WESTGROUP CAPITAL

Our Fundamental Laws of Real Estate Investing

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West Group has a series of 50 real estate investment principles that are derived from successful value investors in the equity markets. We call these *The Thrifty Fifty*. Most of these principles are well known, open and in plain sight. We have applied these principles to real estate investing as we believe the value-oriented, buy and hold model consistently provides the highest risk-adjusted, after-tax return for investors.

We have arrayed our experience – both vicarious and direct – on this framework and have synthesized these concepts into a unified investment approach for West Group that forms a foundational basis to how we make an investment decision. We measure our performance against these principles and have used them successfully on scores of real estate transactions. These ideas enable us to eliminate the chaos and confusion of otherwise complex investment situations. While many of these principles overlap, none are mutually exclusive. Some even compete with each other.

While many of the principles have been intentionally tailored by us to real estate, the bedrock of most of this thinking cuts across many disciplines, areas of business as well as life itself. Some examples, like having a redundancy/backup system are taken from engineering. Others – such as the compound interest model - from mathematics.

Our Findings The core of these investment principles were effectively used to achieve a 20.2% after-tax compound over a 46 year period beginning in 1965 and ending in 2010. In short, they are based on "good math".

The interesting thing, however, we have found over the years is that while many of these principles are commonly mentioned by others in pitch books, on websites and in company tag lines, few organizations surprisingly actually follow any of these principles despite their highly respected roots, widespread publication and proven effectiveness over multiple decades. It is not entirely clear to us why but we have our suspicions.

Nevertheless, we believe most of these principles run contrary to conventional wisdom despite being in the mainstream. While no single principle is carved in stone, we keep these principles at the forefront of all investment decisions. We do our best to implement them whenever possible in today's world although some have proven challenging to achieve (like buy and hold forever). In practice, we have found few investors willing to accept such an investment horizon. That said, we have unshakable confidence in these principles. We have structured our business model – and our long term plan - with this framework in mind. In essence, we are "all in".

To understand these principles is to best understand how we think – although most of these concepts do not represent our original thinking. We borrowed from those smarter and wiser than us.

In being perfectly candid, we distinguish these investment principles from many of our business ideas at West Group that we consider proprietary and guarded. After all, we are a competitive organization and are not about to give away the store. We have included a few tidbits mixed in to stimulate interest but just like a good chef, we have left out a few things when discussing the recipes for our best dishes.

Some of these concepts are phrased in institutional speak, others in plain and sometimes raw language so as not to distort their meaning. We hope you enjoy them and find them as useful as we do. And if you have the guts to practice them, go for it. Otherwise, please feel free to call us as I am sure we can figure something out.

Regards,

John Montgomery
Founder

1 Buy and Hold

Our preferred holding period is forever. Embedded in this concept is one key rule. Only invest in properties that are good enough to outperform for decades.

If we buy a property just because it is undervalued, then we have to think about selling it when it approaches our calculation of the property's intrinsic value. This is difficult. But when we buy only great properties, we no longer have to worry about selling them. Thus, we are partial to putting out large amount of capital where we will not have to make another buy-sell decision for a long time.

We also believe that if we buy a few great properties at fair or bargain prices, we can be confidant with this decision and not look back while our investment compounds. We realize if we can hold an investment for a long stretch of time we will get a major benefit just from the way income taxes work as we will avoid the profit-eroding taxes that would be imposed if we sold the investment. Lethargy, bordering on sloth, is the cornerstone of this principle. We know most investors cannot resist the temptation to constantly buy and sell. While we always actively manage our properties, we know much success can be attributed to inactivity on non-operational issues.

We generally do not sell underperforming properties if the underlying reasons that governed our initial purchase decisions are still present. Instead, we focus on curing the problems that cause the investment to lag.

After a desired level of improvement has been done to the property, West Group typically refinances the property to the longest term financing available. As part of such a refinancing, we may choose to withdraw cash from the property tax free and deploy it for reinvestment in other acquisitions or return it to our investors.

West Group believes people will continue to want to live in San Francisco decades from now and that they will be willing to pay for the privilege to do so. Accordingly, we only like to sell a property if the initial assumptions made about a property are no longer true or to shore up a cash position as we know in business "cash flow is more important than your mother".

In an effort to embrace this all powerful precept while accepting the practical realties and demands of today's investment world, we often attempt to have our cake and eat it too. The majority of the time, for example, we organize our investment structures with maximum flexibility. That is, to allow for investor liquidity in one form or another while concurrently allowing for the possibility of retention of the underlying asset when reasonably possible. We do this in several ways. In doing so, we satisfy our investors' desire for a defined exit and timetable while also giving them the option to decide to stay in the property at a later date should they decide to do so.

If we do ever choose to sell a property, our goal is to first bring the property to the top of its financial performance potential. We use liquidation and exit strategies that have been successfully used in the past, including 1031 exchanges, condo conversions, tenancy-in-common conversions and cash-out refinances on replacement properties. Liquidation and exit strategies vary depending on market conditions and the investment structure ultimately selected.

2 Maintain a Healthy Margin of Safety

In engineering, the industry uses a margin of safety to ensure a building or bridge does not collapse. In this situation having a built in redundancy/back up system for safety reasons makes perfect sense. But in the real estate investment world, many do not incorporate the same principle.

West Group believes the three most important words in investing are "margin of safety". Margin of safety is the difference between the value of a property and its purchase price. It is a discount-from-value approach. We calculate the value of an investment by determining the projected annual compounding rate of return the investment will produce in our hands with our business plan. The annual compounding rate of return the investment is projected to produce is the value we use to determine if the investment makes business sense when compared to other real estate investments.

West Group maintains a healthy margin of safety on all investments.

3 Price Determines Return

Many real estate advisors believe that if you are buying a great property you anticipate holding for a number of years, you need not be all that concerned about the price you pay. Nothing could be more wrong.

The price we pay determines our rate of return. This is a key we wear around our neck at all times. The higher the price, the lower the rate of return. The lower the price, the higher the rate of return. Pay more, get less. Pay less, get more.

4 Seek a Compound Return

Compound interest is the 8th wonder of the world – one should not interrupt it unnecessarily. West Group believes investing over the long term takes tremendous patience and discipline but yields superior results largely due the power of investment compounding. It is probably the greatest investment secret that eludes most investors. West Group seeks on its investments the highest annual compounding rate of return for the longest period of time possible that is not subject to income tax.

We believe time is the friend of a great property and a curse to a mediocre one. We strive to leave our cash inside the great buildings we own, making them largely free from the punitive effect of income taxes. This enables us to put off capital gains tax to some far-off date and to enjoy the fruits of compounding. We believe, in order to do well, one does not have to make money overnight. One only has to earn consistently above-average annual rates of return over a long period of time period.

5 Wait for the Right Opportunity

West Group believes strong returns only follow from going after great opportunities. To West Group, success means being very patient when looking for a buying opportunity but aggressive when it is time to buy. West Group believes if we wait patiently for the right opportunity and we have the courage and vigor to grasp it firmly when it arrives, we will be able to participate on the investment with the full weight of our capital in a meaningful way.

6 Stay Within the Circle of Competence

One of the things we try very hard to do is to stay within our circle of competence. This generally means only investing in situations we understand. West Group believes the important thing is not how large the circle but how well its perimeter is defined. When in doubt, we exclude.

7 Be a Contrarian

We know humans are prone to herd because it is always warmer and safer in the middle of the pack. Indeed, human brains are wired as social animals.

West Group believes in being fearful when others are greedy and being greedy when others are fearful. We are skeptical of conventional wisdom. When the investing public is extremely negative, it is usually a good time to buy. When investors are confidant, we are careful. We know mimicking the herd invites regression to the mean and average performance. We believe optimism is the enemy of the rational buyer.

We often buy when most others are selling and properties are cheap. We often sell when most others are buying and properties are expensive.

8 Embrace Focus Investing

West Group's investment style is focus investing. We work within a defined market and search for unusually mispriced opportunities. We like to buy concentrated positions. When we find a property we like, we buy it. We think it is hard to find good investments so we concentrate on a few.

We believe that good ideas are rare. When the odds are greatly in our favor, we bet heavily. Our risk protection comes from understanding the market better than the market does and being patient enough to buy a property at the right price. Risk can be greatly reduced by concentrating on only a few holdings. We think excessive diversification does not make sense and do not believe that it yields good results. We think all good investments involve relatively low diversification. We think excessive diversification is only required when investors do not understand what they are doing. Instead, we put a few premium eggs in the basket after careful selection and watch the basket very carefully.

9 Measure & Manage Risk

All investment evaluations begin by measuring risk. We insist upon proper compensation for risk assumed. We are always cognizant of inflation and interest rate exposures and structure our transactions accordingly.

We do our best to avoid big mistakes and shun permanent capital loss. The permanent impairment of capital can arise from many sources including (i) valuation risk (paying too much for a property), (ii) fundamental risk (underlying problems with a property), (iii) execution risk (execution of a property's business plan) and (iv) financing risk. By measuring and managing these aspects of risk, we are considerably better served in avoiding the permanent impairment of capital.

10 Distinguish Price and Value

Price and value are not the same thing. Price is what you pay; value is what you get. Do not confuse the two.

11 Apply the Double Barrel Test

We measure the riskiness of an investment by the reasoned probability of that investment causing a loss of purchasing power over the contemplated holding period. Assets can fluctuate greatly in price and not be risky as long as they are reasonably certain to deliver increased purchasing power over their holding period. We prefer investing in productive real estate assets that (i) have the ability in inflationary times to deliver output that will retain its purchasing-power value while (ii) requiring a minimum of new capital investment over the target holding period.

12 Seek Properties with Wide Economic Moats

A key characteristic supporting consistent building operating history is a sustainable competitive advantage. In other words, a property should have a barrier to entry – or a kind of moat – that keeps potential competitors at bay. West Group seeks to establish soundly run properties in good locations because they have wider economic moats than poorly managed properties in undesirable locations.

13 Stick to the Basics

West Group believes it is often possible for a tortoise, content to assimilate proven insights of his best predecessors, to outrun hares that seek originality. Many hares do not want to be left out of the crowd that ignores the best work of the past. We try to profit from learning from others and always remembering the obvious rather than trying to grasp the complex and esoteric. We know it is not necessary to do extraordinary things to get extraordinary results.

14 Know What to Avoid

We believe investment success comes first from knowing what to avoid. We initially focus on what not to do – before we consider the affirmative steps we will take in a given situation. We gain enormous advantage by summarily eliminating all unpromising portions of the chess board and quickly eliminating the universe of what not to do.

By batting away many things, we avoid clutter and stay nimble. We then follow up with an informed and decisive attack on what remains only when the right circumstances appear.

15 Stay Objective

West Group believes objectivity and rationality require independence of thought. We know that just because others may agree or disagree with our opinions does not make us right or wrong.

When making an investment decision, we are neither right nor wrong because the crowd disagrees with us. We are right when our data and reasoning are right.

16 Always Prepare

West Group believes the only way to win is to prepare. We are lifelong self-learners and cultivate curiosity and strive to become a little wiser every day. We develop fluency in our investment principles and thinking from the great thinkers and industry titans that have come before us.

17 Be Patient

We think patience is in rare supply these days. Modern investors concentrate too much on annual, quarterly, monthly, daily or even minute-by-minute price quotes of what they hold and too little on immediate yield and intrinsic worth.

In the absence of attractively priced properties with healthy margins of safety, we either raise cash or just sit on it. We avoid unnecessary transactional taxes and frictional costs and never take action for its own sake. We are always alert for the arrival of luck and enjoy the process along with the proceeds.

18 Be Decisive

When proper circumstances present themselves, we act with decisiveness and conviction. We know that opportunity does not come often, so we seize it when it comes. We know that when opportunity meets the prepared mind, we will do well.

19 Accept Change

We live with change and accept some of its complexity. We recognize and adapt to the nature of the world around us and do not expect it to adapt to us. We recognize reality even when we do not like it.

20 Focus

We focus on achieving what we set out to do. We guard against the effects of hubris and boredom. We do not overlook the obvious by drowning in the small details.

21 Beware of Mistakes of Omission

We believe the most commonly overlooked mistakes are mistakes of omission. There are two kinds of these mistakes. The first – is the mistake of doing nothing what we call sucking your thumb. The second is buying by the thimble things one should be buying by the bucket. These opportunity costs do not show up on financial statements or K-1s but come at a huge price. We believe great investment opportunities do not come along often and will not last long. One has to act in a meaningful way.

22 Maintain a Good Cash Position

We think sitting in cash while you are waiting for an investment opportunity is not such a bad thing. Money does not ever burn a hole in the pocket. It is not battery acid and having cash available allows us to sleep at night. We think it takes character to sit in cash and do nothing.

23 Keep it Simple

West Group believes you need to be smart but not a genius to be a good investor. We believe the country has become too enamored with the idea that the best and brightest can predict the future; too dependent on complicated financial models; and too reactive to every uptick or slight drop in the market. As such, we avoid using higher mathematics with false precision and instead keep it simple. This enables us make all of our investment decisions in a short period of time.

24 Learn from Others

We seek knowledge and know our own experiences are only a small drop from a large ocean of available wisdom. The more good and bad lessons we can learn vicariously through the experiences of others, the better. When trying to learn a concept, we learn from the best work done before us. We study titans in the particular field rather than abstract concepts. We know knowledge is cumulative. We master the best of what others have discovered.

25 Self-Criticize & Stay Open

We are objective. We continually challenge ourselves and are comfortable testing and destructing our most-loved ideas. We are fearful of those fixed to an opinion that potentially could be wrong. All investment ideas are pliable, disposable and subject to change.

26 Jump Low Fences

We like to jump low fences involving things we understand intimately. We do not try to leap over twenty foot fences with razor wire. Instead, we select one-foot fences with big rewards on the other side.

27 Use Common Sense

West Group believes in using common sense at all times. We believe utilizing very basic knowledge is a powerful tool. To us, part of having common sense is being able to tune out "the herd" and "the noise".

28 Be Reliable

West Group faithfully does what it has engaged to do and concentrates on it. If we concentrate on executing the work on our desk well, the rest will follow.

29 Seek Reasonably Predictable Future Income

We only invest long-term in properties whose future income potential we can reasonably predict.

30 Seek Properties with Excellent Business Economics

We believe a property whose net income is reasonably predictable generally has excellent business economics working in its favor. This allows the property to generate plenty of cash flow that can be used to either buying other properties or to improve the profitability of the great property.

A property with excellent business economics working in its favor is usually made evident by consistently high returns on equity, strong net income, the presence of a great location and management that functions with the owners' economic interests in mind.

31 Price and Expected Rate of Return Determines Buy Decision

We choose the type of property we want to own first. We then let the price of the property and the expected rate of return determine our buy decision. This is the functional equivalent of a boy in high school identifying the girl he wants to date and then waiting for her to break up with her boyfriend before beginning his pursuit.

32 Maintain Business Discipline

Business perspective investing is largely about discipline and is a negative art. It is a discipline that tends to tell us as much if not more what not to buy as what to buy.

We believe the two most important things to know about business perspective investing are what to buy and at what price. We think many investors seem to suffer from an action bias– a desire to do something. We believe when there is nothing to do, the best plan is usually to do nothing.

33 Buy Properties at Prices that Make Business Sense

We only buy excellent properties at prices that makes business sense. This means that the property invested in will offer the highest predictable annual compounding rate of return possible with the least amount of risk. We are motivated by the long term – like a business owner.

34 Buy Assets, Not Liabilities

Forget what they teach you in basic accounting. Assets are things that put money in your pocket. Liabilities are things that take money out of your pocket. We buy assets (or things that can quickly be converted to assets) not liabilities.

35 Invest Rather Than Speculate

We think this term "value investing" is somewhat redundant. There are only two relevant terms in this situation – investing and speculation. You are either doing one or the other. If you are not obtaining value on your acquisitions, you are speculating.

36 Only Invest in Things We Understand

If something seems too good to be true, it probably is. The real estate and financial industry has perfected the art of turning the simple into the complex. If we cannot see through an investment concept and get to the heart of the matter, then we do not invest in it.

37 Plan for Competitive Destruction

When one is truly planning on making an investment over a long period of time such as fifty years or more, one has to be confidant the investment will still be viable in the future due to the forces of competitive destruction. Over the long term, history shows that the chances of any business surviving are small. Translated to real estate, this means selecting properties in locations likely to be good locations for several decades, insuring them, and building in a conservative financial structure to ensure the portfolio can withstand the whipsaw of market cycles.

38 Use Insurance to Hedge Downside

We believe sound investing requires some form of insurance to protect against the downside. We protect all of our investments with insurance designed to protect against most foreseeable events.

39 Control What You Can Control

Poor outcomes are excusable given the fact that some outcomes are outside of control. Sloppy preparation and decision making, however, are never excusable because they are controllable.

40 Look out for Folly and Remember Discipline

Business perspective investing gives us the discipline to exploit market folly.

41 Profit from Market Folly

We do not regard the short term whims of the market as a determining factor in the property value of what we own or want to buy. Instead, we profit from market folly rather than participate in it. We concentrate on the real world performance of the properties we own and only pay attention to a given market's irrational behavior when it can work in our favor on an acquisition or disposition.

42 Remember the Weighing Machine

We believe in the short term, the market is a voting machine, letting whim, fear and greed dictate how it votes. But long term, the market is a weighing machine that values a property according to the weight of its intrinsic value.

43 Investing is Like a Bar of Soap

We believe an investment is like a bar of soap. The more you touch it, the smaller it gets.

44 Measure Performance

We believe in measuring what we have, or have not, accomplished. We measure our performance using rational and accepted methods.

45 Avoid Macro-Economic Speculation

We think it is interesting to try to speculate what will occur on macro-economic issues. And while we will sometimes opine on these issues, we do not base our investment decisions on the direction of the real estate market, the stock market, the economy, interest rates, or elections.

46 Make Volatility Your Friend

Investing in real estate sometimes means dealing with turbulence. Instead of running for the exits during times of market stress, West Group greets downturns as chances to buy great properties.

47 Ignore Market Timing

We do not try to buy at the bottom of the real estate market and sell at the top. Our solution to the market timing question is to largely ignore it. We can do this because we buy into properties on the basis of price. If the price is too high, the investment will not offer a sufficient rate of return and we will not buy it. Where the market is at a given time does not really matter to us. We do not think about it. Instead, we think about the property we are considering buying and whether we can get it at the right price.

We want our compounding to go on as long as possible. Over the short term we know we could sell our properties and make a good return. But we are after a superior return. We know the only way to achieve superior returns is to compound our capital at a high annual rate of return for a long time.

48 Look Ten Years into the Future

We are not very interested in what a property will be paying out next year. We are interested in what the property will be earning several years into the future. While most of the market is focusing on near term issues, we realize that to let compounding work its wonders we have to focus on predicting the future income of a property using reasonable assumptions.

49 Utilize Debt Intelligently

We believe leverage is a powerful, but potentially dangerous, beast. It cannot make a bad investment good but can turn a good investment bad. We know that simply piling leverage onto a mediocre investment does not transform it into a good investment. It can further magnify its lackluster qualities.

Additionally, leverage has a darker side from a value perspective. It has the potential to turn a good investment into a bad one. Leverage can limit staying power and transform a temporary impairment into a permanent impairment of capital.

We believe that leverage should be employed at a level that provides a meaningful enhancement to investment returns with terms that do not put assets at risk during periods when sales markets soften or capital markets become constrained. We prefer long term debt with fixed interest rates.

50 Watch & Appreciate Taxes

West Group structures its transactions to best avoid the eroding effect of income tax. West Group harvests losses to offsets gains within the portfolio when possible and ensures it is maximizing its tax efficiency. We have found deferred taxes are a low-cost source of leverage that allows us to safely own far more assets than our equity capital alone would permit as deferred tax liabilities bear no interest.

About West Group

Founded in 2001, West Group is a real estate investment and advisory firm focused on the San Francisco multi-family residential marketplace. We have earned the trust of a series of highly respected individual and institutional investors worldwide over the years. We offer the following services:

Real Estate Investment Management

West Group is one of the leaders in San Francisco multi-family residential real investment. We create and manage real estate investment programs for private clients and institutional investors.

Sales & Brokerage

West Group provides real estate brokerage services to its private and institutional clients. In doing so, West Group helps clients create, grow and preserve wealth by providing the best real estate brokerage services available.

Advisory Services

West Group is a leading independent advisor with significant expertise in San Francisco based real estate transactions. Today clients trust us to provide thoughtful, custom tailored solutions that help drive their strategic real estate goals.

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