Altana Investment Thoughts by Lee Robinson

Introduction

As many of you know, Altana always co-invests our own money either directly into third party entities or by incubating fund managers when we have high conviction in the information or structural advantages they seek to exploit. Our investments range from VC to Growth Capital to asset-backed and also include listed opportunities. We are fortunate to be constantly meeting highly talented investors, ranging from self-made entrepreneurs, billionaires and family office decision-makers. I have created my own deal club initially with 18 entrepreneurial investors in Monaco, each of whom has their own networks, thus multiplying the opportunity sets. This group has grown and now exchanges investment ideas with over 140 individuals and groups around the world. I also sit on the committee for the financial services network of the Young Presidents Organisation, which gives me a privileged insight into the future of our industry. Most investors that we meet first and foremost share our common desire to co-invest and, thus align their interests. They also do not trust or think very little of the financial industry, both from a value point of view (fees) and/or service (lack of quality ideas).

We have been asked to collate an overview of some of my investment theses and ideas from the last few months. Please feel free to share these with other sophisticated investors and contribute your own comments and ideas via email.

It is our long-term intention to cultivate a virtuous network of investors, investment ideas, and resources. One that is free from the usual conflicts of interest.

Altana: Alpha Generation Continues

There are really only two business models: high volume with low margin or high margin with low volume: “commodities" or “luxuries”. In the investment world these are also known as "Beta" and “Alpha" products. Altana is an Alpha-hunter (for those of you unaware…). Combined with our other differentiator - alignment of interest – that has lead us to meet a great many potential and current clients again this year. It may be hard to believe but I have never worked as intensely as in 2017 and 2018… but for good reasons. We have now hired four salespeople and have expanded our meetings to include many of the institutions from my previous role as founder of Trafalgar Asset Managers. For these institutions our performance has helped but more importantly we are in their sweet spot with 30 staff and $500m of assets. This year we have taken in a number of $5m+ subscriptions and even some of $20m. We have been invited to bid on $50-100m mandates. So we are busy for good reasons.

We are improving our crypto fund by adding several young traders to generate more alpha and lower the correlation to the underlying cryptocurrencies. They will trade relative value, short and medium term momentum and day trading to take away some of the pressure from the PM. In the calm few months following the turmoil we have seen several crypto fund of funds launch and even Yale has put $400m into crypto. The space will continue to grow next year ahead of the next halving event when the number of bitcoins released every 10 minutes halves from 12.5 to 6.25. This is expected in Q2 2020. Hence our medium term view remains bullish.

Our team of equity quants has also grown and we have been testing their systems for over twelve months with over $1m of our own money. We do this to iron out any problems ahead of committing a greater amount. To date we have seen close to 20% returns with around 10% drawdown risk. We'll be reaching out in Q1 2019 for advice on how to take this forward.

The corporate bond fund continues to grow and, according to Bloomberg, it is ranked a top 5% performer over a one, two and three year period. All this performance comes with lower duration and reduced volatility compared to peers and the benchmarks. Lower risk and higher returns is Alpha in anyone's book.

We have received requests for a more concentrated higher return portfolio constructed from within our short duration (average duration of portfolio less than two years) credit portfolio. All of the issuers in this sub-portfolio have been drawn from the Altana Corporate Bond Fund, and therefore have been subject to a thorough internal credit review. Our credit selection process is based on answering one simple question: Are we highly confident that the issuer has the ability to repay its bond obligation on a timely basis? Our credit analysis will consider whether the issuer has the cash flow generation capacity and available liquidity (cash and undrawn bank lines) to cover our bond repayment in full when due. If our analysis leads us to have any doubts about its ability to repay its debt on a timely basis then it will be excluded from the portfolio.

We proposed that this portfolio should contain at least 10 names equally weighted to provide adequate risk diversification for the portfolio. It comprises a range of issuers, sectors and ranking (e.g., secured and unsecured bonds). The common theme across the names is strong recurring cash flow, good liquidity and solid asset backing. Furthermore, often some of the proposed bonds benefit from security over a discrete portfolio of assets and have an amortising debt structure (i.e. principal payment is spread over a number of years to final maturity). We believe that these two features reduce the credit risk and greatly increased recovery rate for these notes. The names will always be chosen from current fund holdings so if we are uncomfortable in the fund we will always also sell from the managed account.

The average credit spread for the portfolio is ~500bps across a range of currency denominations, which currently implies a blended US$ yield equivalent of c.8% gross before fees for two year risk on a dollar currency basis. Whilst we are not recommending leverage, we can help clients achieve 50-60% extra leverage on the portfolio at between 50-100bps over Libor from high credit quality custodians which would boost returns before fees to around 10% in US dollars. This allows the client to achieve higher yields of around 7-9% with short duration managed accounts whilst ensuring you remain the priority one client with full control and liquidity.

Our distressed opportunity fund launched in October. We can see private equity type returns of the order of two to three times but with monthly liquidity especially in the oil and gas services industry. Many companies have recapitalised, some have even merged and yet the energy industry has two-three years of R&D catch up especially at the current much higher oil prices. We are very bullish. Both the PM and myself are aligned with $5m of our own capital and we have a private client that has been invested since January 18 with $45m. Total capacity for the current opportunities is limited at $100-150m.

Finally our wine trading fund, the first of its kind we believe, has got off to a good start with over 4% return in the first month. Once again we seek alpha from an information advantage in an opaque buying and selling market to buy cheaply and sell through the PM's distribution channels that include wine exchanges, their own clients and direct via their website. We have been looking at wine trading for over three years as buying and selling wine on exchanges has facilitated the opportunity to compete in a previously closed industry.

Wine is a great inflation hedge as many of its components - labour, land, fertiliser, and transport - are positively correlated with inflation. Investors hold wine for that reason and, of course, to sell or drink in 5-25 years. However, many wine investors, like myself, are not wed to the actual wine that we hold. We are indifferent as to which Bordeaux wines we have in storage. If somebody could profitably buy and sell my portfolio two-three times a year but still give me comparable wines when I wanted to drink or sell them, then I would be delighted. Essentially, I will be drinking fine wine for free.

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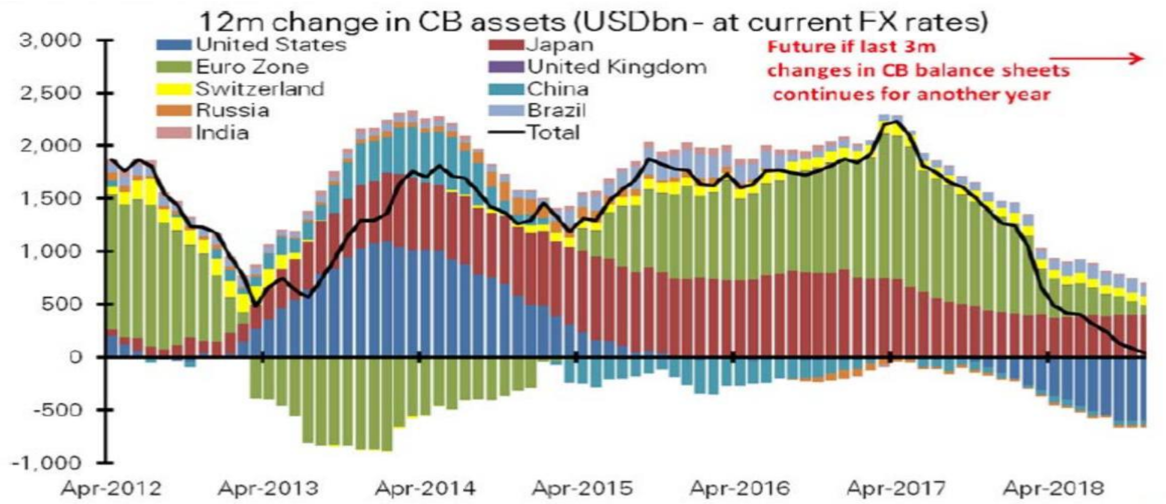
Quantitative Tightening

In our last newsletter back in March this year we wrote about QT:

'Without doubt, investors were given a 'free pass ' in 2017 with respect to almost every asset price, but with rising yields, and central bank tightening of rates as they reduce their balance sheets, combined with higher volatility, 2018 will be a much more difficult year to navigate. One of the most important charts to contemplate comes courtesy of Soc Gen. The black line represents cumulative Central Bank buying of bonds. As you can see, we are heading into a selling period following a 10 year buying spree. For those of you that believe QE supported asset prices, what will the opposite do?'



Source: Société Générale

Clearly, this was a well-timed prediction. We continue to believe that entrepreneurs and business can cope with higher rates and well run businesses should not fail due to interest rates being 2% or 5%. However, if you remove liquidity by reducing the volume of available credit then business struggles. Many market participants focus on the price and level of interest rates but not the quantum of available credit. QT, onshoring of US cash coupled with increased US treasury issuance has caused an imbalance between supply and demand. We believe central banks are making yet another mistake by raising rates and reducing demand at the same time. Better to increase rates first then reduce demand. That way the weaker companies are slowly forced out. Only then should you reduce supply of capital. Already emerging markets are suffering, both in currency and yield terms. Most world stock markets are down for the year, in US dollar terms, and many are falling even as their currency depreciates- a classic sign of capital flight. This is now bleeding into the main stock markets of USA leading to higher volatility.

S&P 500: Total Number of Days with 3%+ Losses & Correlation between Stocks and Bonds

Year	Days	Correlation
2018	3	+0.16%*
2017	0	-0.51%
2016	0	-0.65%
2015	2	-0.73%
2014	0	-0.74%
2013	0	-0.82%
2012	0	-0.85%
2011	7	-0.84%
2010	5	-0.76%
2009	13	-0.45%

This is the first monthly **positive correlation in a decade.*

More worryingly bonds and stocks are falling which also means lower property prices. This is not 2008 whereby your bond portfolio profits easily offset your equity market losses

Whilst emerging markets are without doubt cheaper with China and Brazil looking the most attractive we advise clients to either wait or only partially allocate. Better entry points are likely to occur as the pace of QT increases in 2019.

Portfolio Effects and Hedging Ideas

In our weekly risk meetings over the past months we have been most concerned about an inflation scare. Whilst we continue to see enormous pressure from disintermediation and automation causing downward pressure on wages, we still feel the market is getting to a place where successive good news on the economy was bad news for markets, as bond yields would have to rise. Altana was built to generate real returns after inflation. No one we speak to, not the analysts we read nor even the more extreme bears seem to think that 4% ten year yields are possible.

Neither do we but:

- Job openings are higher than applicant submissions
- US unemployment rate is 3.8%, close to all-time lows
- Rising bond yields [US Five-year bonds are up from 1.65% in Sep 17 to over 3% in Sep 18]
- Shipping and trucking rates are rising
- Industrial metals, such as copper and iron, are trading higher, oil is a lot higher
- Tariffs are increasing producer input prices
- Minimum wage is increasing in most states

We view this as a fragile bond market and the futures curve does not believe the Fed will tighten three times next year. However, we need several months of bad economic news to get the yields below 2.8% but maybe only 1-2 very strong data points to push on to 3.5%. If we then see major bond funds, pensions and endowments, and other central banks deciding to lower their duration at the same time and given the Federal Reserve are no longer buying and the US treasury is increasing issuance we could see a rout.

What does this do to equity multiples? The sell side continues to say rising rates are not bad news if earnings are rising. Earnings are indeed rising and lower tax-rates help, but the argument that there is no alternative to equities has gone. Take strong, stable corporates that trade on free cash flow yields 1% wider than corporate bond yields. Currently these are around 4%. Take the reciprocal and you get a PE of 1/0.04= 25. However, if this moves to 5% due to higher corporate bond yields then the PE is now 1/0.05= 20. This means the stock needs to fall 20%.

Our view is to switch from Long Only to Long-Short, and so reduce gross leverage because volatility will be higher in a rising yield market. In Europe and Japan the moves are less drastic as Bunds, for example, have moved from 0 to 0.75% in the ten year maturity, meaning free cash flow yields on equities still look relatively attractive. However, we would caution that when US stocks fall rapidly Europe and emerging markets invariably trade lower. Keep your bond duration short and exit illiquid investments such as property that are close to all time low yields.

For equities, if moving to Long-Short fund is not possible then adding option protection to protect your portfolio. One idea would be to run a zero cost collar against your exposures. We like to use a 5% out of the money put financed by a 4% out of the money call at zero cost as we find that >5-7% down moves are where volatility increases and asset correlations tend to rise historically. We usually employ one month options spread across four different weeks with 25% allocated to each. This can be done mechanically (just by selling 104% calls and buy 95% puts) however, the volatility varies so you should probably alter the put and call strikes slightly in a band to maintain the zero cost.

This improves returns and significantly lower drawdown. Take this example from the S&P

	Index only	Index +protection overlay
2008	-38.4%	-18.2%
2009	23.5%	22.0%

Practically you [or through a manager like us] would implement this as follows:

1. Set up a managed account with your bank or a fund – The former is better as you can decrease/increase notional daily.
2. Transfer margin – this should be small [1X put premium and 1.5X call premium only with a small buffer]
3. Buy /sell options weekly and roll every month
4. Take profits by rolling the strikes. We tend to roll the strikes when we can achieve 65-70% of the profit - we sell the 95% otm put and buy the 90% for 3.5% credit [70% x 5%]

We can send the full yearly back tests for most major indices with drawdown, IRR and Sharpe ratios if required.

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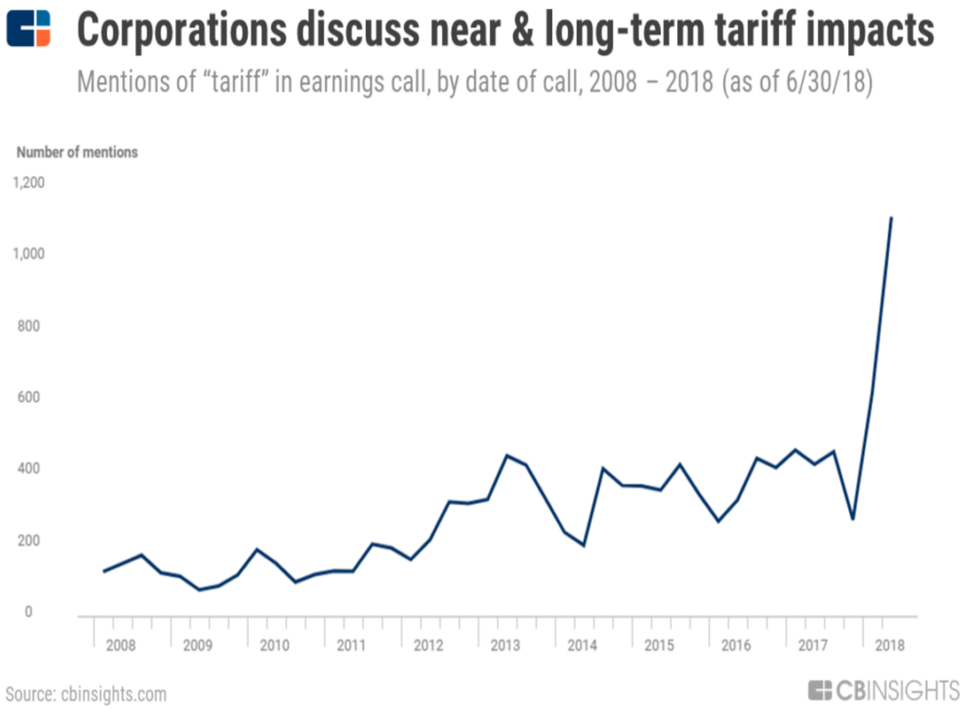
Currency Outlook

As we regularly get asked our views and trade actively on a daily basis in a managed account, we thought we'd pen a few observations. Our last piece stated we were US dollar bullish due to many factors already mentioned and the consequences of the Republican Tax Bill. Never forget that global debt is now more than $200 trillion versus $150 trillion in 2008, and that a large portion of this interest bill is dollar-denominated/ linked. Many market participants are concerned that the dollar strength is over but with QT tightening further in 2019, we think there is much further to run. Add in the loss of confidence in German, Italian and British governments and the Euro looks less and less attractive. Belatedly, the Europeans have realized that a bad Brexit is bad for the UK **and** for Europe. This is why they are scrambling for a deal. The British electorate is prepared for this but we suspect core French and German corporates and voters are not. They will blame the incumbent parties not Juncker and his cronies .

None of this, of course, helps the UK with Brexit. This is the worst British cabinet in history, utterly useless at negotiating, that cannot even decide what they actually want two years after calling for the referendum. Foreign direct investment is clearly on hold and important decisions about where to locate business in Europe are not being made - either into the UK or Europe - due to the uncertainty. Extending this uncertainty by another 9-18 months will only make matters worse. We meet many brilliant entrepreneurs and business people. They adapt to the markets and rules. They will cope with tariffs and border controls, as they do already with many other nations, but they can't adapt when the rules are unknown.



We correctly pointed out in our previous issue in March 2018:

Another currency to watch is the Turkish Lira - a break above the $4 level combined with potential capital controls, would cause contagion in the whole emerging market space. With bond yields rising, I would be tactically reducing EM exposure in anticipation of adding at a better entry level.

The Lira went as high as 7 and currently trades around 6. Short term Turkish foreign debt is manageable but as we progress into Q2 2019 and onwards this will worsen. In parallel, the penal rates for hedging the currency will deter foreign investment. There will be a better moment to buy Turkish assets, but it is a great nation and vital for NATO, so we do think buying opportunities should be grasped when they arrive next year or 2020.

We were planning to chase gold and then silver if they can break out of their long five year trading range. That clearly has not happened and the long patient wait to be overweight has yet to arrive.

10 years on from the Great Financial Crisis

How time flies. Many memories have been resurrected as we read the many pieces discussing the great financial crisis. In a recent interview for EuroHedge we recalled it as a fabulous yet horrible time. We learned so much navigating successfully the various credit problems and sub-prime crisis. We entered the short sub-prime trade in late 2006 but mostly early in 2007. We eventually shorted the full stack from BBB all the way to AAA, making money for our clients and ourselves each time. Early summer, I caught up with Greg Lippman, the main architect at Deutsche Bank behind the whole structure that allowed funds like ours and Paulson's to make life changing returns. He was immortalised by Ryan Gosling in the film 'The Big Short'. [As an aside I am a day one and very happy investor in his hedge fund. If you want an introduction drop me a line]. Both of us have more children and some that have grown into teenagers since those exciting days. However, we both shake our heads when we see that global debt has increased to $210 trillion up from the $150 trillion during the credit crisis. Emerging nations ignored that warning and now have even more non-domestic debt after adjusting for inflation.

Very few senior bankers went to jail and AIG, GE along with many major banks were bailed out at a cost to the nation. No wonder clients dislike banks. They see them as the cause of the crisis yet we all have had to suffer 0% rates in a 2% inflation environment to support them for the last 10 years. Would the alternative of a bankruptcy cycle really been worse? We are sure the western economies would have fully recovered within ten years and would face the future without the added burden of a further 30-50% government debt to slow future growth. Our recurring concern is that with so much debt does every normal inventory or manufacturing recession morph into a credit recession? We are late cycle and we will all soon find out.

Disintermediation & Technology

As the inflation scare continues to grow we still see enormous disruption in most industries. Machine learning and big data are cutting out whole groups of middlemen. Google and Facebook control nearly two thirds of advertising, removing the need for advertising agencies. In the US, there are more Netflix subscription-paying customers than users with set-top boxes. This has driven Disney to buy Fox to try and regain control of distribution and Comcast's insane bid for Sky assets. Whilst you may see GDPR, EU fines and recent Senate hearings as an attempt to control these companies that spy on us daily, the costs required to adhere to these rules just makes the moats around the incumbents deeper. New entrants will struggle to survive, let alone compete.

Driverless cars are still a long way away as the laws to apportion blame in accidents have not yet been created. Is it the software, the hardware, the passenger or the bystander's fault? However, the use of drones is growing. This will lead to more powerful drones capable of carrying more loads automatically to central locations or even your home. In turn this will destroy incumbent postal services and dramatically reduce the number of vans and small trucks on the roads. If you have good ideas for drone investment companies, please let us know. We see Amazon and other online retailers as the clear winners and for a change the consumer - who wins with better service, less pollution and clearer roads.

Indoor farming has also caught our eye. Advances in optical technology allow affordable lighting that can grow crops indoors. Supermarkets and homes will shortly have buildings next door growing fruit and vegetables 24 hours a day, 365 days a year, massively decreasing the costs through reduced transport and the wastage. By adjusting the light spectrums the fresh produce can give more antioxidants, different smell and taste. You could mimic the very best years for grape growths. Will they taste as good and be healthier than the natural ones? We don’t know, but the significant amount of capital currently being invested means we will continue to follow the space.

Private Ventures

Although the excesses of the crazy ICO phase have waned we still get a daily request to support far-fetched ideas under the guise of ICOs. Now they come from even further away suggesting true desperation since they cannot raise money in their home markets. Consequently, we are also seeing longer time frames and lower valuations for seed and series A financing, which is good news for investors. Like many fellow investors we have seen more requests for subsequent funding rounds than exits. We can’t prove it but that is likely to be a factor for the slower fund raising and lower valuations as well.

We have to remain vigilant and recommend all investors always check who at the company has control over the bank accounts. At the very least one group uploads invoices and another authorises. Luke Johnson, a living legend in the start-up and entrepreneurial space, whose books are an inspiration to many, was recently the victim of fraud by the CFO at Patisserie Valerie. Luke bought the company many years ago, took it public as chairman and is the largest shareholder. We have the utmost regard for Luke, who has our sympathy but it is a reminder us that if even a great investor can be caught out then we all should increase both our initial due diligence and ongoing monitoring of private and public companies.

Conferences and Charities

Human Rights Watch defends the rights of people worldwide. It scrupulously investigates abuses, exposes the facts widely, and pressures those with power to respect rights and secure justice. I was kindly invited to a private dinner to hear Kenneth Roth’s view on the world. Kenneth has served as executive director of Human Rights Watch since 1993. Under his leadership it shared the 1997 Nobel Peace Prize as a founding member of the International Campaign to Ban Landmines, and the organisation laid the groundwork for further international treaties banning cluster munitions and child soldiers. Roth travels the world over, meeting world leaders in government and business to push for change and create impact for the most vulnerable people around the world.

Even in these challenging times, when many traditional Western allies are in retreat on human rights, threatening to reverse decades of progress, Human Rights Watch is making a difference. After prolonged advocacy by Human Rights Watch and other NGOs, the European Parliament voted to sanction Hungary’s government for its prolonged assault on democratic institutions, human rights and the rule of law. They continue to push the USA to respect the international courts. For those of you interested to find out more or donate you can click on their website: www.hrw.org.

Outlook

We continue to believe that we are late in the cycle in the global expansion. Clearly, markets will be more volatile than last year, which was the lowest volatility year for the US stock market since 1928. We have already had the largest one-day percentage move in volatility ever recorded. Now is the time to switch to long-short managers rather than long only, to reduce duration on credit and especially cyclical industries. If you have long only then some sort of option protection is warranted. Rising bond yields means lower property prices and lower equity multiples. This is bad for levered portfolios. Risk parity and other levered bond plus equity portfolios should be avoided. Central bank largesse is coming to an end. Hopefully professional risk management will be back in favour.

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We would avoid long lock up private equity vehicles, many of which have moved from seven year (plus multi year extensions) to ten year lock ups. Given they do the hard work of investing in years one to three, why would you pay them egregious fees in years three onwards just to be monitoring companies? The good news is that lower prices will mean better opportunities for us all in the long run. Locking up your capital this late in the cycle means you may miss the opportunities.

Further Information

Previous newsletters, videos and thematic pieces can be found on our website:

http://www.altanawealth.com/news/

and via Youtube:

https://www.youtube.com/channel/UCrjZ4lZ9okIQ0b0-c6wz3PQ

Yours sincerely,

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