BY BRAM DE HAAS

# THE BLACK SWAN PORTFOLIO

## The Don’t Lose Money Edition

Image: Rembrandt van Rijn, The Storm on the Sea of Galilee 1633

## Introduction

I was listening to a financial podcast and the invited guest happened to a venture capitalist who made hundreds of millions by hitting unicorn after unicorn with his angel investments. He was the 3rd or 4th investor in Uber. I'll readily admit I learned quite a few interesting things from this individual.

There comes a point where the conversation touches on markets and this person says he's got his Wealthfront dialed all the way down to risk level 1 or 2 because he is very bearish. He also says he favors barbell investing. He viewed his venture investments and Wealthfront as a barbelled portfolio.

This is an individual with a portfolio in the hundreds of millions of dollars and it is obvious he has no idea what he's doing outside of his circle of competence.

I want to explore a couple of the mistakes he's making because there are some interesting takeaways. .

1) Signing up for Wealthfront - with Burt Malkiel for a CIO - and state your preference for a barbell portfolio means you do not understand what you are doing. Wealthfront is all about the efficient market theory and Markowitz portfolio optimization according to efficient frontiers.
2) The second problem is that the risk dial on Wealthfront runs from 0 to 10 and asset allocations vary by risk level but there are several fixed boundaries. I've looked them up:


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Table 5: Asset class allocation constraints

| ASSET CLASS | MINIMUM ALLOCATION | MAXIMUM ALLOCATION |
|---|---|---|
| US STOCKS | 5% | 35% |
| FOREIGN DEVELOPED STOCKS | 5% | 35% |
| EMERGING MARKET STOCKS | 5% | 35% |
| DIVIDEND GROWTH STOCKS | 5% | 35% |
| US GOVERNMENT BONDS | 5% | 35% |
| CORPORATE BONDS | 5% | 35% |
| EMERGING MARKET BONDS | 5% | 35% |
| MUNICIPAL BONDS | 5% | 35% |
| TIPS | 0% | 35% |
| REAL ESTATE | 5% | 35% |
| NATURAL RESOURCES | 5% | 35% |

40% of assets are put into high risk assets - strongly correlated with equities - at a minimum. Even when you are at the zero risk level.



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But the angel investor indicated he isn't on the zero setting but dialed back to 1 or 2 - meaning he used to invest the vast majority of the safe part of his barbell into risk assets - and I guess it is still at least something like 50-60%.

There's a 5% allocation to natural resources in there precisely because these aren't correlated to stocks and bonds. It just might turn out he's very grateful for those.

If interest rates go up and stocks and bonds happen to go down simultaneously, which has happened before, his portfolio is toast except for this 5% allocation to natural resources.

Unfortunately, when I said his portfolio is toast, I meant the part he considers to be the safe side of his portfolio.

Then there's the other side of his barbell which is loaded with venture investments. Detail; he believes you need to invest in the valley to be really successful as an angel investor. Basically all his investments are done in Silicon Valley. Venture capital can be thought of as super long duration capital and it is likely extremely sensitive to interest rate hikes.

This person has hit homerun after homerun in the field that's most important to him and most of us can only dream of generating the kind of returns he achieved. On the risk front and outside of the venture capital there's a lot to improve here. There's tremendous home country bias, home state bias even, overexposure to equities, this person doesn't seem to know what he owns and finally there's a lack of an overarching investment philosophy unless it's a deliberate choice to bet on conflicting philosophies but I don't think so.



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This service is built around the barbell portfolio model. The model portfolios have their flaws. They are long only. I can't fault anyone for wanting to create a simpler numeraire as compared to what I've put together.

Yet, I much prefer what we are doing here to a portfolio where the safe side of a "barbell" is in 60% risk assets. The other 40% are thankfully allocated largely to bonds but given Markowitz optimization it will be full of maturity risk. That's just not safe at all. That's just running a 60/40 portfolio and crossing your fingers the bull market continues.

The combination of a very vulnerable right barbell with a fragile left barbell defeats the entire  purpose of the style. What this guy needs is a left barbell of 100% TIPS  or perhaps cash. Something that allows him to reload his venture investments whenever disaster strikes. He doesn't want his numeraire to decline 50%  just when opportunities to deploy capital through the aggressive part of the barbell are super attractive.

My take is the left side really needs to offer is protection even under extreme stress. It's not where you want a little bit of extra yield to come from like with a low risk Wealthfront profile.



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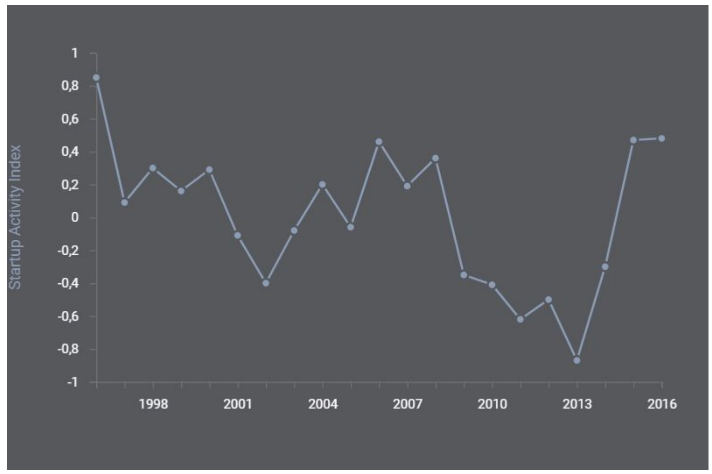
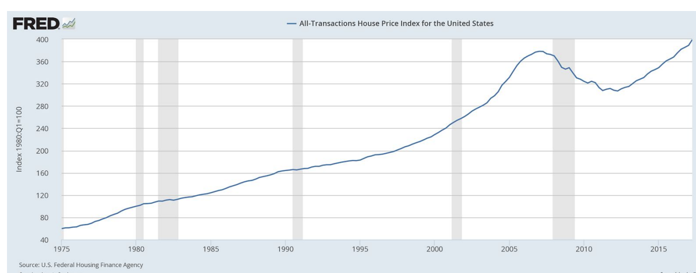
## Market Outlook

The economy is humming. That's how it, is and there are no important indicators signalling an imminent recession. That doesn't mean returns on risk assets will be great. Since the depths of the financial recession we've experienced fantastic returns and economic indicators were rarely this upbeat. A quick tour of several indicators:

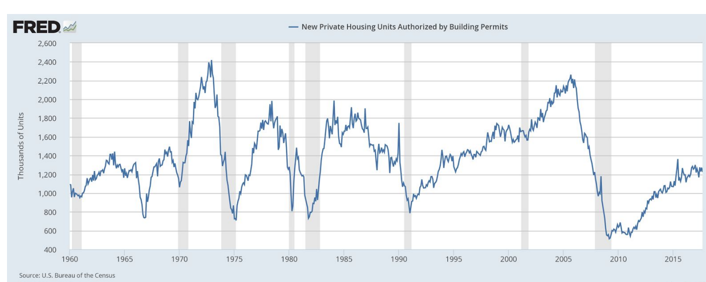
1) The startup activity index has really jumpstarted itself since 2013 and is at levels seen in 1997 and 2006 to 2008.




2) U.S. housing prices continue to rise.




3) Private building permits are still pretty far from highs seen previously:



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4) Valuation indicators like the GDP-to-total-stock-market-value pictured below:


As well as the more often cited Shiller P/E ratio show the market is trading near the upper end of its historical range.




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## Performance

Our portfolios benefit from the booming markets and we seem to ride an unstoppable train. Recently, I issued a few [trading updates] on a company called Overstock and included it in The Black Swan Portfolio. It has been on an absolute tear since. I will discuss this position in more detail in a specific paragraph but would like to emphasize we've been extraordinarily fortunate year-to-date and usually investments take years and years to come to fruition. At the start of this service we've endured a painful stretch of underperformance that lasted over a year. What I'm saying: don't get used to quick moves in the right direction. Compound annual return since inception is 35.38%:

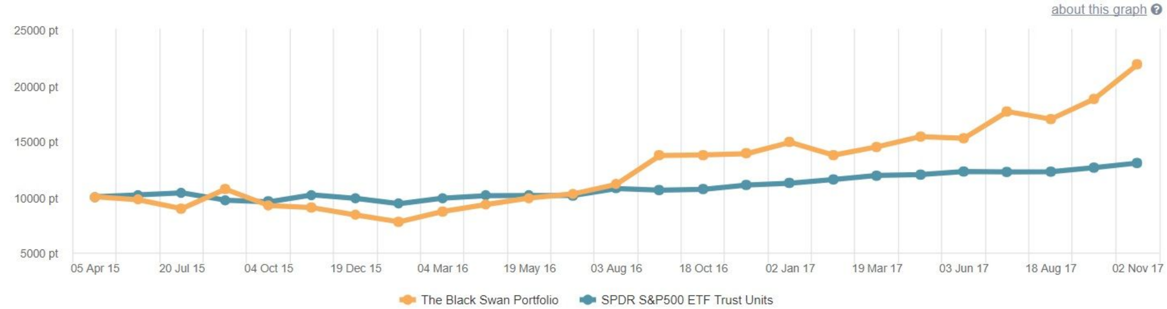
The Black Swan Portfolio

636,932.41 CURRENT VALUE

251,059.02 | 35.38% TOTAL RETURN

since first purchase | Graph performance index | advanced options | Share Checker | Add or Import Holdings

about this graph




| Since 05 Apr 2015 | Total Return | | Capital Gain | | Income | | Currency Gain |
|---|---|---|---|---|---|---|---|
| Your Portfolio: The Black Swan Portfolio | 251,059.02 35.38% | = | 184,680.52 26.03% | + | 57,127.61 8.05% | + | 9,250.89 1.30% |
| Benchmark: SPY.NYS SPDR S&P500 ETF Trust Units | 10.76% | = | 8.94% | + | 2.08% | + | 0.00% |

On the other side of the barbell there's the Numeraire which is designed as a portfolio that should be safer than cash. It is up big for the year and benefiting tremendously from the inclusion of Bitcoin as one of the currency alternatives. The position is becoming outsized due to price appreciation but with the potential for Bitcoin futures trading it seems like a bad time to cut it. Over time I will be satisfied if this portfolio lagged its benchmark slightly. Its true test: retaining purchasing power under a lot of stress, has yet to come.



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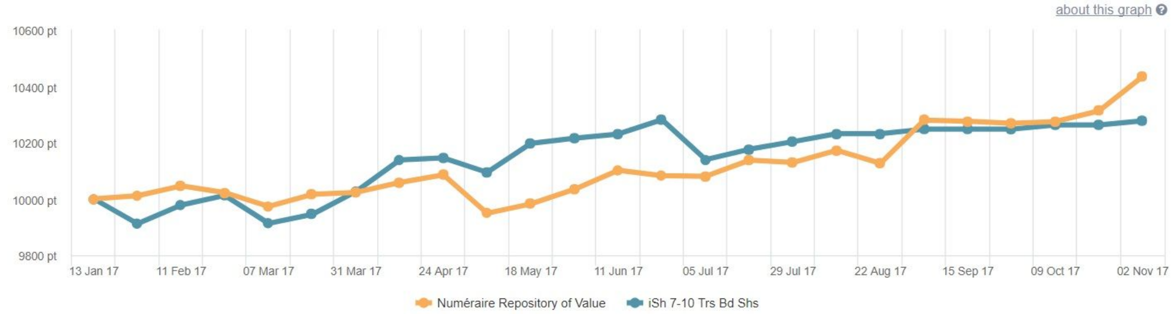
## Numéraire Repository of Value

549,267.96
CURRENT VALUE

22,883.35 | 4.34%
TOTAL RETURN

since first purchase | Graph performance index | advanced options | Share Checker | Add or Import Holdings

about this graph




| Since 13 Jan 2017 | Total Return | | Capital Gain | | Income | | Currency Gain |
|---|---|---|---|---|---|---|---|
| Your Portfolio: Numéraire Repository of Value | 22,883.35<br>4.34% | = | 21,241.42<br>4.03% | + | 1,341.40<br>0.25% | + | 300.53<br>0.06% |
| Benchmark: **IEF.NYS** iSh 7-10 Trs Bd Shs | 2.77% | = | 1.26% | + | 1.51% | + | 0.00% |



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## Blackstone Group

The Blackstone Group L.P. is a U.S.private equity, alternative asset management and real estate firm based in New York City. It is the largest alternative investment firm in the world. The firm is headed by Steven Schwarzman and its investment philosophy can be summed up as: “Don’t lose money”. It has already been included in The Black Swan Portfolio as part of a private equity basket. This issue is dedicated to this firm as I have increased my real world allocation to the firm and will increase its weight in The Black Swan Portfolio.

### Why does this opportunity exist

1) The asset management industry is experiencing tremendous pressure because of the move towards indexation and private equity may have to deal with potential specific tax reforms. Finally, we’ve been in a bull market for a while which tends to elevate earnings and assets under management in the space. Asset managers tend to have a lot of beta. The market could be discounting the group somewhat in anticipation of tougher times ahead. This entire industry is rife with opportunity but I suspect a market drawdown may not be all that bad for those asset managers that implement active value based strategies. A respectable drawdown may highlight the positives these parties bring to the table and as a consequence make it easier to raise assets under management.

2) Blackstone is a typical example of an owner operated firm. Steve Schwarzman owns a high percentage of the firm and that means there isn’t all that much float. With money flowing towards passive strategies and ETF’s being unable to easily include Blackstone Group because of its lack of float these flows are largely passing Blackstone by. For illustrative purposes Blackstone is included in a grand total of four ETFs. Of the two ETFs with sizeable Blackstone positions; one has $300 million of assets under management and the other about $30 million. That doesn’t impact Blackstone’s limited amount of float.



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| Ticker | ETF | ETFdb.com Category | Expense Ratio | Weighting |
|---|---|---|---|---|
| PSP | PowerShares Global Listed Private Equity Portfolio | Financials Equities | 2.31% | 5.06% |
| DALT | Anfield Capital Diversified Alternatives ETF | Diversified Portfolio | 1.30% | 4.06% |

It is somewhat surprising that the largest alternative asset manager in the world with a terrific reputation and brand,  market cap of $40 billion and $300 billion of assets under management is represented in only four ETFs while Twitter with its market cap of $15 billion is represented in 82 ETFs.

## Positives

Competitors like KKR and Carlyle Group did trade up a fair amount since my initial private equity articles (read part I and II). A few key aspects:

1) Defensive investment style
   Schwarzman hates losing and built up the investment philosophy of the firm on that base. Blackstone raised a lot of assets it has not deployed yet. Among the basket of private equity firms it is taking the most bearish approach to asset allocation before taking into account the firm's culture of making conservative investments in the first place. Competitors Oaktree and Apollo specifically have sizeable distressed segments which gives them an alternative way to profit of a downturn.
2) Growth
   Assets under management continue to grow even though many active managers are bleeding assets during the shift to passive investing that's taking place. All segments are growing at solid rates but real estate is the fastest growing segment and Jonathan Gray is getting a lot of credit for the segment's achievements.



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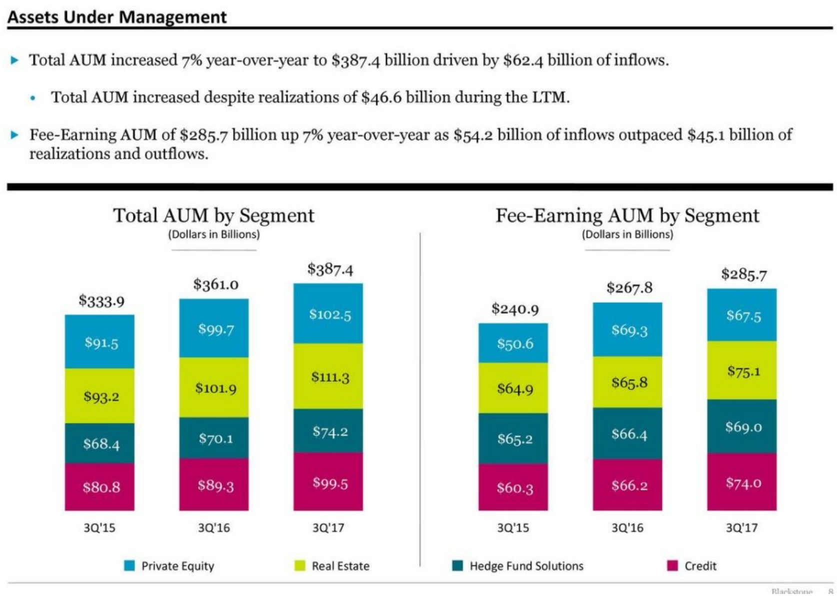
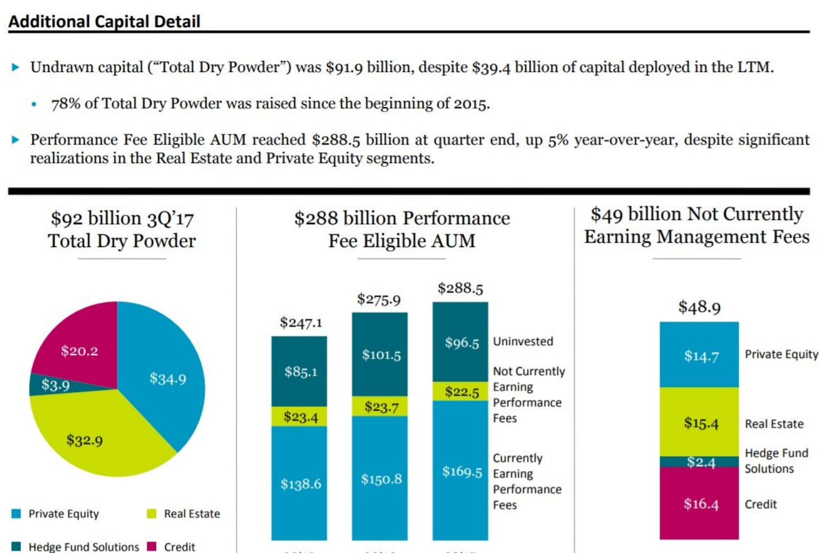
If we look at Blackstone's assets to see what is actually earning fees the hedge fund solutions segment is fully invested but the firm is not as eager to deploy its private equity, real estate and credit funds. There is significant dry powder within these segments:




Blackstone's strategic positioning is one of the premier reasons I've moved it up the list. Essentially a unit of Blackstone grants exposure to about $90 of dry powder to be deployed at fees of 2&20* in case of a drawdown.



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## Risks

1) In case of a recession or market downturn it's almost certainly you'll see Blackstone Group sell off as well. The current surging stock market with its high valuations makes for a terrific environment for private equity to realize exits. Therefore these firms currently generate substantial economic net income as performance fees are settled on exits.
2) Recently pension fund Calpers started to complain publicly about private equity fees and pressure on firms to lower fees has been heating up in recent years. Within a prolonged bull market it is a tough sell for active management to justify fees and Blackstone is positioned at the high end of the fee spectrum. If the firm needs to lower fees in order to retain assets under management that will put pressure on valuation.
3) Blackstone relies on a number of key people like Steve Schwarzman himself but also Jonathan Gray and others. High up executives tend to own quite a large number of units in the firm but unit ownership isn't as dispersed as it is at Oaktree Capital. I view the risk of talent turnover and key people leaving as slightly more elevated.
4) **Check with your tax advisor how distributions from the units are treated. Private equity firms can complicate tax matters.**

## Valuation

| Valuation | | | |
|---|---|---|---|
| Market Cap | 23.07B | Price/Book | 3.32 |
| Enterprise Value | 54.74B | Price/Tangible Book | 4.75 |
| PE Ratio | 14.27 | Price/Cash Flow | 92.31 |
| PEG Ratio | 0.19 | Enterprise Value/Sales | 7.84 |
| Price/Sales | 3.16 | Enterprise Value/EBITDA | 15.66 |



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It is a common practice to look at an earnings multiple variant called *economic net income.* Looking at market cap as a percentage of assets under management is instructive as well.

The entire top 5 of private equity firms is highly attractive compared to the broader market and that's why they are all included in The Black Swan Portfolio. Below you will find a table showing important statistics on these firms.

| **Company** | **Market Cap in $** | **AUM in Billion $** | **Economic Net Income estimated 12 month periods in million $** |
|---|---|---|---|
| KKR | 16,369,952,423.00 | 148.5 | 1779 |
| Carlyle Group | 7,490,230,920.00 | 158 | 759 |
| Blackstone | 39,635,660,470.00 | 311 | 3300 |
| Apollo Global | 6,098,556,670.00 | 232 | 684 |
| Oaktree | 7,193,740,004.00 | 101 | 700 |

In addition Blackstone has about $8.77 in cash and net investments per share on its balance sheet.

The top five firms all trade between a 9 - 11x multiple of economic net income which compares very favorably with the S&P 500 average that's at 25x earnings and at a shiller P/E in excess of 30x. The figures are not exactly apples to apples but it's an improvement over relying on private equity's unadjusted P/E ratios.

The relationship between market value and assets under management is less clear cut and varies between ~3% of AUM to 12% of AUM.

U.S. alternative managers as a group - including hedge funds - trade at around 3.7% of assets under management but the figure is quite depressed by a few hedge fund firms that



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are fairly distressed. Private equity firms charge similar fees to hedge funds. The reason they are worth more is because they lock-up capital for up to ten years and increasingly for longer periods (read more here). Private equity also utilizes a lot of debt which enhances returns and triggers incentive fees more easily.

Purely comparing important statistical measures Apollo is one of the most attractive private equity firms. Carlyle Group would be rated second most attractive. Blackstone is one of the least attractive.

Considering additional factors I currently rate the top five private equity firms in this order of attractiveness:

1. Oaktree
2. Blackstone
3. KKR
4. Carlyle
5. Apollo

## Background material

Howard Marks interviews Schwarzman

https://www.youtube.com/watch?v=6PZziZjlUmM

David Rubenstein interviews Schwarzman

https://www.youtube.com/watch?v=7kThTbLUQdU&t=832s

How Blackstone invests in real estate

https://www.youtube.com/watch?v=K0Q8ibcc9Ko



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## Overstock

| Valuation | | | |
|---|---|---|---|
| Market Cap | 1.09B | Price/Book | 6.85 |
| Enterprise Value | 357.07M | Price/Tangible Book | 8.03 |
| PE Ratio | - | Price/Cash Flow | 20.10 |
| PEG Ratio | - | Enterprise Value/Sales | 0.19 |
| Price/Sales | 0.60 | Enterprise Value/EBITDA | 22.17 |

With Overstock on fire and having catapulted itself up to second place within The Black Swan portfolio in terms of size and the news surrounding its upcoming ICO, I feel obliged to write about it again.

An ICO or initial coin offering is somewhat like an IPO or initial public offering. An organisation raises capital by issuing and selling "crypto tokens" and it usually promises a future benefit to buyers.

Overstock outlined a plan to raise capital through an ICO within two weeks from now.

Usually a capital raise is bad news because it means a company is in a tough spot and needs to dilute its future cash flows to save itself.

That's certainly not the case here.

I identify two reasons for Byrne making this move:

1) Putting the new Overstock ICO exchange on the map with a real Chuck Yeager moment as he likes to call it.
2) To take advantage of raising capital at very, very loose terms

Shareholders benefit from both objectives. In return Overstock will need to give away some or all of the upside within its crypto business to the buyers of these tokens.



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If you feel bad about it, just remember that up until today Overstock's crypto business continues to be a money losing business.

As an Overstock shareholder you'll be trading a current cash drain for up to $500 million in cash which equals half of the company its Enterprise Value.

If the ICO is a success you end up with 1) $500 million of additional cash on the balance sheet 2) higher profits.

Theoretically, as in any transaction, it is possible the above scenario equals getting "the short end of the stick" as an Overstock shareholder but if that's the short end I'll graciously accept it.

## Actions

Hold or even buy until there is more information about ICO event.

Given the current level of valuation as it relates to Overstock fundamentals I would like to trim this position.


Because of the near term ICO event holding or even buying is the superior choice.

For some reason that I do not entirely understand companies can obtain financing at super attractive rates through ICO's. As a shareholder of Overstock we are positioned to benefit tremendously from this influx of cash with few strings attached.

To be continued…



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## Questions

I truly enjoy all your questions. Please use the chat or send me an email at bram@dehaasinvestments.com.



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