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Why and How We Use Alternatives

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There Is No Alter-native

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 great 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 greater 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.

When Absolute Returns Are Not Absolute

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.

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*
- *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 requires 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.

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HTA Client Relationship Summary *HTS Client Relationship Summary*

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