RELATIVE PREDICTABILITY

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Our theme this year is Antifragile, which is taken from Nassim Nicholas Taleb's best-selling book. It's a term that he coined that goes beyond resilience or robustness. While resilient things resist shocks and stay the same, antifragile things improve from disorder, volatility, and stress. Taleb created this term because no word existed to describe things that gain from disorder, unlike fragility (which loses from disorder).

It's not easy to build a business or life that gains from disorder, but it can happen. Warren Buffett and Berkshire Hathaway are a prime example of an individual and firm that are bulletproof financially. When disorder takes place Berkshire Hathaway is one of the first companies wounded firms turn to for life support. Berkshire was built to always have capital and to prosper when capital was priced dearly. This is a prime example of being Antifragile.

At CWS we have tried to build an Antifragile organization that can prosper when more fragile firms are under pressure. We haven't been immune to our challenges over the years, but we have fortunately had access to capital to shore up these challenges to get us through to more hospitable operating and financial environments.

Today I would classify the apartment environment as somewhat fragile, but this fragility is setting the stage for the potential for a much more rewarding environment for those firms with staying power and antifragility. What has transpired to have me classify the environment as being fragile?

Ironically, it's been the tremendous stability of apartments that have created the conditions and actions to lead to a more fragile state. Hyman Minsky was an economist who was best known for his Instability Hypothesis. Minsky posited that stability breeds instability. Essentially, financial actors come to experience and benefit from a stable and growing operating environment which leads to confidence that this stability will continue. As a result, they take on increasingly risky financial structures thinking that they are not really adding much additional risk given that the future will be a continuation of the past. As a result, they look to generate higher returns through financial engineering (i.e. more leverage). This leads to rising asset and collateral values and increasing financial fragility building up in the system. Something changes (e.g. interest rates, a macro trend changes such as remote work, a dominant premise turns out to be wrong, etc.) and capital pulls back, lending tightens up, collateral values are impaired, and the value of assets drops.

Apartments have historically been a very attractive investment because of the durability of their income stream due to how essential they are for our dynamic economy. The United States economy has been the envy of the world as it not only rewards successful risk-taking, but it also doesn't shame or punish failure. A cornerstone of this dynamic is the ability for people to have flexibility to go to where the opportunities are that match their skillset and/or ambition as well as to help get back on one's feet in the event of financial and personal setbacks. Renting enables people to take advantage of both as it offers flexible housing choices for people without any material capital investment to maintain one's home. It also provides housing for those who are unable or unwilling to purchase a home for a period of time.

Given these very compelling attributes of apartments they should experience sufficient demand to fill up vacant units if the rents are at a market-clearing level provided they are in growing areas in neighborhoods with highly desirable amenities such as quality schools, access to jobs, shopping, restaurants, recreational facilities, and places to socialize. Unlike office buildings, where it's possible that very low rents may not stimulate the formation of businesses to occupy vacant space, there is a rent level for apartments that should catalyze the formation of new households to absorb those vacant units.

There are times, however, when fragility may arise if capital becomes too plentiful such that weak sponsors purchase apartment communities with poor execution capabilities, firms have very little margin of safety built into their business plans as they are predicated on aggressive assumptions, too much leverage is utilized with less than five-year loan terms, insufficient cash reserves are raised up front or retained during the holding period, or a combination of some or all of these. The lack of capital discernment often occurs when the operating environment has been quite stable and profitable, and the goal turns to growth and putting more capital to work at the expense of safety. This is how stability can breed instability.

This has very much been the case for lower quality Class B and C apartments that had a perceived value-add (upgrades) story attached to them and could start to materialize for new construction properties as well as having had to absorb the 30% spike in costs and are now coming to market and will most likely be underwater.

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