. It might be referred to as fundamental investing. Buy good real estate. Don't overpay. Implement a thoughtful value add strategy. Know your market so that you are more often than not on the right side of the cycle. Recognize that you have little clairvoyance on interest rates.