The Strategic Investor Mindset

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Reality is determined not by what anyone else says or believes, but by what the evidence reveals to us.

—Alan Hale

Mindset Matters

Real estate investors, strategic and non-strategic, often define themselves as entrepreneurs interested in the creation of long-term wealth. While similarities between these two types of investors do exist, the mindset of strategic investors bears a closer look. Before we tackle the ways a strategic investor uses the real estate cycle to guide investing, let's look at what it means to have a "strategic mindset" and why it is so very important to success.

The strategic real estate investor defines "reality" as the state of things as they actually exist. What's significant about that definition is that it does not include references to socially constructed versions of reality (the idea that reality is what you *think* is real). Here, reality is solely about what "is" versus what may "appear" to be true based on the biased perception of an individual or group of individuals. Strategic real estate investors have a particular mindset because they pursue reality relentlessly. Determined to take action (employ tactics) based on what is actually happening in the market, they know that their ability to identify real-world market cues is essential to being able to effectively use information about real estate cycles to their advantage. They seek reality in unbiased facts and truths (the state of things as they are) and separate them from ones that are tainted by predetermined motivations (based on biased perceptions).

This point is important because most real estate investors would profess that they do pursue reality. However, few actually go far enough to earn the right to call themselves strategic investors. Why? Because the pursuit of reality is a daunting task. Truth often goes against popular sentiment and requires that individuals look well beyond headlines and statistics. In real estate investment, the pursuit of reality requires diligence and trusting the facts. It demands a rejection of emotion and a willingness to ignore the media-fuelled highs and lows in reaction to shifts in the real estate market.

Cycle Secret

A real estate cycle is not the same as a market shift. Strategic investors take action based on the cycle, not how the cycle is impacted by emotions and biases.

Denial and Lost Wealth

Those who deny the real estate cycle are doomed to lose money. But how can an investor know that he or she is taking action based on reality rather than reacting to market shifts? Surely all real estate investors aim to work in a climate where values constantly rise and portfolios always produce positive results. Nobody sets out on an investment journey to lose money.

While that's true, lost wealth is also what happens when investors take actions that ignore signals from the market. This occurs when investors deny market realities—arguably because they do not recognize what's really happening—and thus take action that proves counterproductive to making economic profit. This is exactly what happened in 2006 in the United States. While many market indicators suggested that real estate values were going to drop, many investors continued to over-leverage themselves. Why did they continue to believe that values were going to increase? Why did so many take the wrong actions in the face of an impending slump? By ignoring what the real estate cycle was telling them, these investors exhibited the classic symptoms of denial—and their ignorance cost them dearly.

Harvard Business School professor Richard S. Tedlow eloquently makes this point in his book, *Denial*. He explains that "denial is a pervasive problem not only historically but today. It seduces not only dreamers but the most rational people among us. Why is it seductive? Because it is soothing. It is convenient. It allows us to live in a world of our own creation—while it lasts. It permits us an 'as if' existence. We live 'as if' things were the way we want them to be, rather than the way they are."

A Case in Point

The High Cost of Denial

It was 2006 and David was on top of the world. Ten years had passed since he left his computer-consulting career with IBM to become a full-time real estate investor, and he now had a net worth of over $12 million. David, a father of three, was providing for his family in a way he never could have imagined. A month after purchasing a new family home in an exclusive area of Scottsdale, Arizona, known as Moon North, his hockey fanatic son Jacob came running home screaming, "Daddy, guess who lives in our neighbourhood . . . Wayne Gretzky!" To David, that was a defining moment of how successful he had become. Imagine that, he thought to himself, we are living in the same neighbourhood as one of the greatest athletes of all time. Things just couldn't be better.

The next day, David went to a meeting to finalize a partnership with another real estate investor named Kelly. He had met Kelly at his local tennis club a few years back. Kelly, like him, had the ability to see great opportunities others could not. After doing many smaller deals together in the past, both were eager to move forward on a very large project. At least, that's what David thought the meeting was about. As they sat down to talk, Kelly began the meeting by saying, "David, I can't do this deal with you."

Surprised, David asked why there'd been a change of heart, and Kelly's answer was swift and sure: "Because this market is going to crash, that's why."

"And what makes you so certain?" David asked.

"Over the last year, I have been researching real estate cycles trying to get a handle on what is driving this market," Kelly replied. "I have come to the conclusion that it is cheap, easy-to-obtain financing, coupled with speculation fuelled by greed. If we start this project, it is going to take three years to complete. I am convinced this boom will be over by then and we will be in serious financial difficulty. Therefore, I am out."

David was disappointed, but not daunted. "I am sorry to hear that, Kelly, because this project is one of those once-in-a-lifetime deals and I will be going ahead." Dismissing Kelly's theories about the real estate cycle, David proceeded with the deal and signed a personal guarantee to secure the required financing to build the project. In his mind, the Phoenix market would continue to grow. Arizona has a great renewable resource (sunshine) and real estate values were half of what they were in neighbouring California. As long as the sun kept shining, droves of baby boomers would be arriving in Phoenix for years to come and that equalled increased real estate values.

Kelly, meanwhile, started aggressively adjusting her portfolio in preparation for what she felt would be a significant downturn in the market. She even sold her principal residence, also in Troon North, and started renting. (Kelly recognized that falling rents were an indication of an approaching shift in the real estate cycle from boom to slump.) By divesting herself of a number of properties, Kelly brought her overall loan-to-value ratio down to below 25 per cent, and she also built up large cash reserves. Her plan was to sit on the sidelines, enjoy life, and wait for deals to show once the downturn came. Keeping her beach condo in Hawaii helped in this strategy, although she did sell her yacht, much to the dismay of her family and friends!

Unfortunately for David and his family, the dream lifestyle that he'd built was short-lived. By mid-2008, he had lost it all. The large project that he'd invested in heavily never got past the first phase. With only 5 per cent of the 75-unit phase one sold, he was saddled with a large parcel of land and no ability to finance any further development. The slump also meant he couldn't sell the completed units at anywhere close to his break-even construction costs. The bank foreclosed, and in the process David was forced to declare bankruptcy.

David's story is not an uncommon one in the real estate investment community. After years of hard work and good decisions, one deal fuelled by greed and enabled by denial led to his financial demise. Too often investors make sound purchases based on market fundamentals, and then ignore what those fundamentals tell them when the cycle begins to shift.

Alert

This case study illustrates that denial is a defence mechanism that hinders the acceptance of reality and our ability to take the appropriate actions. Our egos galvanize denial because often we don't want to admit we have made a less-than-perfect decision or choice. It may make us look bad in others' eyes, and it may lead to financial consequences we don't want to deal with.

Aside from financial gains, goals and dreams are also at stake. Denial is so powerful because anything that might derail those goals and dreams, including the truth, is often denied and dismissed. Instead of adjusting their actions and tactics and preparing for the change, people find it easier to deny a situation—even when the writing is clearly on the wall. Clinging to the "if only" scenario might be as soothing and convenient as Tedlow describes, but it can also have disastrous results.

Cycle Secret

When investors are ready to confront denial and face reality, they have taken the first step toward understanding the mindset of a strategic investor.

The Strategic Investor's Point of Reference

In order to acknowledge the emotions at play in the real estate cycle, you need to understand your point of reference and what factors contribute to the way you filter and perceive information. In the words of acclaimed author Anaïs Nin, "We don't see things as they are; we see them as we are." The end result is a socially constructed view of reality that is true to our own perception of what's happening in the world—but that can deny greater truths.

Strategic real estate investors understand that their point of reference is the origin of their opinions. As infants, our point of reference is in the neutral, or unbiased, position. As we age, our upbringing and life experiences naturally bias us and nudge our point of reference in a particular direction. This factors in to how we receive, perceive and filter information. In the context of the real estate cycle, the two most prevalent emotions that move the point of reference into a biased position are fear and greed.

ALERT

Strategic real estate investors recognize and understand that fear and greed can confuse our ability to assess the reality of a real estate market.

Fear and Greed

Real estate investors are not necessarily fearful or greedy. But these two emotions do motivate investors to take action, avoid action or simply do nothing—even when the real estate cycle is telling them to do otherwise. These emotions are particularly dangerous because they operate in the subconscious mind by confusing our point of reference. When that point of reference is biased by the emotions of fear and greed, it impacts the way we filter information, form opinions and adopt tactics.

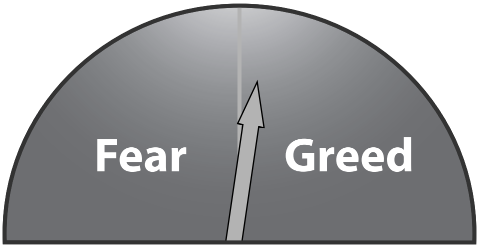

Figure 1.1: Point of Reference for Investors

Opposite Expectations It is important to recognize that while fear and greed are similar motivators, they are accompanied by opposite expectations. As we see below, they motivate us to take similar actions, but for different reasons.

Common fear motivators:

- the potential for a repeat of history, resulting in loss of wealth
- the potential to fail by missing out, resulting in loss of opportunity
- potential risk to the ego, resulting in embarrassment
- potential financial risk, resulting in financial burden

Common greed motivators:

- the potential for a repeat of recent history, resulting in profit
- the potential for success by capitalizing on opportunity
- potential ego boost, resulting in pride
- potential financial reward, resulting in a rapid increase in wealth

Now that you are aware of the fear and greed motivators, it is important to recognize how they are manifested in your actions, either positively or negatively. An investor fearful of a repeat of history probably has suffered financially or emotionally as a result of a previous investment decision. This fear could stop him from buying more real estate and/or could inspire him to sell off his investments at the first sign of a market shift. Similarly, greed can manifest itself in the belief that the more real estate you accumulate, the better off you will be. This ignores the maxim that greater exposure to real estate does not guarantee success. In fact, consistently extending financial resources to accumulate real estate can have severe consequences, potentially making the financial burden too high to bear.

In the end, both fear and greed can bias your point of reference and cloud your ability to clearly perceive reality. Investors will rationalize facts (or perceived facts) because the facts don't quite fit with the reality of the information that is in front of them. This is not strategic, since it means they are denying the situation. Instead of assessing market facts, these non-strategic investors seek confirmation, false or otherwise, that they are making the right choices. They find comfort in headlines or sentiments that uphold their position, while denying a more constructive course of action.

ALERT

Think about when you read the newspaper. Do you have a natural tendency to "feel good" about the articles that agree and validate your reality? Do you dismiss the articles that don't corroborate your views? Which fear and greed motivators affect your point of reference? Be honest!

Strategic Investors Seek the Neutral Zone

Strategic investors are able to use fear and greed to their advantage when they keep their point of reference in the *neutral zone*.

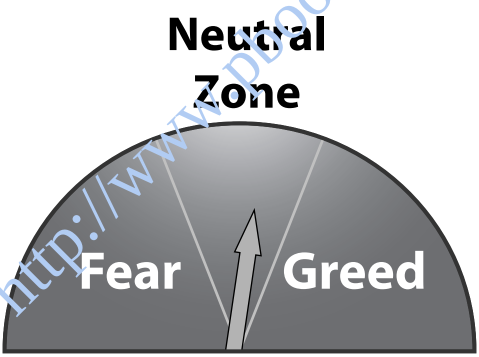

Figure 1.2: Point of Reference for Strategic Investors

When investors are in the neutral zone, they set aside their emotions. This does not mean removing emotion altogether, as that isn't human nature. In the neutral zone, emotions are recognized but not accepted as either right or wrong. Identifying the motivations of fear and greed will ultimately provide valuable clues once you begin analyzing real estate cycles. Because you are in the neutral zone and filtering information in an unbiased manner, you can then make purposeful, non-reactionary investment decisions. This prevents fear or greed from clouding rational decision-making.

A Case in Point

Fear Factor

Sadeep and his brother often discussed real estate. They both had several properties in their portfolios and considered themselves fairly successful. Sadeep's brother recently invested with a group that was building townhomes. The return on investment (ROI) was fantastic, and his brother made sure to brag to Sadeep every chance he got. He had convinced some mutual friends to invest along with him and he talked that up, too. The brother was pressuring Sadeep to also invest in the project, reminding him that he was soon going to have to pay for university education for his kids. This project was lucrative and one of a kind. How could Sadeep not get involved?

That question weighed heavily on Sadeep, since paying for his kids' education was the reason he started investing in the first place. Sadeep began to think that he may never get this chance again. Besides, his brother had already made a lot of money on the deal.

Then Sadeep caught himself. He was always careful to make well-thought-out rational decisions, and now he was considering investing with his brother because he was afraid he would be missing out on a great opportunity. This before he even knew all of the facts of the project! His point of reference had shifted toward fear and he knew he had to bring it back to neutral before he made a decision based on a negative emotion.

Maybe this was a great project to invest in, or maybe it wouldn't be a good fit. Either way, Sadeep was going to base his decision on facts, not fear.

Strategic investors know that fear and greed are natural emotional responses to life situations. Staying in the neutral zone provides the healthy dose of fear and greed that is essential to being a strategic real estate investor. In fact, the neutral zone gives strategic investors a huge advantage over average investors because it enables you to look at a situation while using what you know about fear and greed to assess your options. Being too fearful can nurture procrastination and possibly lead to missed opportunities. Being too greedy can result in being over-leveraged or being saddled with substandard or under-performing properties. In the words of renowned American investor Warren Buffet, "be fearful when others are greedy and greedy when others are fearful."

CHAPTER SUMMARY

Strategic Thinkers, Smart Investors

Strategic investors take deliberate steps to make sure their decisions are based on reality; they do not take steps based on conjecture about what they *wish* was happening, or based on the emotional hype of fear or greed. This is easier said than done, since a skewed perception of what's real can prevent us from recognizing larger truths.

But take heart. You can learn to invest strategically. The first step is all about developing a mindset that values reality by teaching you how to identify and interpret specific market signals related to different phases of the real estate cycle.

You've already got that mindset. Let's focus on learning more about the specifics of the second strategic investor element, the real estate cycle.

CYCLE SECRET

To help strategic investors navigate the complexities of the real estate cycle, the end of this book features the compelling stories of several Canadian strategic investors. In addition to documenting their journeys, we show how they used the power of the real estate cycle to create and sustain wealth. They will share the lessons they learned as they grew their portfolios and discovered why understanding the real estate cycle was critical for their success.