

Concentration Hacks For The Busy Investor | August 2018

“I like putting all my eggs in one basket and then watching the basket very carefully.”

Stanley Druckenmiller

Last month, we looked at the trend in wealth management of constructing more diverse portfolios as a means of risk reduction. We even drudged up Peter Lynch’s term, ‘diworsification,’ in reflecting on the risks of diversification for diversification’s sake.

This month we travel to the opposite end of the spectrum into the land of the concentrators. Its inhabitants include legendary investors such as Buffet, Soros, and Icahn, who through their words, actions, and performance espouse the virtues of highly concentrated portfolios.

But does the approach of holding fewer high-conviction positions belong only in the realms of the gods? Or are there paths to concentration that us mere mortals can follow?

Most people that venture down the concentrated route do so in search of higher returns. If you want to beat the market, you have to be different from it. The rationale for this particular method is that it’s better to invest in your top ten ideas than devoting any capital to number 57. Given the surplus of people scouring for value, there can’t be a lot of undervalued assets to be had. As such, capital should be devoted to a limited number of good opportunities. And with your eggs spread over fewer baskets, it’s easier to be a vigilant mother hen and watch over them closely.

The concentrators also argue that their approach serves to reduce risk. Taking a large position requires a certain level of confidence in the economic characteristics and prospects of the business. The assumption is that this necessitates and invokes a deeper level of due diligence and understanding of the investment. As such, the investor should also find it easier to remain steadfast through turbulent markets.

But therein lie the conditions. To be successful with this methodology, you not only need to be good at both security and business analysis but also have the right temperament and the time to devote to the investment process. The iconic money managers have spent decades honing the art of finding value and developing the fortitude to be ‘greedy when others are fearful’ (not to mention having a host of other advantages at their disposal).

Which returns us to our original question, is this the stuff of legends or does the thesis apply more broadly? Even if you have the right skills and temperament, do you have the time and energy? After all, even professional active managers struggle to select securities that outperform the market.

The authors of a working paper (Yeung et al.) provide us with a ray of optimism and perhaps a balanced approach to concentrated investing (unintended oxymoron). Based on the relative weights of positions in mutual funds, they created concentrated sub-portfolios of 5,10,15...30 stocks (representing the managers highest conviction picks). They found that the more concentrated the portfolio, the higher the volatility but also, the higher the returns and Sharpe ratios.

So perhaps the lesson for professionals is that they’re better off sticking to fewer positions and not diluting their performance. And as investors, we can consider allocating our portfolio across high conviction funds; therefore, receiving the benefits of concentration while diversifying across asset classes, strategies, and styles.



For the do-it-yourself investors who want more control on their big bets, there are another couple of diversification-concentration combos to consider. The first is to follow the conclusion of the Young et al. working paper and construct a portfolio of the high conviction positions of certain actively managed funds; using them as a subset of opportunities to consider.

The second method is for those who enjoy the sport of picking securities. A diversified portfolio augmented with a few large holdings. Taking on large positions if and only if (iff for the logic nerds) there is a deep understanding of the investment's value and risks, and an expectation to achieve above market returns.

Although the legends would say there are no short-cuts in successful investing, it appears that the average person can enjoy some of the benefits of concentrated bets without making it their life's work. The first question, of course, is whether it is your objective to outperform the market. Many investors are satisfied with market returns or lower performance for lower risk. But for those seeking higher growth, these hacks offer interesting options.

The Fund

After a relatively active July, August saw a return to more normal summer patterns with light issuance and thin trading volumes. Despite the low amount of new supply, the usual seasonal tightening was absent with domestic credit spreads unchanged over the month. South of the border, they followed up a powerful rally in July with weakness in August, with spreads wider by 5bps.

Weighing heavy on credit markets is the expectation of the looming fall issuance along with concerns about emerging markets (Turkey and Argentina in particular). The underperformer over the month was autos, with the main event being Moody's downgrading Ford to Baa3 (one notch above high-yield) with a negative outlook. Ford 5y bonds widened 23bps on the news.

Of the \$6.6bn in Canadian supply, the highlight deals were AT&T and BMO who managed to bring billion dollar plus deals into a quiet market. Both were generally priced well and were therefore well received. Several smaller deals (Crombie, Honda Canada, Daimler Canada) were also readily cleaned up.

With little in the way of trading opportunities, the bulk of the month's 52bps return consisted of carry.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2018	1.19%	(0.45%)	(0.35%)	0.77%	(0.25%)	0.26%	0.46%	0.52%					2.16%
2017	1.73%	1.30%	0.44%	1.03%	(0.22%)	0.53%	0.94%	(0.09%)	0.70%	0.83%	0.45%	0.50%	8.46%
2016	0.19%	1.49%	5.32%	3.51%	0.60%	0.54%	1.73%	1.63%	1.01%	1.86%	1.60%	1.62%	23.15%
2015	-	2.29%	2.51%	1.27%	2.46%	0.25%	0.73%	(0.25%)	1.68%	1.71%	1.37%	0.87%	15.86%

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Monthly returns are based on 'Series 1 X Founder's Class' NAV as calculated by SGGG Fund Services Inc. and are shown in Canadian dollars, net of all fees and expenses.

Credit

Fall is generally a busy period as the market comes to life after the summer doldrums. On the supply side, September will see a resumption of domestic new issuance. As for demand, bond maturities and coupon payments will inject around \$31 bn of cash into the market this month. Furthermore, with US investors currently receptive to Canadian issuers (if not our autos and parts) domestic issuance might underwhelm.

It will be interesting to see whether supply expectations over or underwhelm, but the elephant in the fixed-income room is 'bail-in' debt. As of September 23rd, new senior debt issued by banks (formerly deposit notes) will be subject to conversion to equity under certain conditions. Countries around the world have been adopting similar structures to spare taxpayers from the burden of bailing out banks should another financial crisis develop. In Canada, the change will be limited to domestic systematically important banks (DSIB), i.e. CIBC, RBC etc.

The big debate is over how much the banks have to compensate bond-holders for the equity conversion risk. In the early summer, the rumour mill was angling for 10bps back of deposit notes (probably started by bank treasurers). Now there are whispers of 20bps wider (probably the prospective buyers). We believe there is a vested interest by the banking community for the first deal to succeed, so it will likely be priced attractively to draw in a wide array of buyers. Furthermore, we anticipate that banks will starve the market of supply to help 'goose' a new deal.

The elephant status of the new notes is due to banks being the largest issuers in the market, and as such, the spreads of many other borrowers are valued relative to deposit notes. It's going to be very interesting to see where bail-in debt is priced in comparison to deposit notes and whether the pricing of other issuer curves will be affected.

At this point, the last Schedule A deposit note will be extinct on March 1st, 2028 (BMO), and we expect the existing paper to have some 'collectors' premium. We used any weakness during the summer to add to our positions but recognize that benefitting from legacy value is a long-term trade.

While the supply dynamics and the introduction of bail-in debt could dislocate the market and open up opportunities, we have to remain vigilant of the external backdrop with problems in Argentina and Turkey bubbling away, the prospects of a no-deal Brexit growing, and the expanding trade war being waged by the US.

The only certainty is that it will be a very interesting run into year end.

Rates

Despite the 'Turkish currency delight,' lack of a NAFTA deal, and high odds that the tariff battle with China would escalate, bond yields failed to break out of recent ranges. There was some excitement in Canada, as the yield differential between 5y and 30y bonds touched a scant 6bps (30y rates briefly dipped below 10y rates). A few pundits have made the rounds talking about the recession signalling power of an inverted yield curve. Central bankers, on the other hand, point out that quantitative easing might still be exerting undue influence on the curve, thereby making it more difficult to read 'smoke signals.' We are aligned with this view and would be much more concerned if 5y yields were to trade below 3-month T-Bills.

Looking ahead, the Federal Reserve is expected to hike 0.25% later this month, while the Bank of Canada is expected to follow suit in October. With the market having priced these in, we don't see a reason for the recent trading range to break.



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