

Altana Investment Thoughts by Lee Robinson

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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 listed opportunities via our funds to VC, Growth Capital and asset-backed direct investments. We are fortunate to be constantly meeting highly talented investors, ranging from self-made entrepreneurs, billionaires and family office decision-makers. We have created our 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 privileged and unique insights into the future of our industry. Most investors that we meet share our common desire to co-invest and, thus align their interests with ours. They also do not trust or think very little of the financial industry, both from the point of view of value (fees) and/or service (lack of quality ideas).

We have been asked to collate an overview of some of the 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, co-investment ideas, and resources. One that is free from the usual conflicts of interest.

Altana: Review of 2019 Ideas - so far so good

In our January investment thoughts we discussed credit ideas and portfolio protection and followed that up in March with a piece on the cheapness of gold calls. The credit ideas worked tremendously well with many of the names we proposed tightening back to pre Q4 2018 levels and some even tighter. At that point we took profits. Given there are over one trillion dollars in passive bond funds, even small redemptions can cause liquidity problems for sellers allowing us to take advantage as opportunistic buyers.

All of the issuers in this subsidiary portfolio had 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

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analysis leads us to have any doubts about the issuer's 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 20 names weighted with a maximum position size of 5% to provide adequate risk diversification for the portfolio. It comprised 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 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 increase 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 sell from the managed account. The aim is to buy these credits at 8-14% in bond market sell offs such as we saw in Q4 18 and Q2 19. We then hold them until they normalise to better levels before selling and reverting back to cash. Given the reduced US rates and over \$17 trillion of negative rates we will be sending out more details on this opportunity in Q4.

Gold was another well timed idea. The fundamentals were highly supportive – weakening currencies especially emerging markets, trade wars and of course negative rates – and technically a break out above \$1350 was likely to lead to a big move. Given implied volatility was at times below 10%, the calls were a great way to play the trade with an asymmetric risk reward profile highly skewed in our favour. Some clients who couldn't trade the options themselves asked us to set up separate mandates for them. We are trialling this with a small number and will expand if successful.

Our other big call was the Bitcoin halving trade. The number of Bitcoins released every 10 minutes halves in the middle of 2020. This happens every four years and typically leads to a strong rally in the preceding months as longs increase and shorts are covered in anticipation of the event. When Bitcoin was around \$3500 we felt the risk reward was \$1500 down and at least \$3500 up. Upon breaking resistance levels Bitcoin very quickly rallied to above \$10,000. One of the striking differences this year has been the involvement of institutions rather than retail driving the rally. We think there will be another push higher before year end. Again I must caution that this is a high risk investment but we feel that new highs could occur in the coming months followed by potentially crazy moves even higher. The break out back above \$4000 also drove demand for more leverage and our crypto lending fund has seen a pickup in lending rates leading to returns of around 2% a month. Thus the fund benefits from more Bitcoin volatility with very little volatility itself.

Another brilliant idea came from our quant team who created our Protective Alpha Strategy. This typically returns over 10% IRR unlevered but with less than 10% drawdown and a significant negative correlation to the equity indices it trades. It is a beautiful trade but has very limited capacity. Every day we go short an index future and long another with a knock out option but we pay no upfront premium. If the market moves upwards or falls less than a set amount (say 1%), then you remain flat and with no market exposure. However, if the market falls by more (say 3%), then you are stopped out at -1% on your long with no slippage (including overnight gaps), but remain up 3% on your short. We then cover the short either with a profit target, a stop loss level or if neither is achieved then at the close of business we cover so you are flat market exposure again. This works really well in falling markets to add performance and is essentially flat in rising markets. Hence its beauty, as it gives returns when you really need them. We launched with leverage of three times as we only need limited margin to run the strategy. We sent out the information early February and quickly filled our \$100m capacity. We are testing another \$40m of capacity and hope to be able to offer that shortly. Personally, it is very comforting that smart short alpha trades with positive convexity are so well received by our client base. Note to myself, we need to find more of these ideas.

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Negative Rates

It's a strange world when you have to pay to lend. Even stranger when over \$16 trillion of bonds have negative yields including some corporates. Many central banks continue to see lower rates as a cure for not a cause of the problem. It is clear to us that if rates go below certain thresholds any benefits to borrowers stop as banks still need a lending margin and in conjunction savers are hurt more and more so spend less and less. Either central banks are stupid or they are trying to weaken their currencies in a race to the bottom. Who owns these bonds? Certainly not HNWI or family offices. Yes, some traders own them, betting on being able to sell them to pension funds, insurers and other regulated institutions that have to buy them or better still to the central bank itself. Take the August bond issue by Germany, one of the highest quality credits. Germany just tried to issue negative interest 30-year bonds with a total offering of €2bn of which they only 824 million were purchased. Therefore the prices we see on our screens are not a real market. This is QE driven and this will continue to falsely inflate prices. Do you believe 10 academics should set the price of copper centrally? The price of food? The price of oil? So why would you let them set the price of money, which is typically half of all transactions? Where is the free market rate for government bonds such as Italy or Greece? Certainly not below that of the USA in our opinion. There will be liquidity gaps at some point.

Another question, would any scientist when testing solutions move multiple variables at each iteration? Clearly that would be irrational, yet central banks have raised rates and reduced QE at the same time and more recently lowered rates before ending QT. Are they competent or just grasping at any solution to try and redeem themselves? Draghi certainly looked a beaten man at recent ECB conferences, he can see his policies are not working. Powell after a good start is flip flopping and making an even bigger mess. At least the US has options to cut rates.

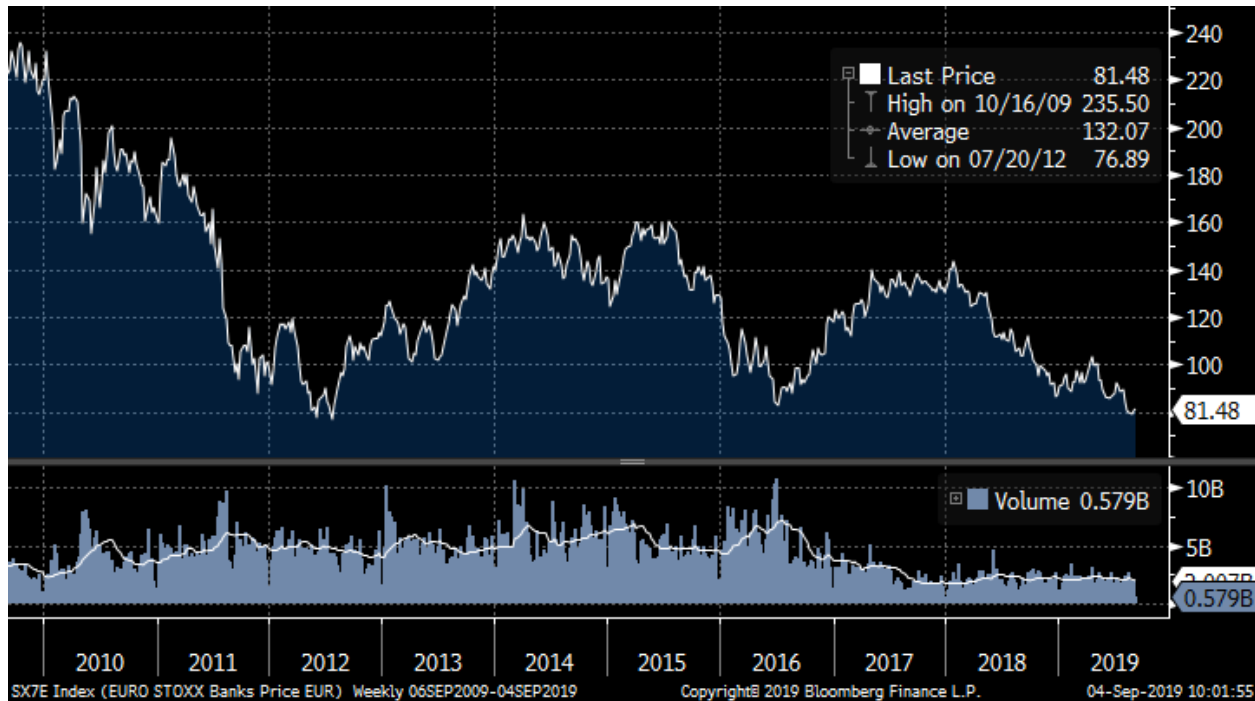
The consequences are showing. Gold and silver are marching higher. As they go higher, eventually many sovereign wealth funds will buy more precious metals and sell equities to get back to their pre QE holding levels of equities which were close to zero in many cases. Certainly some of the crypto demand is driven by the folly of negative rates. We continue to prefer US dollar short term corporate debt and gold over almost all other currencies. We are particularly concerned about emerging market currencies and will discuss this later in the newsletter.

Recession Fears

There is little doubt that the global economy is contracting. Purchasing Manager Surveys, global trade, container shipments, hiring plans are all in decline. We could list more red flags – Korean and Singapore exports, rising inventory levels, falling sales but you get the idea. US bond yields are at all time lows. Similarly occurring in almost all other countries. Stocks excluding a small set of tech companies are falling. More QE is coming so we could see a further rally but we remain concerned that in a world with over \$200 trillion of debt that any normal recession can quickly morph into the rarer and more dangerous credit recessions as per the 1930's and more recently in 2007-09.

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European Bank Index:



Above is a chart of European bank stocks. As you can see they are back to the lows of the 2012 crisis. Lower rates drive bank stock prices lower and thus they are less inclined to lend. A doom loop that may only be cured by a bankruptcy cycle. The ECB and others will continue to buy assets such as corporate bonds and eventually equities but there is a political limit as they cannot buy private companies. Again, this is driving gold and silver higher.

Many people talk about negative rates as a sign of deflation but what if it is smart money preferring to lose a small amount versus losing 90% if their bank fails? The chart of European banks is an alarm bell to depositors to be fearful.

Tariffs, Taxes and Socialism

One of the most successful self-made persons I know suggested I read 'The Trap' by James Goldsmith

"James Goldsmith, after amassing a vast fortune in the 1980s, turned his companies into cash before the stock market collapse on Black Monday. He officially "retired" from business to devote himself to ecological causes. His enquiries led him to confront the worldwide problems of unemployment, urban decay, the poisoning of our food and air, and made obvious the lack of essential solutions politicians, of whatever persuasion, were offering. He confronts in this book, the "sacred cows" of modern political and economic thought, exposing why global free trade will destroy nations, the lies about the nuclear energy industry, why agricultural policy is poisoning and destabilizing communities, and the cost of a welfare state that doesn't deliver welfare."

Written with great foresight in 1994 he pointed out many government fallacies and that developed nations would increase protectionism to prevent any decline in wages and standard of living in the West. The trade wars are part of politicians' clamour to retain power in a world where the welfare state is no longer affordable. The costs are compounding at exponential rates. As we have discussed in previous letters, at some point between 2025 and 2040 almost all western nations will be insolvent. The pathway will not be rational but instead a drift to the left and

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more taxes and spending to try and halt the demise under the current politicians' tenure. Ultimately of course this makes it worse for the next leader and the ones after that until the nation is declared insolvent and true change occurs. We'll see more tariffs and, I think, a global tax system based on passport similar to the US system will spread throughout Europe and eventually to other continents. Socialism is spreading, even in the USA, where the Democrats are slight favourites to win back the White House next year with all their candidates standing on policies of inequality and redistribution of wealth.

Who is John Galt?

Going back to tariffs, my view on negotiations is well known. Whoever controls the timetable should win. Trump has painted himself into a corner by upping the stakes but he can't afford a deep recession in 2020 or else his primary goal of re-election will almost certainly fail. China knows he must strike a good deal before Q1 2020 so they sit, wait and run down the clock. They may overplay their hand but as they don't want to face an angry one term only president in Q3 2020 so they will wait for Trump to panic and offer a better deal. However, Trump may continue to up the ante with more tariffs before that happens. China would gain immensely if the trade war causes a President to not be re-elected. This would deter future first term Presidents from attacking China on tariffs for at least four more years and potentially longer. Trump's recent call to US companies to 'come home' will only increase uncertainty and stall investment globally. We will likely see several volatile days in the coming months.

Another concern is the digital tax. In our view there has been too little discussion about the implications of the French and British decision to apply a global digital tax. The Americans complained given it mostly targeted their largest US companies – Amazon, Facebook, Google etc. - that pay little tax in Europe. Reluctantly the US agreed at the August G7 meeting to allow the tax to remain for two years until the G7 agrees a global minimum rate. Whilst governments are slow to enact almost everything that is positive, they are very quick to put in place temporary tax measures that become permanent. This has very negative implications for US tech companies and is yet another tariff. Expect European consumers to bear the brunt of these extra costs in the same way US consumers are now paying for US tariffs on Chinese goods.

Currency Outlook

As we regularly get asked our views and trade currencies actively on a daily basis through a managed account, we thought we'd pen a few observations. Our last piece stated we were US dollar bullish due to the many factors already mentioned and the consequences of the Republican Tax Bill. Never forget that global debt is now more than \$200 trillion up from \$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. With economies slowing and oil prices lower there are less US dollar proceeds to repay debt, of which the largest proportion are US dollar related. This debt means the world needs to find extra dollars from somewhere. Negative rates, both nominal and real, also mean most investors prefer positive yielding US assets. Additionally a huge proportion of the emerging market currencies are not investable due to a combination of default and hyperinflation, capital controls, sanctions or a combination of all three. Many of these nations are high GDP nations such as Argentina which will become the IMF's largest historic loss.

Another consequence of the rise of digital currencies will be the downfall of weak fiat currencies. Why would you own a fiat currency in an emerging currency when you can have Tether backed by US dollars, Libra the new currency from Facebook, or a digital version of the Yuan reputedly being developed by China? Turkish deposits in foreign currency have almost equalled the domestic Lira. In many other nations the ability to hold harder currencies is desired but it is very hard for the average citizen to gain access to a foreign bank account given the increase in difficulty of opening an account by national regulators. Opening digital wallets is much simpler. These digital currencies will continue to grow and suddenly local fiat currency will no longer be accepted. Venezuela is a great recent example where the US dollar has usurped the local Bolivar. I believe the countries with the weakest

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contract law and thus highest corruption will fail first and in an increasing number over the next decade. I therefore struggle to get bullish on emerging market currencies which I believe will fall further.

Nearer to home, the ECB is trapped and will shortly repeat the tactics that have failed over the last decade. They cannot cut rates much further and as they do so the yield curve flattens further causing more bank losses. The combination of lower rates, a very weak, uncompetitive banking sector that still requires recapitalisation in many countries will drive the Euro lower, which I believe is their true aim. The only brake on that is the export lead growth of core Europe. However the trade wars and tariffs are slowing world trade driving even great countries like Germany into recession. If Germany is not exporting then Europe and the Euro are in big trouble.

Brexit doesn't help, of course, for either European exporters or British corporate sentiment. However I am getting less bearish on the pound as I expect some sort of fudge on the Brexit deal or an election that is unlikely to give any party the mandate to do anything other than stay or soft Brexit. On bad days in the coming weeks we plan to add.

As we said late last year and above, we were planning to chase gold and then silver if they can break out of their five year trading range. That clearly has happened and the long patient wait to be overweight has now arrived. Buy precious metals ideally via call options on dips. Remember, a neutral allocation to gold is 4-5% of assets given Gold is 4-5% of global assets. We suggest investors aim for at least that and ideally 10-15%.

For those interested we will shortly be opening a currency account on the Deutsche Bank platform that allows investors to participate in our managed account via a margined Deutsche Bank platform. Ian Gunner has been managing this account for seven years and has a long track record. Please call for more details.

Asset Allocation

This neatly brings us on to asset allocation. In our last piece, we discussed option overlays to reduce risk for those that need to retain equity exposure but without the gut wrenching risk of a 2008 drawdown.

	IRR	Drawdown
S&P	6.6%	57%
S&P with zero collar	6.1%	30%
S&P with 1.5 collars	5.4%	21%

We showed that by adding zero cost collars returns remain similar with materially lower risk. More conservative investors could add 1.5 collars to add convexity which, put simply, means you go from long to short the market on large down moves. This lowers returns to a respectable 5.4% versus 6.6% but reduces the maximum loss from 57% to 21%. Clearly a better risk reward ratio.

Using sophisticated tools to make life easier should be part of any investor's planning. We don't need to understand how an internal combustion engine works to decide that using a car is better than a horse or to understand the internet protocols to prefer streaming calls to tapping out Morse code. At Altana we are always happy to help in that respect.

We took classic trend following models [ours is called the I-System] and applied them to various core markets such as equities, treasuries and gold. We proposed to long only equities investors to be long in an uptrend and flat in a down trend. Effectively this is a variant on the CTA hedge fund except it is used for asset allocation, thus equity long-only investors can hedge their portfolio exposure during price-down-trends, thus avoiding major draw-downs as the following case illustrates.

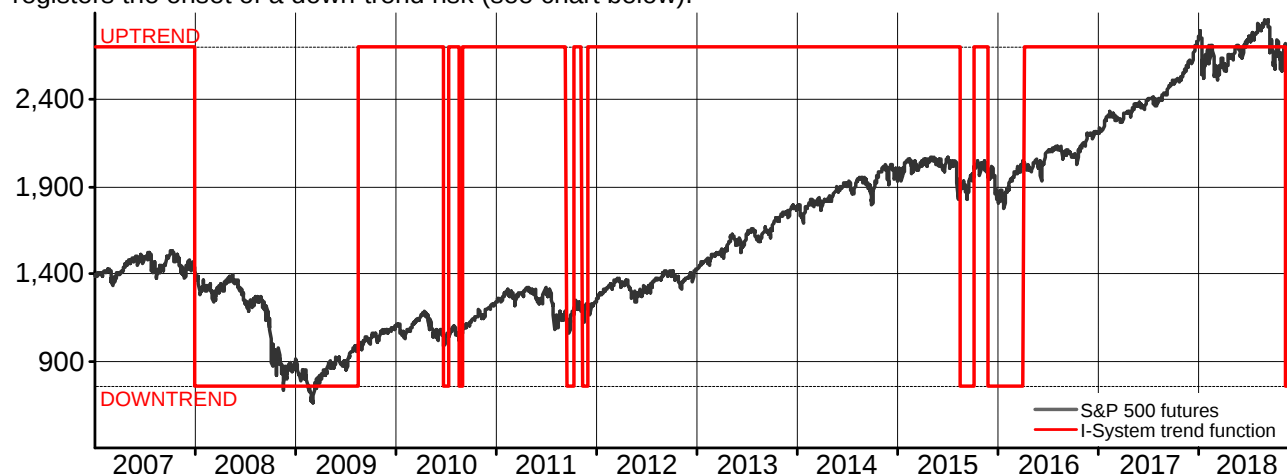
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The portfolio below is 100% long in an uptrend but flat in a downtrend. [Note returns are conservative as this does not include cash interest.]

S&P 500 long-only portfolio with and without a selective down-trend hedge



The above portfolio goes to zero risk [puts on a full hedge] through periods where I-System trend function registers the onset of a down-trend risk (see chart below).



[01/01/2007 – 31/12/2019]	Long only portfolio	Hedged portfolio
Compound annualized return	5.14%	5.64%
Sharpe ratio (risk-free = 2.5%)	0.15	0.32
Max. drawdown	-57.11% (in 2009)	-17.30% (in 2016)
Series correlation	95%	

As this example shows, protecting an equity portfolio during downturns and bear-markets can achieve a higher Sharpe ratio and a 70% reduced draw-down without sacrificing performance. The lower drawdown means the portfolio will have significantly more capital in periods of stress [in this case 100% more] to take advantage of stressed sellers. More importantly pension pay outs can more easily be maintained throughout the cycle.

We extended this to the classic 60:40 equity bond portfolio that so many wealth managers recommend to their clients. As you can see using sophisticated tools in simple ways can increase returns with lower risk. True alpha.

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The 'simple modified portfolio' here is the classic 60/40 portfolio that reduces equity component by half when S&P500 is in downtrend, becoming 30/70 portfolio. Under the 'switching' modified portfolio, the fixed income portfolio here uses U.S. 10-year T-Note (TY) as proxy. The trend-modified version reduces bonds component from 100% to 0% when TY enters downtrend, switching all fixed income assets into cash (earning LIBOR) so the investor is 30% equities and 70% cash in extremis. When uptrends reappear the portfolio switches back

[01/01/2007 – 31/12/2019]	Simple 60:40 portfolio	'Switching' modified portfolio
Compound annualized return	2.41%	3.71%
Sharpe ratio (risk free = 2.5%)	-0.01	0.18
Max. drawdown	-44.5%	-19.20%

With the exponential growth of passive tracker funds that are cheap to trade and almost zero management fee, we expect the next big area to threaten wealth management is low cost asset allocation products.

Venezuela - The Greatest Sovereign Debt Trade Ever?

Every so often sovereigns default and/or trade at distressed levels. Recent examples include Argentina, Ukraine and Greece. Typically the distressed bonds trade around 35-40% of par. Negotiations occur and from two to seven years later investors receive 75-90% of par plus rolled up interest for a 200-300% return, but with no income over that time period. When Venezuela defaulted in 2017 a similar pattern occurred. Many forced sellers that cannot hold defaulted debt sold bonds and hedge funds bought them. Bonds traded in a range of 35-40%. Venezuela has the largest proven oil reserves in the world, GDP was \$450 billion four years ago versus just \$150 billion today so bond holders expect any settlement payment to be at least as high as Argentina [75%] and maybe as high as Ukraine at 90%.

However, earlier this year the US put in place sanctions preventing US citizens holding any Venezuelan assets. Given most of the hedge fund buyers were American or had significant US investors they too became sellers. Very little else has changed. Expected recovery levels are unchanged but now paper trades in the mid-teens transforming this into a potential 400-600% return trade. Can Venezuela trade below 10%? Given Cuba which has been in default since the 60s and is still very poor, trades at over 5% we think this is unlikely. Can this be a sideways trade for 3-7 years? Of course, but we have never seen a better risk reward in defaulted sovereign debt. As a comparison, Argentina, which is likely to default again, is trading around 40%. Venezuelan debt is a rare situation whereby there are forced sellers and many of the recent buyers have now also become forced sellers. The sanctions have been the differentiator. Debt is not easy to source, bonds have different clauses and coupons, you need to maintain your claims as current through legal process and most banks don't allow you to trade them.

We are creating a SPV to take advantage of this incredibly asymmetric opportunity. It is only open for non US investors due to the sanctions. Clearly illiquid investments should pay you a premium for the lower liquidity and is why we suggest HNWI and pension funds should have a proportion of less liquid opportunities in their portfolio especially these potentially high reward trades. Given the lack of liquidity then how much should you allocate? Amounts vary from person to person. Someone with \$5m and liabilities could maybe justify 10% in illiquid investments in total. Whereas someone with \$100m could justify 90%. Whatever your number I take the view that over a ten year period we should consider ourselves lucky to see one of these great trades per year on average. So I will be allocating 10-15% of my illiquid portfolio to an investment such as Venezuela.

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Private Investments

Diligence as a Service (DaaS) is now fully up and running. Many of you have seen the newsletters highlighting the 35 or so direct ventures that have had initial screening reviews. As a reminder their clients which include ourselves send their private deals for initial screening and review. They also collate a lot of the documents that often are not initially sent by the company. I find their service incredibly time saving, not only getting through a large body of work but filtering and thus freeing me up to focus on the best deals.

To take a free trial or just receive the ideas update please visit: <http://www.diligenceasaservice.com/>

Outlook

We continue to believe that we are late in the cycle in the global expansion. Clearly, markets will become more volatile. Now is the time to switch to long-short managers rather than long only, to reduce duration on credit and especially in cyclical industries. If you have a long only portfolio then some sort of option protection is warranted. Continue to seek alpha.

As always we welcome your ideas and thoughts in response.

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/UCrjZ4lZ9oklQ0b0-c6wz3PQ>

Yours sincerely,

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