INTEROFFICE MEMORANDUM

TO: JOHN MCCARTHY

FROM: SCOTT SCHWEIGHAUSER

SUBJECT: TWENTY GOOD QUESTIONS

DATE: **APRIL 8TH, 2021**

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1. **You helped build an excellent investment organization [Aurora Investment Management], from early days, and grew it to a large and market leading position, then managed its decline and liquidation. What are the major lessons of this rise and decline?**

   So many lessons! When Dan Harris, Patrick Sheedy, Chris Gorter, and I were forming Borealis in the autumn of 2016, we spent hours talking about this very issue – we took a hard, comprehensive look at the good, the bad, and the ugly, and what we could take away from that evaluation that would put Borealis in a better position to create long-term sustainability. The French painter Odilon Redon said "It is precisely from the regret left by the imperfect work that the next one can be born." So true! Here's a list of lessons and observations, in no particular order:

   - Always do the right thing, no matter what. Unwavering integrity cannot be overestimated. "Character is destiny." --*Heraclitus*
   - The good thing about starting at the ground floor the first time around is that you know what the ground floor looks like the second time around.
   - A culture of excellence is critical: take your work seriously, but don't take yourself seriously. Have fun and be joyful in what you do.
   - Operate leanly and efficiently; bloat is costly and hard to eliminate.
   - Investment firms are only as durable as the quality of returns they deliver to LPs.
   - No matter what, all businesses are fragile and highly path-dependent. "What does not destroy me, makes me stronger." --*Friedrich Nietzsche*
   - Honesty is vital – honesty to self, honesty to employees. Don't believe your own BS. "You can avoid reality, but you cannot avoid the consequences of avoiding reality." --*Ayn Rand*
   - You're not as smart as you think you are when things are going well, and you're not as dumb as you feel when things are going against you.
   - Encourage open, honest, and candid debate among your colleagues. If you must speak, speak last.
   - Disagree well.
   - Base judgments on facts, not emotions.
   - A good process generally leads to a good outcome. A bad process generally leads to a bad outcome. Don't be fooled when the obverse occurs. "Chance favors the prepared mind." --*Louis Pasteur*
   - Create alignment at every level: alignment of purpose, alignment of incentives. This ensures, to the greatest extent possible, that everyone is on the same page, working towards and rooting for the same outcomes.
   - Lead from the front – walk the walk. "Never give in--never, never, never, never, in nothing great or small, large or petty, never give in except to convictions of honor and good sense." --*Winston Churchill*

2. **You have invested in firms large/old and small/new. Are these two things completely different?**

   Yes and no. On the one hand, the objective is identical – will the firm in question generate outsized returns in a fashion that is sustainable? On the other hand, the framework in which you determine that answer is substantially different:

   - Evaluating an established track record vs. a limited (or nonexistent) one
   - Reviewing an organization with depth and complexity vs. one with a flat, "lean-and-mean" structure
   - Gauging whether appropriate incentives are in place for the firm's stakeholders
   - Assessing an established culture vs. an embryonic one
   - What is the motivation for the firm's partners – outsized returns (get rich) or stability of returns (stay rich)?

   At the end of the day, it boils down to deciding if the principal leading the organization – large or small, established or new – has the drive, energy, motivation, focus, and grit to generate the returns that merit your allocation of capital to them.

3. **You have referred to investment firms as having good or bad DNA. Do you still see this as true and can you expand on it?**

   100% true. "Culture," by which I mean qualities such as a firm's:

   - ethical standards,
   - stewardship of capital,
   - appreciation for the finiteness of their investors' capital,
   - focus on excellence,
   - collaboration and collegiality, and
   - intellectual honesty and candor

   will infuse everyone who works for that organization and create a blueprint – an unofficial operating manual, if you will – that they will take with them far into the future. There is a self-sustaining quality to these characteristics, too, particularly if intellectual honesty and candor are embraced and rewarded.

4. **Any personal characteristics that foreshadow investment management success?**

   - Unwavering integrity
   - Natural competitiveness
   - Grit
   - Focus
   - Humility, *i.e.,* being aware of one's limitations
   - Self-confidence and a healthy regard for one's well-being
   - Great backstory/path, *e.g.,* first generation, overcoming significant adversity, bootstrapping one's career

5. **Any personal characteristics that tend to predict failure in investment management?**

   - Past blow-ups – often a manifestation of a deep-seated tendency to self-sabotage
   - Lying, or embellishing the truth
   - Inability to answer questions directly
   - Intellectual laziness
   - Stubbornness
   - Indecisiveness
   - Carelessness/sloppiness

6. **Any team or partnership characteristics that foreshadow investment management success?**

   For early-stage managers, teams need to have:

- Alignment, alignment, alignment. Because people respond to incentives, put the right ones in place.
- One team, one dream. Aligned up and down – no "eat what you kill" types of compensation structures.
- Centralized, not diffused, decision-making. One decision-maker – the buck stops with the PM.
- Simple and clear, not complex, organizational structures. Accountability and "ownership" at every level. No dropped fly balls.

7. **Leverage seems to be a common presence in failures. True?**

   Generally true – it's probably the most common reason why funds fail. Leverage magnifies and accelerates the effects of mistakes and creates asymmetry to the downside from which it's nearly impossible to recover. Not surprisingly, leverage is often a barometer for the type of culture you'll encounter at an organization. The higher the leverage, the higher the stakes for risk-involved individuals, leading to brittleness in the fabric/temperament of the organization – definitely less of a "one team, one dream" dynamic.

8. **What is the difference, if any, between investors and traders?**

   The differences between the two boil down to time horizon and informational input. At one end of the spectrum (and most definitely an anachronism, but suitable for illustrative purposes) you have the scalper in the pit. Pure trader – he does not care one whit about anything fundamental; his sole focus is how the supply/demand dynamics in the moment might drive the price higher or lower, and using judgment/instinct to determine what the best way is to reliably capture a profit. 10 seconds to 10 minutes is his time horizon. The time horizon is so short that real, fundamental information is irrelevant. At the very other end of the spectrum is Warren Buffett. Pure investor: buy and never sell. Fundamental information is everything when you have an infinite timeframe. Those are the extremes, and neither precisely intersect with the type of manager Borealis wishes to underwrite. The ideal "investor-to-trader ratio" for Borealis is probably in the neighborhood of 80/20, depending on strategy.

9. **Your career has seen a long period of hedge fund popularity, say 1995-2012. For the last decade, hedged funds have been far less popular. What is different?**

   I'd probably narrow the "popularity" date range a bit to 2001-2011, with the beginning of the era catalyzed by the collapse of the tech bubble beginning in 2000, and the end of the era marked by both the GFC in 2008 and the European banking crisis of 2011. This popularity—frankly, frenzy – was fueled by two related dynamics: a) performance-chasing driven by unrealistic investor expectations, and b) a massive supply-demand imbalance. Despite the substantial decline in equities in the 2000-2002 period, hedge funds generally performed extremely well, leading to a tsunami of capital coming from large institutional investors seeking to add alpha to and decrease beta in their portfolios. The resulting demand for talented managers overwhelmed their supply, and that's when we saw a lot of silly things happen as many thousands of funds launched to absorb the demand. It seemed like anyone with a halfway relevant background and a pitch deck could raise $500 million at 2/20 without breaking a sweat. The hedge fund ecosystem became bloated with mediocrity and exhibited all the hallmarks of a classic asset bubble. That bubble popped in two stages, starting with the GFC in 2008, and then three years later with the European banking crisis catalyzing an extended, multi-year period of mediocre, unsatisfying performance from hedge funds, from which it seems we're just now emerging. Once the bloom came off the rose, so to speak, disappointed and frustrated investors shifted their focus elsewhere, particularly into strategies that benefited from the highly accommodative monetary environment. Since the GFC, the Fed and other central banks pulled out all the monetary stops to stabilize markets and support asset valuations, and the resulting market dynamic has generally been disadvantageous to most active investment strategies, especially ones that have any sort of hedging component. Fortunately, that monetary headwind is starting to abate as concerns about inflation appear to be affecting long-term interest rates (as of the date of this memo, 4/8/21, the 10-year Treasury yield stood at 1.63%, vs. its low of 0.52% a year prior), which means that the opportunity cost of risk will be more rationally priced -- and way more amenable to the execution of active investment strategies.

10. What are the major implications of the rise of indexation?

Lots of dimensions at play in that question. I'd probably widen the scope a little bit by describing the phenomenon as passive investing, which incorporates both indexing and ETFs. With each, "investment decisions" are not predicated on merit-based judgments of the underlying securities, but rather on objective qualities such as market capitalization, industry segment, etc. Capital flows into and out of the passive pools that adhere to these formulaic mandates can be substantial and drive valuations of the underlying securities well beyond the boundaries of reasonable intrinsic value on either the upside or the downside. There are pluses and minuses to that, of course, depending on what your position might be and how it's affected by those flows. Either way, it has a distortive effect that will presumably be resolved at some point in the future. In a more subtle way, and an effect that has been around for quite a long period of time, is the extent to which a fund manager's behavior is affected by benchmarking her performance to an underlying index. "Hugging the index" (or closet indexing), is a natural consequence of using an index as a performance yardstick and amplifies the effects of the capital flow dynamic. In the long run, I have to believe that short- to medium-term distortions that may be created by these passive pools of capital create long-term investment opportunities for active managers, as long as they can navigate through sometimes troubled waters from time to time.

11. Any areas where investors should avoid indices?

I think of index-based investment products as pure beta plays with ultra-low friction (high liquidity, low fees, etc.). I cannot think of a good reason to avoid them, particularly if they fulfill a top-down, macro role in an investment portfolio – an information edge is generally unobtainable/non-existent, and the cost advantage is substantial. The natural follow-up question is: are there any areas in which investors ought to seek active management exposure? You bet! For complex, hard-to-analyze, less-trafficked markets, (*e.g.,* small cap stocks, distressed bonds, emerging markets, just to name a few), the information edge is substantial for fund managers willing to do the work, and the resulting alpha opportunity can overwhelm the fee differential.

12. Over the last few decades, the number of public traded equities in the USA has contracted, while other parts of the world, the number of listed equities has increased. Any implications?

This is an excellent topic for a PhD candidate's dissertation! In the U.S., my guess is that we're seeing the effects of consolidation in maturing industries/market segments, as well as the consequences of mountains of private equity capital being deployed in take-private situations. Also, it seems that VC-sponsored companies are slower to go public because of the excessive regulatory burden that becoming a public company entails. Outside of the U.S., particularly in Asia, I would guess that the increase in publicly listed companies is a function of freer and more liquid capital markets as investors gain comfort in putting capital to work in those historically less-trafficked markets. As for the implications, I suspect that investment firms will continue to develop their capabilities in and expand their exposure to non-U.S. markets.

13. Around the world, are the number of investment management firms increasing or decreasing?

Again, a guess, but I'd say that they're probably increasing on a net basis, particularly in Asia. The pace of gross formation in the hedge fund space is what's of interest to us, of course, and we've seen a pretty consistent, robust flow over the past four years, averaging nearly 600 per year. It's a pretty exciting time to be deploying seed capital.

14. Traditional Wall Street training, for example at Goldman Sachs, seems to be under new scrutiny. What are the implications?

That's a tough question to answer, particularly since the influence of COVID-19 on those organizations will probably be far more consequential in how junior talent is onboarded, trained, and cultivated. Even so, we are now 11 years removed from Dodd-Frank, which severely limited risk-taking (and extinguished the attendant culture) at the banks. So, while firms like Goldman still have value for the training ground "basics," including intimate understanding of the capital markets, developing work ethic, financial modelling, etc. – the "training" for risk-taking must now take place at buy-side firms.

15. What will ESG strategies look like in the coming few years?

Based on current trends, I'd guess that ESG and ESG-like funds will be far more prevalent than they are now. That being said, it's hard to see how an ESG filter on any strategy will make the investment returns better. The misguided trend to "stakeholder capitalism" will likely mean that capital allocators of all stripes – from fund managers to CEOs – will also be judged on more subjective metrics, leading to suboptimal performance outcomes (*i.e.,* disappointing returns). For these strategies to be a more viable part of the investment landscape, investors will need to agree on a common framework – definitions, objective metrics, etc. – or else ESG will end up being highly fragmented and fundamentally irrelevant.

16. Blackstone, Dyal, and Goldman Sachs have been active acquiring minority ownership in older firms, especially private equity firms. What is the upside and downside in your view?

For the sellers of the stakes, it's a good way to monetize their equity in the businesses they've built. At the end of the day, however, I believe that there's relatively little real value being created in the transaction – the firms are generally not improving their lies in the transfer of partial ownership from the founder(s) to the LPs of these GP-stakes funds. The least-rewarded cohort in these situations are the GP-stakes LPs themselves, who are paying considerable fees to the sponsors. It's pure friction. On top of that, one could argue that the transaction itself – as knowledgeable insiders cash in some chips – should be a clear signal that the organization's future will be different than the past. And on top of that, it's not clear to me that there is a viable exit strategy for the LPs of the GP-stakes funds. At the other end of the spectrum, seeding puts our capital in a radically different position – rather than buying solely into the equity at a multiple of profits, Borealis is investing in the underlying fund and receiving a warrant on the firm's future growth and success.

17. Over the last 20 years, have pension consultants become a larger or a small influence on where money gets invested?

On balance, I'd have to say that the pension fund consultants' role is waning in its influence, simply because the defined benefit model is a dinosaur, and on a long glide path to extinction. That's not to say that there aren't big sums of money at play right now, but the influence is definitely decreasing at the margin.

18. Management fees for active management or private asset management, have come down generally in recent years. Will this continue?

It's hard to say, but my gut tells me that we're at a fair equilibrium point right now. At the margin, I think we'll see a trend towards management fees that reward loyalty and create capital stability, *e.g.,* fees that decline the longer an investor remains invested in a fund. It's a question of creating the best alignment of the manager's and investor's interests alongside of incentivizing the right outcomes.

19. A theory: what markets are doing when you enter the investment business tends to strongly influence throughout a career. Agree or disagree?

Emphatically agree for the broad cohort of investors, but it's a quality that needs to be thoroughly evaluated and scrutinized on an individual basis. For better or for worse, most PMs in the market today have never experienced or confronted an extended period of market malaise – the GFC lasted for about six months, the COVID scare lasted all of two months, and the tech bubble collapse occurred 21 years ago, and really only lasted for two years. If anything, the takeaway from these episodes is that the Fed and policy makers in general are going to ride to the markets' rescue no matter what, and that scares me in the long run. Moral hazard on steroids.

20. If you ruled American financial regulation for a year, what one regulatory area would you seek to expand, and what one area you seek to curtail?

Ah, the proverbial Magic Wand. If I possessed such a magnificent tool, I would expand nothing, choosing instead to remove all regulations that treat investors like imbeciles who can't be trusted to make their own decisions. It might take more than a year! 😉