THOUGHTS FROM THE FRONTLINE

There Is No Alternative

By John Mauldin | April 20, 2024

There Is No Alternative
Changing the Great Reset
Cape Town, Europe (?), and British Columbia

Today, we look at the world of "alternative investing." I put it in quotes because this was originally a somewhat pejorative term. Back in the 1960s (and maybe before?), brokers sold you stocks and bonds, saying that was how smart people invested. Of course, by pure coincidence, they sold these securities at markups and commissions that would choke a horse by today's standards.

If you didn't buy what they sold, they would say you were buying an inferior choice. Like commodities. Or mutual funds. Except mutual funds that brokers sold were also smart investments, with 4–5% fees.

Hedge funds, you were told, were risky alternative investments. For the rich. With high minimums. And in the 1980s and into the 1990s and early 2000s, that was more or less true. But the world changed. "Alternative" is a useful term now, so we will use it.

I became involved in the "alternative" space in the early 1990s as a partner in what the Managed Funds Association later called "the first low-cost public commodity fund." It was not low cost by today's standards, but by comparison. Other, similar funds were charging as much as 20–25%. Not a typo.

Then, in the 2000s, I started really focusing on hedge funds, helping pioneer access to "retail" investors with $1,000,000 net worth and up. I testified to Congress about private funds and access for all investors. I have often thought that if you said certain funds were not available to [pick a minority group], there would be a protest a mile long. But Congress can protect the "poor" by denying them access to funds the "rich" can get. Originally, it kept them buying fee-rich products from brokers, and now it is just a legacy discrimination.

We as an industry were generally quite successful in opening up the alternative space. Now there are numerous portals with relatively lower-cost access to all sorts of funds. But even so, there still remain access issues to some truly elite funds.

I recognized then, as does my partner David Bahnsen, that alternative funds are really just different management approaches attempting to make money from a particular niche. Howard Marks at Oaktree and others invest in distressed debt. That takes CONSIDERABLE expertise. As does private credit. As does [insert a very long list of different investment approaches].

When you invest in an "alternative fund," you are investing in management. Not unlike when you invest in a stock. You might think you are investing in a particular technology or service, but that company is run by people. Management may not be everything, but it is at the top of the list. Bad management can screw up anything.

ALL investments are basically choosing management. Stocks? Certainly. Starting your own business? YOU are management. Running your own investment portfolio? YOU are management investing in other managers.

For the next two weeks, we are going to look at how to find, analyze, and invest in any number of private funds doing any number of things. How do you blend them to get the balance, risk, and return you need? If you are worth a million or more, you really should take advantage, especially in a world where many stocks have nosebleed valuations.

I am doing these letters with David Bahnsen of The Bahnsen Group. Besides a serious dividend growth stock focus, they also have a major commitment to "alternatives." I consider myself somewhat conversant and connected in the space, but David is better. He will write the first draft and I will kibitz. This is VERY important, as it is one of the ways I plan to use to get through what I see as a coming crisis.

But before we turn it over to David, this will be the last time I write asking you to sign up for the Strategic Investment Conference, as it starts Monday. If we seem to get a little frantic promoting the conference as the deadline approaches, it is really your fault. Well, not you personally, because you have already gotten your Virtual Pass. (I mean, surely you have already done so!) No, it is those other readers who wait till the last minute and register. You have trained us to market up till the last minute. So, I am writing to those who have procrastinated but know they want to attend.

Seriously, look at our lineup. The best ever. Felix Zulauf, Howard Marks, Ron Baron, Mario Gabelli, Leon Cooperman, Neil Howe, Joe Lonsdale, General Petraeus, Louis Gave, and 40+ others in their league. No one does conferences like I do. Watch it live or at your leisure. Audio podcasts. Transcripts. It's all there. Click and see the All-Star faculty. And then sign up. Join me in the conversation of how we get through the coming crisis.

As I do a final edit, I just learned that we have geopolitical rock star Pippa Malmgren as part of the conference faculty. Pippa has an incredible resume and has advised governments and major businesses all over the world, and still finds time to get very involved in launching successful tech companies. She literally grew up in the world of geopolitics, as her father, Harald, served four presidents directly. Their dinner table often featured his highly connected and placed friends. What a time to get to hear Pippa!

There Is No Alternative

It is somewhat ironic that I am writing in John Mauldin's newsletter about my firm's philosophy around alternative investments because John Mauldin initially played a pivotal role in the development of that philosophy. In the implosion of the late 1990s tech boom, a lot of investment beliefs were being called into question. Fortunately for me and my clients, I never believed that an intelligent investment plan was to buy the Munder Internet Fund, or 10 dot-com stocks that had all lost gobs of money, all in the hope that someone else would pay me 5–10X what I paid for those stocks a few months (or days?) later. But even beyond the mistakes of that particular mania, an embedded assumption out of Modern Portfolio Theory was that stocks and bonds were the two asset classes on the capital markets line from which asset allocators were to blend risk and reward. John Mauldin taught me that this was not true.

My understanding of alternatives would deepen when I was introduced to Alexander Ineichen, then the head of Alternative & Quantitative Investments at my then-firm (UBS). [John here: Alexander was fundamental to my own process as well. Never knew we had that connection. I had lively dinners with him and others in Switzerland.]

Ineichen wrote a piece in June 2003 called "Fireflies Before the Storm" that forever changed my understanding of alternative investments. His fundamental thesis in 76 pages of brilliance was that alternative investments are not an asset class; they are asset managers. The paper had much more to say, all of which I absorbed like a sponge, but fundamentally, I rid myself of the notion so many implicitly wanted to believe after the market crash of 2000–2002, that there were three types of investments that basically looked like this:

- Stocks—can go up a lot and down a lot
- Bonds—can go up a little and down a little
- Alternatives—a magic fairy dust that goes up a lot but can't go down

Now, did I really believe that? No. Did other investors? Not exactly. But was there an implicit or operational understanding of "absolute return" investments at that time, which basically said, "Alternatives are a secret sauce that go up when markets are good and that go up when markets are bad"? Yes, I think there was. There was no mystery as to why such a delicious food with no calories would be desirable—humans are human, and my late father's doctoral dissertation was on self-deception. I have always had a strong appreciation for the intellectual and even spiritual effort people will make in order to believe something they *want* to be true—sometimes that they *need* to be true.

The 30-month drawdown after the March 2000 peak and violent tech destruction of that era, coupled with the events of 9/11 and subsequent market deterioration, gave investors a strong desire to believe something that intuitively could not possibly be true. But look, the 1990s were a huge boom for stocks, and most hedge funds did great! And then 2000–2002 saw the stock market get its face ripped off (particularly the Nasdaq), and many alternative investments seemed to do great! Investors not only *wanted* to believe that alternative investments were a new kind of "heads I win, tails I also win" investment; they had sort of just experienced exactly that!

But along comes Ineichen in 2003 pouring water all over the thesis. John Mauldin had already taught me, years before he and I developed an impenetrable friendship, that the era of the 1980s and 1990s was not likely to repeat into the 2000s. Asset classes like stocks and bonds had an entry point component to their long-term expected rate of return, and macroeconomic circumstances were growing in complexity. John's "Muddle Thru Economy" concept made a lot of sense to me. Some form of portfolio diversifier which met that moment made sense. My only problem was that the fantasy-land view of alternatives that was so popular in the early 2000s contradicted one of the most important economic principles of my upbringing (thank you, Milton Friedman): "There is no such thing as a free lunch." The idea of there being no trade-off around the risk-reward dynamic of alternative investing was absurd to me, and Ineichen's revelation helped me crystallize how this had to be manifested in a client portfolio.

Essentially, the takeaway is this: **Investors do not forfeit risk when they pursue the returns of alternative investments; they replace one risk for another.** In other words, the broad factors that drive equity returns (earnings growth and multiple expansion) and that drive bond returns (interest rates and credit conditions) may not be the same factors that drive alternative investments, and in fact, ***if the correlation of an alternative investment to stocks and bonds is high, then it isn't an alternative investment at all***! It may be a leveraged play on beta, but it isn't an alternative investment! This is what we call a tautology—an alternative that is actually not an alternative is, wait for it, not an alternative.

Now, what is the risk we substitute market risk for when it comes to alternative investments? Well, this is the million-dollar question (million(s) for clients and investors, but trillions for the financial markets at large). And the answer is: idiosyncratic risk, often expressed as Manager Risk. But in English, it simply means this: **the broad risk of stock and bond market returns is minimized in favor of the execution, talent, and specific risks of a given manager**.

We will spend more time next week on the specific alternative strategies (and categories of strategies) that we embrace, follow, monitor, and utilize. There are multiple reasons that one approach may be more attractive or less attractive at a given point in time. Yet the high-level introduction to our embrace of alternatives has to be understood in this context: We believe that the equity market beta we take on as dividend growth investors can be reduced, and the risk-adjusted return set we pursue optimized, by blending best-of-class alternatives with a dividend growth equity portfolio. We are not seeking to eliminate portfolio risk with the portion we allocate to alternatives; we are seeking to change the risk in that portion of the portfolio.

In a sense, this is the most sophisticated application of Modern Portfolio Theory, properly understood. Limiting one's use of capital markets to a 60/40 stock/bond portfolio creates little room for non-correlation, and the reason we desire non-correlated investments within our dividend growth-centric portfolios is that we want investors to achieve the returns their underlying investments have to offer. They cannot do so if their natural behavioral and psychological inclinations shake them out during periods of market drawdown. They cannot do so if the math of the drawdown impedes their long-term objectives. They cannot do so if they negatively compound their portfolio by withdrawing principal during periods of decline. We believe dividend growth provides ample equity beta, as discussed the last two weeks, but with far superior income, growth of income, and underlying portfolio quality and value. And by coupling dividend growth to appropriate alternative investments, we believe the total portfolio volatility can be managed to a point that is reasonable for most investors.

But to repeat my earlier contention—alternatives are not a magical or ethereal "asset class"—there is no such thing as "hedge fund beta" or "private markets beta." There are inefficiencies in certain asset classes that may be exploited, there is an illiquidity premium that may be pursued, there is access to a return set that is not found in the S&P 500, but these are *asset managers* finding returns within asset classes. What makes it "alternative" is that the source of risk and the source of reward is not the beta of stock and bond indexes, but the manager's talent, expression, and particularity in that idiosyncratic pursuit. Managers can be wrong. Managers can fail to see things correctly. Managers can be guilty of following the crowd (hedge fund trades can be notoriously overcrowded). Paying a higher management fee and adding an incentive fee does not make it an alternative investment. A non-correlation to stocks and bonds is table stakes, and manager talent, philosophy, discipline, and access become the value-added need of the hour in this discussion.

So, to that end we work. Yet more is to be said. Next week, we'll peel back the onion a bit on what some of these approaches mean in 2024, what can go right, and what can go wrong. The construction of a portfolio in the 2020s ought to look different than it did in the 2000s. But the first principles that drive it all should not. And in that vein, I am very grateful for Alexander Ineichen AND John Mauldin.

Changing "The Great Reset"

I used the term "The Great Reset" many years before it became a theme from Davos. For me, it refers to a time when excess debt will be "rationalized" in a crisis, resetting the economic landscape.

I am writing a book (almost finished) on this topic, but I can't call it *The Great Reset*, as all the searches basically point to the WEF and Davos. I want to crowd source a title for the book. I have been given a few decent ideas from readers and realize the best idea is sitting in your mind. Simply reply to this letter or send your suggestion to business@2000wave.com. I will acknowledge you in the book and try and find a way to get together and buy dinner. Thanks!

Cape Town, Europe (?), and British Columbia

Shane and I go to Cape Town in early June. We are now leaning against going to Europe but instead exploring some of our neighboring islands here in the Caribbean. Then fishing at the very tippy top of British Columbia for trophy salmon, cod, and halibut. This time with 30 readers as the start of my 75th birthday celebration.

DC was just awesome. Progress is being made on a drug that seemingly lengthens telomeres. And is a massive anti-inflammatory. Huge disruptor if/when we can get it. Hopefully in a few years. More later. Just fabulous dinners. I met with some Alpha Society members. Did you know there is a tech out there that can send and receive from inside of a Faraday Cage? Completely new wave to send signals and information. Underwater. Around curves. Not electromagnetic. What a world we live in. Talk about dual-use technology.

And with that, it is time to hit the send button. Have a great week! And don't forget to sign up for the SIC!

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