Ashdon Investment Management

Investment Implications when Index Returns are Concentrated

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- **The trigger for a market cycle turn cannot be predicted unknown**
- **Concentration in crowded market names amplify investor risks**
- **Ashdon's manager searches focus on strategies that invest away from narrow index leaders**

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We read the comments of a wide variety of managers each week. Hosking Partners is a London-based large cap global equity manager with a quality/value bias for tax-exempt institutional investors. The team has always done a good job articulating their view. They lay out market risks, to the point of articulating an expectation of a market correction or more significant event:

"The bout of market turbulence in the first quarter prompted us once again to wonder what it will take for the current market cycle to turn. Is it enough for investors to be reminded that volatility is not dead, and pullbacks are not automatically to be either bought or ignored? If not, then what will cause the weather to change? Rising interest rates, whose second and third order effects are still unclear, may be the catalyst as the unappreciated cost of leverage is made apparent. Corporate balance sheets encumbered by debt to fund buybacks of overvalued shares on the basis that they were more tax efficient than dividends (it being a fortunate coincidence that management's earnings per share incentives became a little easier to hit) are one example; leveraged ETFs juicing passive returns and sustaining the momentum trade of buying high and selling higher are another. Ultimately, if either pushes the value of the underlying shares too far away from intrinsic value, the support from inflows will cease and the trend will end."

However, they acknowledged that timing is unknown. They further articulated their portfolio positioning now and featured the need to move away from the major market indexes in order to better protect capital and to position for more long term growth.

"In the meantime, we continue to look for stocks that will display resilience in a correction, whether they be termed value stocks or simply cheap stocks with a margin of safety. If nothing else, they are off the list of crowded names which our peers running high-conviction, concentrated strategies may find get squeezed in the rush for the exit if investment sentiment sours." While U.S. economies and markets show improving conditions, we believe we'll continue to see growth for the next several quarters. As always, there are economic risks.

Understanding that Hoskings' central point is that crowded names are the problem, while concentration in those names amplifies their risks, we subscribe to both the view of the macro environment/market structure and the view that the solution isn't avoiding market exposure, but investing in companies that are far away from the "crowded" major market indexes and the "crowded" names that have, so far, dominated those trends in those indexes (think F.A.A.N.G. stocks - Facebook, Apple, Amazon, Netflix, Google/Alphabet). Our investor portfolios are exposed to these companies and have benefited. The F.A.A.N.G.'s are all amazing companies, but they are not forever immune to the economic forces changing consumer preferences, lagged, but progressing regulation (in multiple jurisdictions, no less), and ever evolving technologies introducing new competition.

Like Hoskings articulates, we believe investors should look elsewhere for both protection and growth now. We have attempted to articulate similar thinking in our commentary, though not as concise and articulate as Hoskings. However, our manager searches are clearly targeted in this direction. Our searches in distressed credit were focused on small and/or emerging managers with truly diversified strategies that are focused on smaller deals with less participation (think Yellow Pages instead of TXU). Our searches for new equity managers has led us to managers who execute "high-conviction, concentrated" strategies, yes, but our focus was on managers who find profitable companies that are unknown to the passive investors now dominating the indexes (think Allied Motion Technologies vs Keyence).

It is probably challenging to discern our thinking about asset allocation only from the manager search output. That is why we've taken the opportunity to share this commentary. In the meantime, we hope this note will make it clear to our investors that there is intentionality behind our labor. And at every point, our investors should know that their goals and needs drive the effort.

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