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What Ted's Thinking

The Melvin Dilemma

In the early days of institutional interest in hedge funds, Byron Wien published a paper entitled "The Inherent Instability of Hedge Funds."[1] He described how strong performance leads to inflows, which can shift the investable opportunity set away from the one in which the manager thrived. Weak performance can lead to concerns over the stability of the organization. Either way, hedge fund businesses are hard to maintain. Wien published the piece for Morgan Stanley in 2001, right before the big bucks started flooding into the industry.

Melvin Capital has experienced both performance extremes and is tasked with figuring out how to move forward. Considered a rare talent and Master of the Universe a little over a year ago, Gabe Plotkin and his team at Melvin crashed like a supernova. The present dilemma for Melvin, its investors, and the industry is a real-time case study on incentives, option value, and decision making under uncertainty.

<u>Background</u>

Let's start with the backstory. Gabe Plotkin spun out of SAC Capital in 2014. He was a star at SAC, raised $1 billion at launch, and posted returns for years that were among

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[1] Wien, Byron R. "The Inherent Instability of Hedge Funds." U.S. Investment Perspectives, Morgan Stanley, May 2001.

the best in the industry. Melvin's profits included significant wins on the short side, a treasured source of differentiation and alpha in a hedge fund landscape that underwhelmed during the same period. Assets ballooned to somewhere in the vicinity of $10 billion by the end of 2020.

Last year, Melvin got caught in a meme. Large short positions and targeting by the Robinhood traders and the Reddit community crushed returns, at one point falling over 50%. The fund received an infusion of cash - a bailout of sorts - from Point72 and Citadel, and after a modest bounce in returns finished 2021 well in the red.[2]

The rotation out of growth stocks starting in the fall of 2021 put Melvin under the gun again. Further losses ensued, reportedly more than 20% in the first quarter of 2022 and over 50% from the peak. With long-term lockups in place, it's safe to assume that Melvin's investors that rode the elevator up were still on when it came back down.

This brings us to the Melvin dilemma – what does a hedge fund and its clients do in the face of a massive drawdown with substantial assets ($8 billion+) still in place?

Hedge Fund Compensation from First Principles

Before tackling Melvin's decision and those of its investors, it's helpful to walk through the incentive structure of a hedge fund from first principles. When an investor allocates to a hedge fund, they grant the manager a series of annual call options in the form of an incentive fee. Each call option has a one-year expiry, a strike price at the previous highwater mark, and a notional value of 20% of the fund's profits. This option has minted billionaires out of leading hedge fund managers.

The math of option pricing dictates that the value of an option is a function of the volatility of the underlying security – the higher the volatility, the higher the option value. It's one of the hidden incentives given to hedge fund managers by their investors: managers are rewarded for taking more risk.

Melvin exemplified the maximization of its call option. Using a healthy amount of leverage to magnify stock selection, Melvin posted huge returns, gaining 30% per year up until the collapse and sharing royally in the upside. The volatility worked in reverse as well, but investors took the full brunt of the pain in 2021 and 2022.

Melvin's Challenge

Melvin's performance woes put it in a pickle as a viable going concern. Needing to make back its losses before earning an incentive fee, Melvin risks losing its team to competitors with the wherewithal to pay performance fees now. That team got its start at SAC and understands how to operate within the risk constraints imposed by platform hedge funds. As a result, I would presume that every team member has lucrative, standing offers from Point72, Citadel, Balyasny, Millennium, and the rest.

[2] "Gabe Plotkin's Melvin Capital Reboots After Crushing String of Losses," Bloomberg, 4/21/22.

Alongside a mechanism to keep its team in place, Melvin must consider the impact of its risk posture and liquidity on its economics. It admittedly grew to a size that limited its investment universe and constrained nimbleness on the short side. Melvin now plans to limit its asset size to address the issue. But a smaller asset base also implies lower management and incentive fees. To be sure, determining the required amount of compensation to keep a team happy is more art than science. There are no easy answers here.

Melvin's opening salvo was one of the worst looks for the hedge fund industry since the financial crisis. Eschewing its deal in place with investors, Melvin offered to continue managing capital only for clients that erased its existing highwater mark. The firm offered modest concessions of slightly reduced fees, slightly better liquidity, and slightly lower assets. The proposal optimized for Melvin's incentives and put its interests ahead of its clients.

I give Gabe Plotkin credit for quickly realizing his proposal would have broken the social contract with his investors. Allocators staying by their manager, particularly through drawdowns, should have the opportunity to earn back all their losses. Plotkin no doubt believes Melvin still has the scarce resource of alpha to provide and deserves to be compensated once it delivers again, but he initially missed the boat and was wise to reverse course.

Path Forward

In short order, Melvin will come back to investors with a more equitable path forward. Those options might include honoring the original deal, creating a modified highwater mark, or introducing a different fee structure.

In the normal course, Melvin would have to make back approximately 100% in returns to reach its highwater mark and earn incentive compensation. While that sounds like an impossible dream for many, Melvin would need three years to make back losses at its performance cadence prior to 2021. Melvin certainly earned enough in the good years to support its team for a few lean ones. The concept has ample precedent – Taconic Capital, for one, has long retained a portion of its incentive fees on the firm's balance sheet to support its team in lean years.

After the financial crisis in 2008, Lone Pine introduced a modified highwater mark to strike a balance between the needs of a manager and its clients through a drawdown. In a modified highwater mark, the manager continues to receive a reduced incentive fee until it makes back losses (and then some). The structure allows long-term investors to be made whole or better while providing the manager resources to support its team in the interim.

Other innovations in fee structures like the 1-or-30 introduced by Britt Harris while at Texas Teachers Retirement System arose from a realization that hedge funds generally

receive more than 20% of profits through a cycle but shouldn't receive more than 30%. In Melvin's case, the incentive compensation since inception was substantially higher than 30% of total profits.

Irrespective of the structure Melvin and its investors agree to going forward, the firm will encounter the inherent instability of a hedge fund that was true when Wien wrote about it two decades ago and remains true today.

The Allocator's Choice

Melvin didn't build confidence with its investors in its initial proposal. Even with a fair structure, the investors have a tricky decision that is influenced by behavioral bias and core values. Not knowing what the future will hold for Melvin, it's a fascinating time to walk through the allocator's choice.

Melvin's initial proposition would have made it easy for investors to run for the hills. Allocators pride themselves on partnering with great people whose incentives are aligned and care deeply about the fees they pay on the path to net returns. On both metrics, Melvin fell short. Assuming Melvin comes back with a reasonable structure, allocators still have a hard choice to make.

Let's assume an investor suspects that Melvin's magic has worn off. Even then, the investor would have to rebuff behavioral biases to follow through and exit. First, allocators suffer from loss aversion, and Melvin's 50% drawdown is a big one to overcome. Second, Melvin introduced the fear of missing out to those contemplating an exit. Should the asset reduction allow it to return to its prior glory, a former investor would get whipsawed watching from the sidelines. Third, while thoughtful allocators may try to create a dispassionate process by "re-underwriting their decision," Annie Duke teaches us that our biological makeup cannot be fooled when we're "in it," and we will still be subject to bias. Fourth, exiting Melvin may cause an investor to confront two aspects of their identity. Roughly 100% of the allocator community describes themself as a supportive, long-term investor. What better way to prove it than to stay the course with a fallen angel? Additionally, most allocators believe hedge funds in general struggle to deliver, but their selection of managers are exceptions. Those who profess a scarcity of true talent in the industry will need to assess where they went wrong with Melvin.

On the other hand, let's assume an investor believes Melvin can return to its prior winning ways with a reduced fund size. In that case, the investor may have to reconcile conflicting views on the importance they place on partnership and alignment of interest. After a quarter century in the investment management business and a few hundred podcast conversations, I hear repeatedly that character is the most important aspect of manager selection. Those who profess to care most about the people they choose to partner with will have to make peace with Melvin's instinctive response to its dilemma. Allocators often only learn about true character during times of great success and great failure. When Melvin soared, it made a seemingly straightforward portfolio mistake of mismanaging liquidity and grew unbounded. When it faltered, it initially put forth a

Faustian bargain for investors. If the cycle plays out again, would an investor be surprised if a different investment blind spot arose in the good times or if Melvin put itself first when times get rough? The choice these investors make will shine a bright light on what they really care about – is it the partnership with the manager that matters, or just the net returns?

The decision is likely an easier one for prospective investors. It's hard to envision that someone on the outside watching the drama play out would choose to engage a manager with highly volatile returns that kept incentive fees from the good years and considered recutting its deal with investors after the bad ones. Melvin will be hard pressed to raise new capital for a long time to come.

What Would David Do?

A few weeks ago, I attended a truly special memorial service for David Swensen. Both speakers and the crowd of family, friends, colleagues, and managers referred to a familiar aphorism to those in David's ecosystem: "What Would David Do?"

David had an unparalleled moral compass about what was right for the industry. Melvin's implicitly arrogant initial proposal alone would have permanently put the firm in David's penalty box. I imagine he would have held it out as an example of everything that is wrong with the industry, and if we had been lucky, highlighted it in a third book.

I have no doubt what David would have done. But most of us, myself included, don't see the world as clearly in black and white as he did.

The question that remains is what would you do?