

Active Core Position Trading as an Alpha Generator and Mitigator of Risk

In a recent meeting with a prospective investor in our fund (we'll call him "World-Weary Hedge Fund Allocator"), I explained that one of the ways in which we believe we differ from most other deep value, distressed, event-driven and/or credit hedge funds, is our active trading around our core positions. It is our view that active trading around core positions mitigates downside deviation. As we foresee interim events prior to the occurrence of our anticipated *Revaluation Catalyst* or achieving the target price, we will trade to take episodic gains or reduce position size in anticipation of a dip in price.

Most of us in the strategies mentioned above are studied in the deep value "bottom up" approach to analyzing companies. And many of us have the tendency to maintain or add to positions based upon the sacred nature of their models suggesting a company's securities are cheap (or rich, if short) on an intrinsic basis. Add to this intellectual hubris the fact that many of these funds are massive asset gatherers ("Index-Like Funds"), with bloated assets under management. De facto, they *cannot* trade actively even if they wanted to and are stuck in static portfolios.

The ability to trade is a critical alpha generator and risk mitigator. I will discuss the importance of active Core Position Trading, and delve into the logic and mechanics of it.

Market Wisdom from My Ancestry– They are Both Correct

Marty Whitman – Third Avenue Funds	Izzy Englander – Millennium Management
<i>"We believe our research, a drop in price is a signal to buy more".¹</i>	<i>"You might be right, but we are not in the being right business, we are in the money management business."²</i>

Having a sound fundamental basis for your short or long is essential. In most markets, this might be enough but 2008 tested many of us. In this time and place you cannot invest without a sense of the technicals. You should not put on trades without hedging out risks exogenous to the thesis. As Warren Buffett said, "only when the tide goes out do you discover who's been swimming naked."

Isn't it possible that there is some happy middle ground here? If a fund has the appropriate size AUM for its strategy and builds a portfolio suited to its liquidity terms, shouldn't the manager be able – be *obliged* to trade actively enough to mitigate foreseeable events or harness temporary gains that would impact Net Asset Value?

¹ Circa July, 1990. Most positions in our portfolio were down 20-30 points in a day or two.

² Circa August, 2008. I was short regional and community banks. Every bank CEO on their Quarterly call exclaimed they weren't cutting dividends, or raising capital - *today*. Shares soared. I was defending the position.



We are Right and the Market is Wrong

In this market, face it; technicals trump valuation - plain and simple. We look at every trade idea through this same methodological lens³ but technicals, *today*, really matter. While we await our *Revaluation Catalyst* the sky could be falling, or oil rising, or Sovereigns reneging. How many months do you want to hear from your manager that they are right and *the market is wrong*? How many months should you tolerate hearing that to then deal with gates and side-pockets?



Multiple Choice Question: Why Don't Index-Like Funds (and others) Actively Trade Their Core Positions?

- A) Sheer size - AUM is too large, creating positions too large relative to market to trade.
- B) Intellectual hubris that markets and technicals don't matter when their proprietary models suggest a position should remain.
- C) Lack of trading acumen.
- D) Too lazy and/or petrified that they will look wrong if markets change tomorrow.
- E) All of the above.

Size Matters

Let's get back to Mr. World-Weary Hedge Fund Allocator for a moment. So when I explained that we actively trade around our core positions, he literally scoffed, "well at *your size* it's easier to do that." I've heard this in the past, but not post the 2008 market disaster. My gut reaction was to laugh. Then I begged forgiveness of Mr. WWHFA and said, "So are you apologizing for the Index-Like Fund's inability to trade *because of their size*? Yes, my fund should be able to trade its book but shouldn't any *professional* manager?" Isn't it a choice to scale so large that the Index-Like Fund's inability to trade creates additional risk and volatility in these seemingly stable brands? Scale your Assets Under Management to the liquidity terms you provide and strategy you employ. Stop raising money at that point that you can no longer actively trade your book. Simple.

Trading is a Tool of Portfolio Management, Not Something Incongruous with It

We are not talking about day trading for ticks. As mentioned, everything we do is rigorously reviewed through the lens of our Methodology. Trades put on are rich or cheap on an intrinsic basis and have some plausible *Revaluation Catalyst* that can drive a security to fair value in a

³ Tiburon's *Five Pronged Methodology*. Described in various interviews and marketing materials. See also: <http://www.distressed-debt-investing.com/2009/09/exclusive-interview-with-hedge-fund.html> for a detailed discussion in an interview.



step-function change. Given this, however, we still operate in a market with foreseeable and unforeseeable influences. It is my thinking that we, as professional money managers, have a fiduciary responsibility to deal with any event we might think negatively impacts Net Asset Value (or creates unsupportable gains). If foreseeable, aren't we breaching some fiduciary responsibility to not deal with it? Oh, right... unless you are so big you cannot or will not.

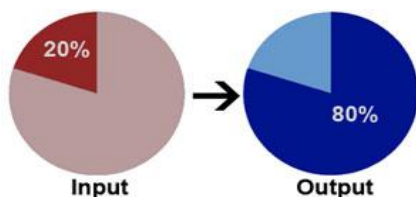
As part of our Methodology, we identify Rational Actors and perform a *Rational Actors Assessment*. These are parties in interest like management, shareholders, strategics, bank debt holders, unions, suppliers, etc., whose actions in pursuit of their rational self-interest are predictable. These behaviors can influence markets and outcomes. *Rational Actors Assessment* at the trade level provides myriad moments in the time line of a position, to reduce or increase a position to mitigate risk in front of an event or take outsized gains promptly after one.

There are also misunderstood events exogenous to the trade thesis. One of my favorites was Landry's Restaurants in front of Hurricane Ike's onslaught on Galveston, Texas. The company had a firmly underwritten management buyout that was to take out bonds due in March, 2009 at 101 (we were long the bonds, short the stock). I was watching the eye of the hurricane on one screen and bond prices on another. 25% of Landry's revenues were derived from the Kemah Boardwalk in Galveston. Bonds were still 99 bid. I called a few friends that were also in the bonds. In typical fashion, most simply said, "we have an underwritten takeout at 101 and we are covered to par on valuation." Yes, but Hurricane Ike could destroy the Kemah Boardwalk, where would bonds trade in that event? We sold our bonds between 98 and 99. We maintained our equity short. If Ike missed Galveston, I could always buy bonds again, but really, at 99 for a 101 takeout? Shares I was short were already trading near the buyout price so were unlikely to move up if the hurricane missed. Ike obliterated Galveston and Landry's CEO was quoted in local papers as saying, "this is not the company I thought I was buying." Bonds fell 23 points and shares plummeted.⁴

The Pareto Principle and Core Position Trading

The *Pareto Principle* often referred to as the "80-20 Rule" or the "Law of the Vital Few", states that for many events, roughly 80% of the effects come from 20% of the causes. Put in the context of trading and profitability, *that 80% of the profits are derived from 20% of the efforts*. The theory is the work of Vilfredo Pareto, an Italian economist, looking at wealth distribution in Italy in the early 1900's.

The Pareto Principle



Vilfredo Pareto



⁴ We can discuss this trade in greater detail upon request. We did buy back bonds in the 70s and covered our short some \$12 a share lower.



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The *Pareto Principle* informs our Core Position Trading as given our *Five Pronged Methodology*, conviction level about our trades, largely influenced by conviction about a *Revaluation Catalyst*, should mean that trades where we are most confident are also the larger exposures in the portfolio – our *Core Positions*. Actively trading around these Core Positions should reduce downside deviation. Further, as we know these positions best, we are best able to foresee near-term events in the life of the trade that will create trading *opportunities*. While I often talk about Core Position Trading as a defensive strategy, I use the word *opportunities* as the trading, overtime, should be additive to alpha in the trade thesis. We should outperform a buy and hold, static investor that puts on the same trade, given our Core Position Trading ethos.

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