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What Ted's Thinking

Short-Term Gain, Long-Term Pain, Part 2

David Swensen lived and breathed long-term investing. From his license plate ENDOW to his aphorism "Don't be so short-term," David walked into the office every day with a mindset that embodied Yale's perpetual time horizon. The issues I raised in Short-Term Gain, Long-Term Pain three weeks ago would have resonated with him.

Since then, the collapse of SVB revealed another example of long-term pain inflicted by short-term gains. The conditions leading to the bank crisis included violations of two of David's beliefs - invest according to first principles and take risk only when receiving adequate compensation.

Yale's Fixed Income Portfolio in 1994

In 1994, part of my job at Yale was managing the bond portfolio. Its purpose was to protect the endowment against periods of deflation. David built a portfolio true to that objective comprised almost entirely of long-duration Treasuries and seasoned agency mortgage-backed securities backed by the full faith and credit of the U.S. Government. The only deviations from that model were security specific opportunities to get paid for illiquidity without taking any interest rate or duration risk. We owned a stripped Brady bond[1] and a closed-end fund trading at a discount[2] as examples.

[1] Before the days of CDS, fixed income managers did not have mechanisms to take single country risk in emerging markets. The Brady Bond program helped emerging markets raise debt by packaging local country risk on interest payments with a U.S. government guarantee on the principal. We were shown an opportunity to own the principal-only at a discount to the same U.S. government issue because a money manager wanted Philippine country risk and was willing to pay a premium.

[2] The closed-end fund we owned was a plain-vanilla portfolio of fixed income backed by the full faith and credit of the U.S. trading at a 10% discount to NAV run by a manager at Morgan Stanley who had a substantially larger open-end fund side-by-side. We became the largest owner of the closed-end fund and quietly urged the manager to combine it with the open-end fund, removing the discount.

My role was paper-intensive and kind of boring, but the capital market environment that year was one for the ages. The Fed hiked interest rates seven times, doubling short-term rates from 3% to 6%. That move led to blowups in mortgage funds (Askin Capital), public pensions (Orange County, CA), and emerging market debt (Tequila crisis). Innovations sprung up that became the predecessor to structured credit - crafty derivatives to dissect mortgages, interest rate swaps to hedge risk, and other funky securities borne out of Wall Street.

David would have none of it. When the fixed income world got thrown into a tizzy, you wouldn't have known if you sat on the desk with me. We stayed the course with our approach and made one trade a month to rebalance. We looked for enhancements to the portfolio, didn't find any, and carried on our merry way.[3] That year, our bond portfolio performed near the top of the charts. Boring was beautiful.

The Opposite of Yale - Smooth Return Fixed Income Management

Last week on a panel discussing the banking crisis, the head of a large private credit shop discussed the repositioning of their portfolio to take less risk for similar returns than recently available by moving up in the capital stack of corporate issuers. The CIO of a mega private bank also on the panel agreed with the moves.

That approach is one David would have thrown up all over. The strategy begins with an output – deliver smooth returns for clients – instead of an input from a first principle. In fact, it's the opposite of a sound strategy; It's called "buy high, sell low."

When markets ignored risk and offered scant compensation, the manager took more risk and stretched for returns by moving down in the capital structure. Now that risk surfaced, the market is scared, and commensurate rewards are higher, he chose to take less risk. This approach may generate smooth returns, but it fails to optimize risk-adjusted return through a cycle. I was afraid to ask what pain the clients realized along the way.

Yale's Securities Lending Book in 1994

I also oversaw Yale's equity securities lending book at the time. Securities lending was a nice activity to add a little value to the stock portfolio. For a primer, we lent out stock held by growth managers (a.k.a. short sale candidates desired by hedge funds to borrow) and received cash collateral for the securities. We paid interest on that cash (the "Short Rebate") of around Fed Funds minus 0.50% and reinvested the proceeds in AAA-rated credit on a short-term basis that matched the duration of the loans. We earned a spread of around 0.75% (AAA yield – Short Rebate), which could be decomposed into the "lending spread" of 0.50% (Fed Funds – Short Rebate) and the AAA-credit risk premium of 0.25% (AAA yield – Fed Funds). We achieved that return with no duration or interest rate risk. It was the kind of small thing David found in markets

[3] I had a chance to bid on Orange County bonds and got outbid by others who paid up for the novelty value of the issue.

a hundred different ways that added up to meaningful value-added for Yale above its external manager returns.

During the year, the niche market of securities lending changed. Competition came in from custody banks, whose clients were previously unaware of the opportunity. Custodians conducted securities lending on behalf of their clients and split the proceeds 50/50. The increase in supply of securities available to borrow caused an increase in the short rebate and commensurate reduction in the lending spread from 0.50% to around 0.25%. At the same time, the custodians took more credit risk on the reinvestment of proceeds than we did. Although the true value of their services came from only the lending spread, the clients weren't sophisticated enough to understand they were also paying a 50% carry on a credit risk premium.

What did David do when the once lucrative business got less attractive, and others were taking more risk than he felt was prudent?

He exited the business.

David believed that corporate bonds weren't worth owning most of the time. In fact, he wrote his PhD thesis on the subject, concluding that corporate bonds failed to offer the safety characteristics of U.S. government bonds or the upside of equities.[4] Our re-investment of securities lending collateral in AAA-rated credit was about as much risk as he would accept. When the return attribution from the program shifted from favoring the lending spread to the reinvestment of proceeds, he said "No, thanks." If only others running large books of assets and liabilities behaved the same way.

The Opposite of Yale - SVB Balance Sheet Management

SVB was a beloved bank. They served the venture community, offered terrific client service, made loans that others wouldn't, supported decades of innovation, and thrived alongside the growing venture ecosystem for 40 years.

They also managed their balance sheet the opposite of how David would have. When reinvestment opportunities dried up in a low-rate environment, SVB didn't exit the business. On the contrary, they extended duration and assumed unhedged rate risk despite paltry returns available. Like many short-term focused strategies, it worked until it didn't.

What Would David Do Now?

It's one thing to point out problems. It's another to suggest action. As frequent podcast guest and macro strategist James Aitken likes to say, "So what?" and "Now what?"

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[4] The dissertation is entitled *A Model of the Valuation of Corporate Bonds.* I never read it, but David shared the thesis liberally. It's apparently still available in library archives on microfiche.

Times of great stress present opportunities. Warren Buffett says when the tide goes out, we find who is swimming naked. That's true a little bit, but most of the time we need to look closely just to see if the color of a money manager's trunks is what we thought it was (for those still clothed).

It's time to sharpen our pencils on first principles because things are about to get interesting. Re-underwrite a manager's competitive advantage in sourcing, due diligence, decision-making, portfolio construction, and risk management. When a manager finds an opportunity in the mess and calls for the ball, confirm that their first principles resonate with the opportunity set and be ready to pounce.

That's what David would do.