Generalists in Search of Specialists

Q2 2019

The story of the quarter was all too familiar. The market declined 6% after a tariff-related tweet from President Trump only to fully rebound and then some when the Fed shifted course and signaled a rate cut. Bonds had a strong rally and global bond yields are now at 120-year lows. Some $15 trillion of euro- and yen-denominated bonds now have negative real and nominal yields. Yes, investors are contractually committing to an economic loss by owning those instruments—it's only somewhat better in the U.S. where ten-year inflation bonds are yielding 0.3% per annum.

It says a lot that equities did well and bonds even better as rates declined, while at the same time, the yield gap between growth versus value stocks has remained close to record levels. We see these as more fragile times: markets are pricing in a slowing global economy, and there are high levels of technological disruption, a continuation of trade tensions, and low long-term inflation expectations.

In this increasingly challenging investment environment, our expectations are that future broad market returns will be modest. Global equities delivered about 5% real over the last 30 years and we see no reason to believe that expectations for market returns should be much different over the next 30 years. However, what is obviously different this time is that real U.S. bond yields are close to zero which means that almost all of the real return from a global equities/bonds portfolio will be coming from equities. The 60/40 portfolio therefore is projected to deliver only about 3.2% per annum after inflation, far short of its historical return. Achieving higher returns for comparable risk requires a value-added approach to risk control and the ability to generate significant alpha.

At HighVista, our focus remains on relentlessly seeking opportunities where we can add significant value. Our search is bottom-up in areas with structural and persistent drivers of inefficiency and where we can get a meaningful edge. In each case, we seek one or several specialist partners through which we can execute on that opportunity.

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Active investing should always be done keenly cognizant of one's edge. Investing edge can come in many forms, including talent, domain knowledge, pattern recognition and experience, the sourcing of opportunities, execution capability, investment mandate and governance, and stability of capital. For the opportunities we consider, which are reliant on bottom-up fundamental analysis, having an edge requires specialization at the individual security, company, or deal level.

In thinking about investing edge, we find it useful to bucket managers by the latitude they have to invest, in particular, by whether they have niche or flexible mandates. Niche mandate firms constrain their investing to relatively narrow segments of the capital markets. The niche segments we are active in may lie within an industry (like biotech or community banks), a geography (like China), or a type of instrument/risk (like distressed debt or catastrophe risk). In each case, we require that there be a capital market inefficiency that lends itself to systematic exploitation by a high-quality player. Niche firms will have career specialists with narrow but deep expertise, and they will tend to follow a playbook honed for their particular opportunity set. With exceptions, their spaces will be less crowded because the larger, well-resourced players cannot profitably deploy sufficient capital there. The skillsets required in niche markets are hard to come by, and we take great care in how we select and work with our partners in these spaces.

Flexible mandate firms, by contrast, source investments across a fairly broad spectrum of sectors and instruments. They are more reliant on and skilled at acquiring the needed specialization as opportunities present themselves; they will often do so with the help of an ecosystem of partners, including other managers. They benefit from being able to deploy pattern recognition across a more diverse range of investments, and also by being able to rank the attractiveness of opportunities across a wider spectrum. We value close partnerships with such managers who, in addition to generating excess returns on the capital we have with them, have served as good barometers for changing opportunity sets.

Flexible mandate firms, however, face some headwinds today. Because they depend more on acquiring "just in time" specialization, such firms need to be better resourced which usually requires a larger capital base. In turn, their size constrains them to look for larger-sized opportunities. However, finding and executing on large opportunities has become fiercely competitive as many institutions (including certain sovereign wealth funds, pension funds, and the larger endowments, foundations and family offices) have mushroomed in size and sophistication. At the same time, investment talent, whose primary career choice has been to work for the larger hedge fund and private equity firms, have been finding it easier and often more attractive to hang a shingle of their own and raise capital from sophisticated end-investors. As a result, these end-investors—including HighVista—are a bigger factor today in competing for alpha with flexible mandate firms.

In our view, flexible mandate firms are likely to do best in significantly dislocated markets—when sellers are needier and even a large availability of capital will not crowd out opportunities. Smaller-sized niche mandate firms, by contrast, will have a better chance of performing in less extreme conditions. We think it is important to invest with both kinds of firms, although our target now is for niche firms to comprise the majority of our allocated capital. We believe that these managers will provide the opportunity to earn the highest returns while maintaining a portfolio that's well diversified for a range of economic environments.

As generalists working with specialists, we are able to keep our eye on what is critically important—preserving flexibility and thinking strategically in a dynamic world. Overall, we are seeking to strike a balance that will deepen our investment capabilities while also helping us to better understand the bigger picture in today's quite foggy landscape of investing.

Important Disclosure

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