Tiburon Capital Management

Shark Bites Volume 6 Article 1 April, 2016

Far from the Madding Crowd
Averting Underperformance (and Profiting) from Crowded Hedge Fund Trades

Recent hedge fund performance has been profoundly underwhelming, especially when considering the cumbersome nature of buying/selling hedge fund interests and their outsized fees in this low risk-free rate environment, eating into client net returns. Larger hedge funds performance has been abysmal. But then there are still reasons to prefer *active* (hedge fund manager) asset management versus *passive* asset management (most mutual funds and ETFs). If we accept the premise that the *efficient market theory*[1] is flawed and bogus – that is - that risk-adjusted returns are more than just a random walk, then properly and professionally managed active management investment products should yield better risk-adjusted results than passive investment products do. How then, to reconcile the recent profound underperformance of large, well-known hedge fund managers and the indices most heavily influenced by their returns? I would argue sheer size might compel a herd mentality among managers who pile into the same trades, causing high correlation in returns and dangerous technicals due to crowdedness. Many managers lack a refined all-weather, holistic investment methodology to capture these factors, and finally, their excessive fee structure reduces what is left as a net return for the investing client.

The solution, in our view, is to invest with quality active managers featuring:
1) A penchant for underfollowed trade ideas and keen eye on the technicals related to crowded trades;
2) A scalable, dynamic and holistic investment methodology; and
3) An enlightened (low) fee structure.

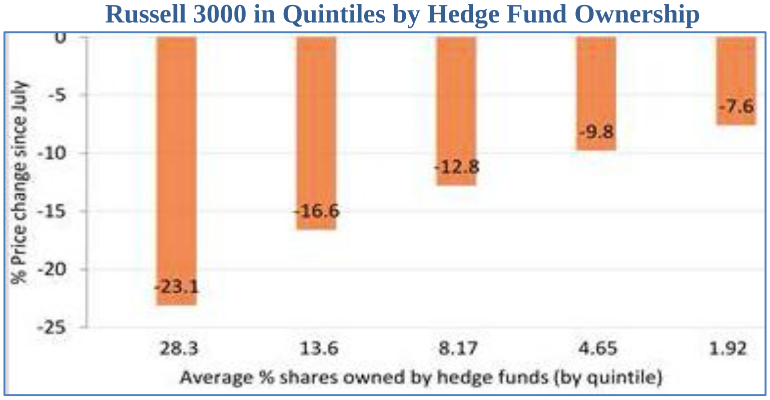
These are the three elements necessary for active management to outperform the market and passive products on a risk-adjusted basis, in this time of sideways trading markets, high correlations due to crowdedness and a low interest rates, hence, a low risk-free rate.

Avoiding Crowded Trades

I take the title, *Far From the Madding Crowd*, from the 19th Century Thomas Hardy novel. To be far from the madding crowd, according to *Merriman Webster*, is to be removed, either literally or figuratively, from the frenzied actions of any large crowd. To this end, we, and any professionally run and mature active asset manager would be wise to not be blindly influenced by the involvement in any investment, of larger, well-known or outspoken hedge funds. Perhaps, frankly, to *zig* when the crowd *zags*.

Since July, *Russell 3000 Index* companies in which hedge funds have the highest ownership percentage have plunged 31%, compared with a 2.8% decline in the *Standard & Poor's 500 Index* (as of this writing), according to data compiled by *Bloomberg*.

Russell 3000 in Quintiles by Hedge Fund Ownership

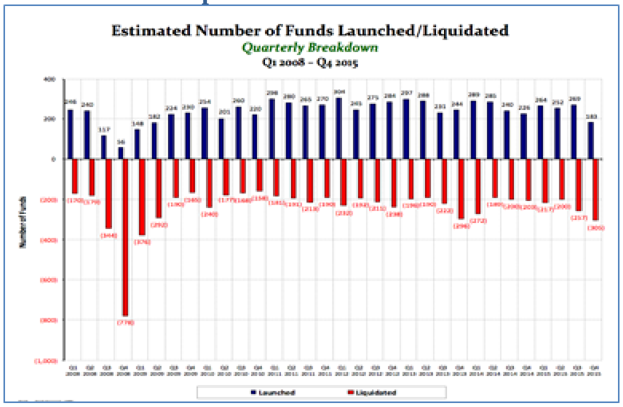


Source: Bloomberg

[1] There's the joke that an efficient markets economist walks down the street, sees and steps over what appears to be a five dollar bill…"if it were real, it wouldn't be there". This is the difference between an efficient markets believer (some economists and ETF salespeople) and active managers with edge. No, sometimes the five dollar bill is, in fact, a five dollar bill.

Hedge fund clients of *Bank of America* have sold $3.5 billion in equities in 2016 *thus far* - more than any other type of investor, according to their research note of March 8th. There's been heavy hedge fund selling following a nine-month stretch in 2015 that also saw more funds shut down than any time since 2009.[2] With the benchmark gauge fresh off its second 10% correction in less than six months, hedge funds are facing sizable redemptions. That's forced money managers to *free up cash by selling not what they want, but what they can*. This forced selling is a vicious cycle: selling begets lower prices, causing lower marks for securities, begetting lower NAV's, fomenting redemptions and so on.

2015 Marked the Worst Year for Hedge Fund Closures & Start-Ups Since The Great Recession



Source: HFR

Crowded Trade Avoid List (with exceptions, like when the Avoid List is the "Buy" List)

So what positions are/were most at risk - the most crowded trades? And how have they performed of late? An index tracking the mostly highly concentrated holdings of equities by hedge funds has plunged 45% from July 2015 through the end of February 2016, according to *Novus*, which follows a universe of almost 1,200 US stocks. That's a worse relative performance for the group than any equivalent stretch during the 2008 *Great Recession*, and the worst since at least 2005.

On a global basis, hedge funds are "crowded" long into technology company securities while generally short the broader markets, a *UBS* "Crowded Position Report" from the bank's prime brokerage unit shows.

Below is a list of their Top 25 most crowded US manager longs and shorts:

Top 25 Crowded US Manager Longs and Shorts

US - Crowded Longs			
Rank	Stock	Last Rank	Diff.
1	ALPHABET INC-CL A	1	-
2	APPLE INC	2	-
3	FACEBOOK INC-A	3	-
4	ALPHABET INC-CL C	4	-
5	MICROSOFT CORP	6	1
6	VISA INC-CLASS A SHARES	5	(1)
7	ALLERGAN PLC	7	-
8	ALIBABA GROUP HOLDING-SP ADR	8	-
9	CITIGROUP INC	11	2
10	GILEAD SCIENCES INC	9	(1)
11	JD.COM INC-ADR	10	(1)
12	YAHOO! INC	13	1
13	NIKE INC -CL B	18	5
14	DELTA AIR LINES INC	12	(2)
15	PFIZER INC	14	(1)
16	AMERICAN INTERNATIONAL GROUP	20	4
17	MOLSON COORS BREWING CO -B	17	-
18	AT&T INC	21	3
19	TIME WARNER CABLE	19	-
20	VALERO ENERGY CORP	15	(5)
21	MASTERCARD INC-CLASS A	-	-
22	TIME WARNER INC	-	-
23	ACTIVISION BLIZZARD INC	16	(7)
24	INTEL CORP	22	(2)
25	COCA-COLA CO/THE	-	-

US - Crowded Shorts			
Rank	Stock	Last Rank	Diff.
1	SPDR S&P 500 ETF TRUST	1	-
2	NETFLIX INC	3	1
3	CARMAX INC	4	1
4	UNDER ARMOUR INC-CLASS A	6	2
5	WW GRAINGER INC	5	-
6	CHARTER COMMUNICATION-A	11	5
7	WESTERN DIGITAL CORP	16	9
8	ALIBABA GROUP HOLDING-SP ADR	8	-
9	DEERE & CO	7	(2)
10	ISHARES RUSSELL 2000 ETF	9	(1)
11	TARGET CORP	10	(1)
12	NEWELL RUBBERMAID INC	15	3
13	FASTENAL CO	13	-
14	BALL CORP	19	5
15	GENERAL MOTORS CO	20	5
16	RANGE RESOURCES CORP	12	(4)
17	KROGER CO	-	-
18	WORKDAY INC-CLASS A	17	(1)
19	WALT DISNEY CO/THE	-	-
20	FORD MOTOR CO	-	-
21	MOODY'S CORP	-	-
22	MARRIOTT INTERNATIONAL -CL A	21	(1)
23	SOUTHWESTERN ENERGY CO	-	-
24	ALCOA INC	18	(6)
25	GENERAL MILLS INC	-	-

Source: UBS

[2] Hedge Fund Research Inc. ("HFR")

The Market – A Pari-mutuel Betting Environment – the "A" Actors Matter

Our Tiburon proprietary investment methodology is dubbed *BRACE* – a dynamic five-pronged acronym with each element weighted to assist in our buy/hold/sell/short decisions. To not assess other market participants, particularly large hedge funds – one of the "*A" in BRACE - Actors* – or the technical market aspects of crowded trades – an *"E" - Externality*, is to profoundly handicap one's ability to make money (conversely, to not lose money) in these markets. There are slingshot-like consequences to herding in investments. When funds herd in together, they buoy securities prices past estimated reasonable fundamental valuations and then may all race out at the same time, potentially driving share prices through fair value. This arguably provides an advantage to those mindful of herding and with an all-weather and holistic methodology. The market is essentially a pari-mutuel betting system.[3] Pari-mutuel betting differs from fixed odds betting (casinos) in that the final payout is not determined until the pool is closed – in fixed odds betting, the payout is agreed at the time the bet is placed. *With pari-mutuel betting and markets, the bettors - their number and prices paid - influence the odds*.

We posit that this market characteristic alters a static, deep value margin of safety approach in that *the market price of a security is impacted by other market participants*, buyers and sellers, and while a security may trade at a discount to intrinsic value, absent knowledge of other market participants' involvement, cost and price targets, it may not be attractive relative to other alternative securities or be temporarily overvalued (or undervalued). Further, that "sound" value investments require a sense for *relative margin of safety* – that is, how are your odds changed by how crowded the trade is? [4] How often do a manager's forensics on why a position did not produce the anticipated returns have to lead to the black hole of technicals ("E") and other market participants ("A") before one wakes up to these dynamics? Lack of a refined and holistic investment methodology, that in this time and place, considers crowdedness, can lead to highly faulty money losing decisions.

The *Avoid* List as the *Buy* List

Aspects of *BRACE*, including an ("A") *Actor's Assessment* informing a view of trade crowdedness, knowledge of manager selling, redemptions, etc, and can lead us to a heightened conviction regarding attractive entry/exit prices. That is, that the crowdedness of trades on any list of hedge fund heavily-owned securities, *de facto*, doesn't suggest outright shunning of trade ideas, just vigilance around such "E" technicals assuming attractive price ("*B" Bottom-up*) and plausible events that potentially re-prices *("R" Revaluation Catalyst*) securities in a step-function change to fair price. Consequently, crowdedness, while introducing additional volatility, can be accepted, hedged, managed. But surely, it requires awareness and aforethought.

An Enlightened Fee Structure Insures Fair Pass Through of Returns in a Low Return Environment

Your hedge fund manager is a de Medici – they belong in the pantheon of genius managers…only performance has sucked as of late. While the recent technical matter of crowdedness of trades among hedge funds is a factor, the more endemic issue may be *expected gross and net returns* in this low interest rate/return environment. With a proxy for a risk-free rate of return approximately 1.85% (the 10 year US Treasury Bond), what is a reasonable excess return an active manager should generate for their investors? If a manager says they anticipate delivering a high-teens return, assuming this is attainable, they are probably taking some additional significant risk (to deliver such excess return relative to risk-free rates) or they are looking at a multi-year hold (plausibly with a multi-year intended lock up of your money). Finally, *even reasonable return expectations, whatever they might be, will be net of the hedge fund manager's fees* – usually somewhere between 1.5%-2.0% on assets per annum, plus 15-20% of the profits. The traditional hedge fund fee structures, at best, are punitive to clients in the current return environment. At worst, the traditional hedge fund fee structures create bias for an active manager to take more risk, particularly with other people's money, given the asymmetry of potential profit participation (high to the manager, low to the investing client).

---

[3] I first covered this in Shark Bites Vol 2 Article 1. Lupoff, February, 2011. *Fallacies in an Expected Value Approach and Opportunities Present due to the Pari-Mutuel Nature of Markets*, http://www.tiburonholdings.net/uploads/Fallacies_in_Expected_Value_2_.pdf

[4] Edge/Odds should always be considered in sizing positions. See, Shark Bites Vol 1 Article 4. Lupoff, March, 2010. *Edge/Odds – The Kelly Formula and Maximizing Returns* http://tiburonholdings.net/uploads/Kelly_Formula_Letter.pdf . It's our view Edge/Odds be considered in determining intrinsic value as well.

Tiburon Capital Management
Shark Bites Volume 6 Article 1 April, 2016

Active Management with Enlightened Fee Structure

We, Tiburon Capital Management, are an advocate of more enlightened fee structures. Tiburon offers liquid event-driven strategies utilizing our agnostic mandate (directionally, among securities and events), with all trade idea prospects considered through the lens of our proprietary *BRACE* investment methodology. Further, these products feature heightened liquidity, with returns net solely of management fees and typical operational charges.

Vintage Tiburon Tote Bag Swag, circa 2010
People laughed until it turned out that *not sucking* wasn't so easy

Source: found in closet this weekend

Investment with Tiburon provides our investing clients with our differentiated portfolio as cultivated and shaped by our proprietary, dynamic, holistic (all weather) investment methodology – *BRACE*. As a manager, Tiburon has a preference, a penchant for underfollowed trade ideas. In this market, we are mindful of and seek to benefit from a perspective on hedge fund crowded trades, as divined utilizing the "A" *Actor's Assessment* and "E" *Externalities* components of *BRACE*. Finally, we operate as an *active* manager – regardless of the product "wrapper" - offered including investment vehicles that afford heightened liquidity and transparency and an enlightened (low) fee structure when compared to more traditional active hedge fund structured vehicles, delivering the vast majority of earned returns back to investing clients.

Peter M. Lupoff **April, 2016** **Tiburon Capital Management, LLC**

Tiburon Capital Management, LLC
85 Broad Street 17th floor
New York, NY 10004
646.840.4925
www.tiburonholdings.net