THOUGHTS FROM THE FRONTLINE

ME

When Absolute Returns Are Not Absolute

By John Mauldin | April 27, 2024

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This week is part two of our conversation about alternative investments. As I pointed out last week, this space has evolved into a distinct asset class of its own. I believe investors need to understand the good, the bad, and the ugly aspects of investing in alternatives.

The Strategic Investment Conference is going very well. I am thoroughly delighted with the speakers so far. The feedback has been great. I will be covering some of the highlights of the conference in future letters but can only skim the surface. Serious investors (you are one, aren't you?) should read the transcripts or view videos when the conference is over. As we've done for the past few years, we will make these available to those who weren't able to attend as it happened. And we still have next Monday and Wednesday to go, so sign up here and start catching up.

The bulk of this letter is by David Bahnsen. I have made a few edits, but anything substantial from me will be inside [brackets], plus some closing remarks at the end. This may be the best short analysis of the alternative space and its evolution I have ever read. It is worth your few minutes of time. Now let's turn it over to David.

When Absolute Returns Are Not Absolute—*By David Bahnsen*

Last week we focused on the philosophy behind our inclusion of alternative investments in a portfolio. Contrary to much of the wishful thinking that permeated alternatives at the beginning of the century, and despite the assurances of the marketing departments at many “absolute return” strategies, we do not view alternative investments as a magic potion whereby risk is replaced with certainty and performance becomes one-directional. The asymmetry of risk and reward that many spend their investing careers looking for is quite elusive; prudence and diligence, on the other hand, are valuable tools in getting to the right outcome.

The outcome we are after with alternative investments is to reduce the exposure we have to traditional beta in other aspects of the portfolio, *which inevitably means replacing that risk with a different risk* (unless we are looking for a risk- *and* return-free strategy). The risk we consciously inject into a client portfolio with alternatives is idiosyncratic, with market risk being lower, yet “manager” risk being higher. Execution, talent, skill, and other bottom-up factors matter more with alternatives. This process is necessarily labor-intensive, and all attempts I have seen to mix passivity with alternative/idiosyncratic risk and reward have been, shall we say, sub-optimal.

The case I have made presents a large burden for asset allocators. On one hand, I have stated that the return thesis embedded in alternative investing is primarily one of manager skill and selection; and on the other hand, the asset allocator is responsible for such selection. I should add that the burden of alternative investment selection goes beyond “picking managers that do well”—as important as that may be—but invites other risks that more conventional investing may not. One may have to worry about public equities going up or down, or in our case, whether or not dividend cuts are avoided, or targeted dividend growth achieved, etc., but in traditional investments one has far less worry about leverage being taken, trading efficiency, regulatory compliance, manager compensation, personnel retention, institutional health, and overall organizational due diligence. Traditional assets garner their return from the asset class, but if alternative investments present a risk/reward paradigm around these idiosyncratic circumstances, then a significant amount of new research and diligence is required. It is not for the faint of heart.

[Read that paragraph again.]

What becomes the default selection criteria for most private clients (and often, institutional clients!) when it comes to alternative investments? You guessed it—performance history. Compliance departments can slap those famous words all over every document in the world, it is not going to stop many people from believing that “past performance DOES guarantee future results.” With many alternative managers, nothing could be further from the truth.

So principle number one in alternative selection: look at the process, philosophy, point-of-view, and personnel *first*; look at the performance *second*. The number of hedge funds that got famous with a certain call (and oh, by the way, with a certain level of leverage!) and that have sucked wind (the academic term) ever since is unfathomable.

A reliable organization with impressive people who have a consistent process, a competitive spirit, and a serious discipline in achieving results—that is an entirely different animal than just picking the hot manager of last year (or last decade!). The fact that this is true of individual stocks and long-only managers, too, should just reiterate the principle. *This isn't supposed to be easy.*

Many of the largest hedge funds—the "name brand" institutions we often think of when we think of hedge funds—are entirely different organizations and models than they once were. From Steve Cohen whose S.A.C. Capital is now his family office, Point72, to Israel Englander's Millennium, to Ken Griffin's Citadel, some of the best-performing and well-known strategies on the Street are now behemoths of "pods"—which is to say, dozens upon dozens (hundreds in many cases) of *different portfolio managers and traders* representing different asset classes from fixed income to equities to currencies all blended together in a way meant to hold very little beta risk, and very little directional risk. The idea is that with a couple hundred brilliant people trading in a very tiny bandwidth of up and down movement, enough micro-moves properly captured will aggregate to a good high-single-digit return with minimal downside volatility. Two things are true at once in this new hedge fund evolution: (1) It has so far worked pretty well, and (2) These return objectives are half (or less) of what made these shops rich and famous. A couple things caused this shift in the industry, starting with the passage of Dodd-Frank after the financial crisis. The forced disintermediation of Wall Street firms from their own proprietary trading desks flooded the Street with talent—serious talent—and the only institutions that had the capital and infrastructure to take them on were these mega hedge funds. That necessitated a change in business model, and change they did.

The other piece to this was the huge swelling of assets under management. Fundamental alpha and various niche arbitrage profits are a lot easier to come by with $1 billion than they are with $25 billion. *Size is the enemy of performance when niche is your value.* Capacity can be nearly unlimited when you are adding infinite numbers of traders, each simply trying to squeeze out basis points of return, all blended to a computerized risk management. By the time fixed income, global currencies, and even commodities are added to the menu, these "pods of pods" hedge funds can deploy tens of billions of capital, no problem.

I would not be critical of the above evolution and acknowledge it has largely worked thus far. I would, however, point out that 2 and 20 is a lot to pay for a 6–8% return aspiration that is half of what they previously pursued. These funds were built on the unique talent and skill of megalomaniac geniuses; now, they are essentially one massive HR operation. The value-added has gone from finding a mispriced security and placing a trade (few people did that better in their day than Steve Cohen, for example) to recruiting, hiring, compensating, and retaining hot shot traders. It's as bureaucratic and institutional as it comes, and that is fine—it just isn't what it used to be. Color me nostalgic.

This "mega-pod" multi-strategy hedge fund model may have a place in the alternatives component of a portfolio. Risks would include the possibility that there is an increasing zero-sum dynamic at play, where traders are just sharing basis points with each other, and that over time the real value gets harder to find. Less likely but more significant is the risk that the boat capsizes if these "pods" are all too heavy in one space or another. I am less worried about that but acknowledge we are dealing with new territory here.

Ard the good old days of celebrity hedge fund managers who are alpha-generating machines fully gone? Have large hiring bureaucracies replaced the hot shot managers who knew how to work a trading desk? Not entirely. Some talent continues to focus on strong conviction value—often with hedges, often with an activist bent, often with a short component—but fundamentally driven by the point of view of the leadership talent whose hands are on the steering wheel. Bill Ackman and David Tepper are good examples here. Again, this is a classic case of investing in the talent and track record of a person, and many of the alternative investing world's best and brightest are susceptible to cold streaks or even significant reversals of fortune. Dan Loeb's performance looks very different since his asset base went parabolic versus the prior decade. Others like John Paulson and Jim Chanos have just been caught on the wrong side of a given call (or multiple calls). But all this leads me to one of the most important principles I can share in selecting alternative investment strategies:

Famous people who are worth many billions of dollars personally have a different psychology and pathology and investment objective than you likely have with yours. A smart person who made $10 billion but is now down to $7 billion has a huge incentive psychologically to take a big risk to get that $3 billion back. They will still be worth $4 billion if they fail, but their ego and pathos want that $10 billion high watermark again. You, on the other hand, may not be looking for a 40% swing of luck one way or the other.

To summarize, we believe there are three good reasons to keep exposure to name-brand managers and media darlings to a minimum:

- Change in the business model of many name-brand hedge funds,
- Uncertainty of a given manager's sustainability of good calls, and
- Competing pathologies between famous multi-billionaires and our clients.

While the temptation to invest "alternative" capital in the most famous and sizable of strategies may be high, the optimal path for investors is to try something different. We prefer to take an approach that looks something like this: size and scale as a value proposition for those strategies that require such, but nimbleness and flexibility for the rest. This barbell approach has served us very well.

A classic case of an alternative strategy that benefits from size and scale is private credit. Coupons are coupons, yields are yields, yet not all underwriting is the same. Not all deal flow is the same. Not all capacity for workouts is the same. A small, boutique manager in private credit is not getting the first looks or the best deals, and yet is ending up with a portfolio of loans that target the same yield as a larger institutional manager who has the resources to properly underwrite, to partner with sponsors who can work strategically through an impairment, and who have vast experience and intellectual capital throughout the organization. In our opinion, large institutional managers who have built an infrastructure around private credit, who have significant talent on the other side of the wall in private equity, who have the strategic and financial resources to get first looks at good deals, represent a better way to achieve private credit returns without the risk of a lesser-known operator who may very well find the same yields, but is unlikely to have the gravitas needed in a bad cycle.

Outside of private credit (direct lending, middle markets, providing credit at a first lien, senior-secured level that is floating rate to sponsors doing leveraged buyouts, etc.), we also believe structured credit provides a non-correlated return stream that can be very opportunistic. Unlike private credit that is generally backed by cash flows, structured credit is usually asset-backed, can involve various interest rate and credit hedges, and can go up and down different levels of the capital structure to find value. Whether the assets involved are commercial mortgages, residential mortgages, or something as bespoke as aviation assets (tied to cash flows), the specific skills involved in niches of these markets and overall inefficiencies provide great opportunity for talented managers.

We have been heavily invested in various arbitrage strategies over the years (merger arbitrage, convertible arbitrage, relative value arbitrage, etc.). The investment into mispriced securities or leveraged plays on “reversion to the mean” has seen a very diminished opportunity set over the years and is less tactically attractive now as the space has become more efficient.

Private equity is, of course, a play on operating businesses, and yet like private credit, requires gifted operators, financiers, and strategists. It is a long play on capitalism, and that is a never a bad idea, but fundamentally the return advantage needs to come, to some degree, from either a distress entry that presents opportunity for value-added, or else a financial restructuring that is itself additive. We favor larger operators and sponsors for the same reason mentioned in private credit—there are too many things that can go wrong to take a risk with less seasoned players.

At the end of the day, there are a lot of asset managers out there who can be classified as alternatives. Bespoke opportunities exist but require extensive diligence and research. The philosophical summary we would offer is to focus on people and process, to avoid the allure of celebrity and hype, to not mistake leverage for talent, and to maintain a respect for markets in terms of what can go wrong. Alternative managers must have a culture of risk management. Too many alternative managers are psychopaths in suits.

And even though many traded away their suits for a Patagonia vest, the psychopath part still needs to be avoided.

Thoughts on Portfolio Structure and Alternatives

(John here.) I have been a proponent of alternative investing and absolute return investing for well over 30 years. In general, I’ve had good results, with a few missteps here and there. Here are some observations through those 30 years.

1. Opportunities change. There was a time in the ‘90s and even into the middle aughts were certain styles of arbitrage worked. Long-short strategies by great managers seemed to be a layup. Pretty soon though, so much money came into these various strategies that they literally arbitraged out the return. When collectively $100+ billion goes into a space where there is really only room for about $50 billion if people are going to make money, returns suffer. Some managers react by increasing leverage, taking more risk to create the returns they want. That generally leads to a negative outcome.

Things don't change on a dime, but if you were paying attention, you could see the trends and say it's time to move on from this strategy no matter how good it's been to you and no matter how much you like the manager.

2. It was not a reach back in the '90s into the early 2000s for a small guy like me and then in partnership with other companies to do due diligence and to allocate to hedge funds and other alternatives. Today, that's just not practical. It takes depth and reach to be able to properly do due diligence. That means a team dedicated to just that and nothing else.

3. The alternative investment strategies that I want require access that small allocators just simply don't have. Getting into the large, well-managed funds takes capital. $10 million may be the minimum to get in some of them, and that doesn't get you access to the top management. You need to be writing 9-figure checks. You need to have a certain gravitas about you that gets you into meetings. David has that and I don't.

I've been deeply thinking for quite some time about partnering with David Bahnsen. We've become good friends over the last decade or so, after meeting on the set of *Fast Money* back in the day. I knew his father and published some of his theological works. We started out with that connection, and it just developed from there. I don't switch partners lightly.

As I wrote the series last year on cycles and government debt, I realized I needed a different approach to my own portfolio. I actually want some exposure to beta, but I do it through dividend growth stocks. I also continue to believe in alternatives and have been happy with my portfolio performance but wanted access to some better managers. I should point out that some of my current managers are also part of The Bahnsen Group's portfolio choices.

You should consider checking them out if you are looking for a different approach to portfolio management. They also do tax planning, estate planning, family office services for larger investors, and more. They create bespoke portfolios. Your portfolio would look different from mine because your needs are different.

I also trust them to adapt when needed. We have no idea what we are facing. Since I will likely be 80+ when the crisis really hits, I assume I will need help then even more than now.

You can contact them directly or sign up for their daily letters and weekly thought pieces here. To get a handle on how they manage dividend portfolios, you can read David's very readable and relatively short book on dividend investing: *The Case for Dividend Growth: Investing in a Post-Crisis World*.

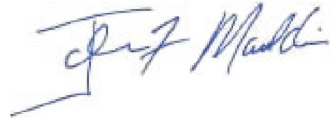
Cape Town, the Caribbean, and Fishing

Shane and I will be going to Cape Town, South Africa, where I will be doing a speech for RMB in early June. We have decided rather than Europe, we will visit some of the local Caribbean islands we've never been to. Then in late August I'm going to far north British Columbia to fish for salmon, lingcod, and halibut with 29 readers, as part of my 75th birthday celebration.

Last week I asked for title suggestions for my new book. You overwhelmed our mailbox with countless great ideas. Thank you to everyone who pitched in. Many hands make the work go quickly… though picking just one is going to be tough!

It is time to hit the send button. Have a great week.

Your ready for some more fabulous SIC presentations analyst,



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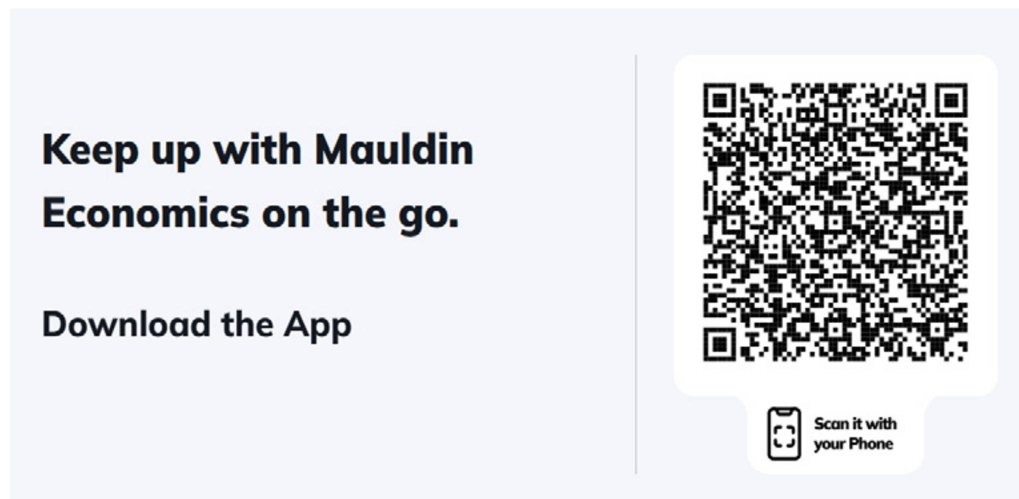

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