Investment Philosophy

Over the years we have evolved our investment methodology to make it more effective under all market conditions and efficient to implement in a timely manner.

As long-term investors aligning our investment principles and processes to mitigate risks based on market cycle and positioning accordingly in a state of risk aversion or state of risk appetite have resulted in achieving our objective of sustainable return generation through all market cycles.

For our purposes, we consider there to be market conditions that can be clearly & accurately identified. Early Cycle and Late Cycle. The following are our definitions.

Early Cycle

That's when no one can miss the fact that the economy or market in question is going through a significant retraction. There are many times in history when such events occurred and significant opportunities arose for those with (a) the "Presence of Mind" – not suffering damaging losses that normally causes panic -, and (b) with "Risk Appetite" - ability and access to increase portfolio risk to take advantage of unique investment opportunities at the time.

Late Cycle

That's when the market has recovered from the effects of the valuation shock caused by the economic or market retraction.

Other elements such as time cycles also come into play to fine tune what market condition we are most likely experiencing.

Cycle Aligned Portfolio Construction

Late in a cycle, the portfolio construction and allocations become conservative (State of Risk Aversion), and early in a cycle one would opportunistically reach for a more aggressive construction (State of Risk Appetite).

We identify that we are in an Early Cycle when two conditions are simultaneously met. First, broad equity indices drop by more than 25%, and Second, this value erosion lasts for at least 18 months. This a simplified excerpt from a study called "Crash Analysis" we conducted in 2004 to measure the effect of cycle-based risk allocation versus a passive approach.

Consider the 2007-9 crash for example:

Using the S&P500 as a barometer, the peak came in early October 2007 and by April 2009, both conditions that define a market crash were satisfied. The Index was down by more than 25% and the decline was now entering the 19 months. Time to consider moving to a state of Risk Appetite. Those who had the presence of mind and available risk appetite were handsomely rewarded. The less fortunate were already fully loaded with maximum risk by the time Q4-2007 come along. They could only watch, with very little to do.

In contrast, by 2013 the market had exceeded the October 2007 high recouping all its losses indicating that the period of Early Cycle was well behind us. Time to consider moving to a state of Risk Aversion. Except that the Time Cycle condition was not yet in play. The 7-year cycle would peak in 2016, and the 10-year cycle would peak in 2019, the latest time, according to our methodology, to move into a state of Risk Aversion.

Accordingly, the ideal time to move to a state of Risk Appetite was April 2009, and the best time to revert to a state of Risk Aversion is 2016, and no later than 2019.

As we established Lakemore Partners in 2016 – originally under the name of Aspect Investment Partners, our investment strategy focused on Risk Aversion from the onset.

Remember this is not a market call, or clever market timing. This is simply following a structured approach to defining where we are in the cycle and allocating portfolio risk accordingly.

Once we witness the next market crash, our intention is to have constructed a portfolio that allows us to be in the right state of mind as losses would have been contained and have risk appetite to take advantage of the unique opportunities that are present early in a cycle.

Risk Allocation

When constructing a portfolio, we size positions in accordance with maximum downside risk (MDSR) potential using extreme stress testing models rather than based on variations around expected return. In addition, Performance Stabilizers (a combination of core of stable earning & effective diversifiers) are critical elements of the risk allocation and portfolio construction process.

As we allocate risk across the portfolio, we consider various elements to harmonize expected performance with our purpose of delivering performance through all market conditions.

These elements are:

- Core of Stable Earnings

We construct portfolios that have a sizeable allocation to exposures that generate a core of stable earnings to achieve persistent performance during times of economic & market stress.

- Effective Diversification

Investments that act as a hedge in times of extreme stress provide effective diversification. CLOs are a case in point as they provide both a core of stable earning, and effective diversification as their earnings power increases during market retractions. Since 2000 tranches of CLOs have been central to our Portfolio Construction.

- Never Being a Forced Seller

During times of stress, investors are frequently forced to reduce exposures and realize large losses. This occurs either as a result restrictive or MTM debt covenants, or a funding term mismatch. We make every effort to ensure that we are never in a forced sale position.

- Multiple Levers to Value Creation

As active investment managers we always ensure that we have the ability to implement several strategies to manage risk and enhance returns. This drive returns during good times and allows for effective risk management during tough markets.

- Being Prepared

Installing a plan that considers the possible market scenarios, the range of expected outcomes to the portfolio, and the appropriate action to take under each condition is part of our decision-making process to approve and investment and forms the cornerstone of our active management thereafter. Being prepared we believe is the only way to improve the quality of decision making in stresses times

Portfolio Construction

Drivers of performance that are central to portfolio construction are:

- Cycle aligned Portfolio Construction is the starting point to define the most appropriate and viable investments

- Measuring the Maximum Downside Risk (MDSR) of each investment and the portfolio as a whole under the most extreme scenarios is central to efficient Risk Allocation. Building a portfolio that is aligned to the Market Cycle, and sizing exposures in accordance with MDSR
- At all times, Performance Stabilizers (a combination of core of stable earning & effective diversifiers) must feature in the portfolio. In a way it is our way of admitting that the future is an unknown and therefore an element of caution must always be in play.

Looking back at what went well, what didn't go as planned, and what we learnt as a team since we got together in 1991, we conclude that (i) a methodical approach, (ii) implemented with discipline, (iii) that captures learnings to evolve over time, is a sustainable approach to delivering performance.

We also contend that implementing the above requires building a sustainable team that is fully aligned and focused on delivering sustainable performance to all stakeholders, most importantly of which without a doubt, must be the client.

LAKEMORE Partners

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