SuperCash

The New Hedge Fund Capitalism

JAMES ALTUCHER

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Dedicated to my mom,

Rita Altucher,

for being my hero

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INTRODUCTION

What Is SuperCash?

During the day, Superman is mild-mannered Clark Kent. He doesn't want to make waves or draw attention to himself. He is safe, calm, and offers no excitement to the adventure-prone Lois Lane. However, when he's out saving the universe, using every power at his disposal, he becomes Superman. Even with his red-sun-enhanced superpowers he often risks his life as he saves the lives of those around him.

The same thing is true of cash. Most cash sits in bank accounts, money market funds, index funds, and shoe boxes, doing whatever it can to just stay alive, not seeking to do more.

But cash can wake up and fill the cracks in liquidity that stretch throughout capitalism. Capitalism is constantly reaching out to fill a much larger universe of possibility and, in doing so, creates opportunity wherever risk aversion has kept out larger institutional players such as commercial banks and mutual funds. It is this risk aversion, and only this risk aversion, that creates the anomalies in liquidity that allow an investor to make money.

As hedge funds and other investors have awakened to the possibilities, they have begun doing more than simply trading stocks in the expectation that they will go up. For every dollar they manage, they attempt to find a customer for that dollar and then charge that customer. Moving beyond stocks, many hedge funds are actively lending money to companies and individuals that banks won't or can't touch, finding arbitrage situations that the larger mutual funds are unable to dip into because of size or regulatory constraints, and putting their dollars in companies where activism could perhaps extract more value from the investments.

These savvy investors are turning cash into supercash where instead of paltry returns of X percent they are seeing returns on their investment of Y percent. Gone are the days of buying a stock and watching it triple in a day. Now every dollar needs to be pushed out the door into a good home, and then the hedge fund manager needs to actively monitor that dollar, making sure maximum value is being sought by the new holders of that dollar.

The question a fund manager has to ask himself is: Why should capitalism reward me with a paycheck? For instance, if a mutual fund manager says to himself, “I’m going to buy Intel today, I think it’s going to go up,” it is hard for that manager to prove that he has an edge over the other 8,000 mutual funds, or tens of thousands of day traders and analysts out there who are also debating whether to buy Intel. Everyone has the same information and with the Internet, all new information is assimilated instantly. This is efficient market theory in action, and although markets are not perfect and anomalies exist, the market is largely efficient, particularly in the large cap stocks that are so widely followed.

The way to get beyond the inefficiencies that taint most transactions in the markets is to actively control the transaction. In other words:

- With stock picking, either (1) directly negotiate with the company to structure the transaction (see Chapter 4 on PIPEs), or (2) vigorously persuade a management team with poor return on equity to take actions that increase the use of cash (see Chapter 2 on activism).
- With fixed-income transactions, do not simply buy the debt structured by others and let loose on the open market, but actively enter into the arenas the banks are avoiding and structure and lend as if you, the investor, were the bank.
- With arbitrage opportunities, engage in the situations where the investment banks and large hedge funds are simply too big to flexibly and nimbly find and take advantage of the remaining anomalies.
- In cases where any of the above are difficult, find the players who are finding *alpha* and simply piggyback behind them by following their publicly disclosed transactions.

This book can be thought of as the third book in a series on attempting to map out where the gaps and holes are in capitalism. Since the landscape is constantly changing, any road map is just a guide; and since the universe of opportunity is so vast in a global economy, I’m afraid I’ve only mapped out the space of a few square miles on a world that is millions of miles wide and long. My first book, *Trade Like a Hedge Fund*, attempts to find the basic anomalies and inefficiencies that I feel will recur again and again in the markets. An example is how, when formerly large cap stocks declare bankruptcy (think Worldcom and Enron), their stocks tend to double or even triple within 48 hours of declaring bankruptcy. Another anomaly I explore is the tendency for stocks to reverse direction when they have significant gaps down due to an earnings miss or some other equally bad news. The 19 or so anomalies I look at are perfect for short-term trading accounts and work well with funds with less than $100 million in assets. With too many assets it is hard to be nimble enough to take advantage of the various trading anomalies.

Trade Like Warren Buffett was my second book. Buffett is definitely the world's greatest investor and has demonstrated this again and again over a career that has spanned more than 50 years. But I was dissatisfied with most of the books out there and decided to do my own study of his multifaceted career. For Buffett, the most important aspect of an investment is not necessarily a stock's return on equity, or the P/E ratio, or any of the other familiar valuation metrics. However, with each one of his investments, he always had one, two, sometimes even three "back doors" that assured him he had a margin of safety and would not lose his money. Gillette is a great example. Although that is usually considered one of his greatest stock picks, it never was actually a stock pick. The CEO of Gillette, worried that his declining business (Bic was eating Gillette's lunch in terms of market share) but solid cash flows would attract a predator, approached Buffett about being a white knight. Buffett bought, direct from the company and not on the open market, an interest-bearing note yielding almost 9 percent a year that was convertible into common stock. Buffett knew several things when he made this investment:

- In the worst-case scenario, he would get his money back since he had senior debt, and even in a bankruptcy (which was pretty much unthinkable for Gillette) there would be assets to liquidate.
- Even if the stock went down, he knew he would be making 9 percent a year on it since cash flows at Gillette were very steady. And if the stock was down when the term of the debt was up, he would simply get his money back.
- He knew that if the stock went up, past his conversion price, then he would just convert and have a nice profit on the investment, which is what happened.

In other words, Buffett was able to put a significant amount of money to work, never really worry about getting his money back or even losing a dime of his money, and enjoy the benefits of any stock appreciation—all the time getting paid 9 percent a year while he waited. While this seems like a great deal if you can get it, this is business as usual for Buffett, and I made a conscientious attempt to catalog all such similar margin-of-safety characteristics that Buffett has used over the past 50 years.

SuperCash takes it one step further by examining all of the new types of investments that have been developed over the past few years by the top hedge funds and investors in the world, including asset-backed lending, PIPEs, closed-end fund arbitrage, new types of IPOs, and even securitizing the cash flows from elevator music.

In the following chapters, I will show you how savvy traders and hedge fund managers are turning cash into supercash in today's tough markets. We'll look at the following topics and strategies for supersizing returns:

- Hedge funds as the new banks. Hedge funds are feasting on the scraps from banks. Banks will not do short-term debt, they will not do hard-to-collect loans, they will not take risks on microcap companies, and so on. So hedge funds have become the new banks on everything from subprime auto financing to trade factoring, hard-money real estate lending, tax lien investing, life insurance premium financing, and more.
- Activism. Much has been written about so-called "value traps," stocks that have all the characteristics of value stocks (i.e., low P/E ratios, steady earnings, great balance sheets) but never seem to move higher. Sometimes the reasons for the trap are clear—management has become entrenched and lost whatever competency it ever had in terms of bringing value to shareholders. Or sometimes the reason is more insidious—management is raping the company blind and not leaving much excess cash flow for investors. Activists invest in deep value situations where they think management is, for whatever reasons, refusing to unlock that value. The activists then begin communicating with management, expressing their opinion on how to extract value, and then, in the worst case, attempting to change things forcefully, either by taking over the board of directors of the company or by taking over the entire company. Although it is difficult for the typical retail investor to be an activist investor, it is possible to piggyback on the coattails of larger activists and to learn about their investment philosophies and activities through their very public SEC filings which document their approach.
- Delinquent credit card debt. Hedge funds have become the credit card issuers of last resort. While you can't get a VISA card from a hedge fund, they may be the holder of the outstanding balance on your card. Some banks have been unable to collect on bad debt and are now wrapping up the delinquent debt in securitized paper and selling it off to hedge funds, who then outsource the collection.

- PIPEs. Private investments in public equities (PIPEs) have been quietly replacing the traditional secondary offering as the financing of choice for many small cap and mid cap public companies. Rather than paying an investment bank 7 percent or more in fees, dealing with expensive SEC filings, and going on six-month road shows while everyone shorts your stock, public companies are opting to raise money by going directly to hedge funds, negotiating terms, and closing financings in a matter of days or weeks rather than months. Chapter 4 examines the various deal structures that have become popular and the post-deal performance of these PIPEs.
- A new approach with IPOs. The large banks and brokerages used to have the monopoly on IPOs and the profits that could be gained by investing in those IPOs and then flipping them on IPO day. But a new crop of IPOs has sprung up, simultaneously taking some power away from the blue chip investment banks and giving some power back to the retail investor. Chapter 5 looks at Dutch auctions, pioneered by investment firm WR Hambrecht, and the 90 percent or higher returns garnered by this strategy. I also examine how reverse mergers don't deserve the reputation they've garnered over the years, and look at an unusual innovation combining private equity with the IPO—the specialty acquisitions corporation (SPAC).
- Trade like a billionaire. Where are the world's richest putting their personal money? A look at the portfolios of Bill Gates, Michael Dell, Carl Icahn, Peter Lynch, Mark Cuban, and others.
- Closed-end fund arbitrage. This is one of my favorite "arb" strategies. The idea is to find closed-end funds that may be undervalued when you look at the combined values of the components of their portfolios. Closed-end funds are often fairly illiquid, meaning not enough volume, and hence difficult for the larger institutions (even those with more than $20 million in assets) to be nimble enough to get in and out of without leaving wreckage behind. In Chapter 7 I provide some real-world examples, interview a fund manager who specializes in this approach, and describe how the retail investor can play in this as well.
- Short-selling. I'm not a big believer in short-selling. I think the market does have a tendency to go up over time and, even if it doesn't, the odds are stacked against the short-seller simply by the fact that even fraudulent companies can have stocks that can go up multiples of a hundred percent before they head down. Nevertheless, Chapter 8 looks at the arena and offers a few methods for short-selling that have withstood the test of time.
- Art, music, and rare coins. The finer things in life can also generate cash flows. A great example is the so-called Bowie Bonds developed by David Pullman. This was a bond that allowed David Bowie

to borrow $50 million using anticipated cash flows from his music catalog as the asset backing the loan. The loan remained investment grade throughout its life, and Pullman was able to continue using this innovative structure to provide financing for other musicians. Bowie benefited, the investors got paid, and Pullman created an industry for himself. Chapter 9 also takes a look at Fernwood, a fund set up just to invest in art, and I talk with Sylvano DiGenova about investing in rare coins.

- Trend versus countertrend. John Henry versus Toby Crabel, Richard Dennis versus Monroe Trout, volatility versus consistency. How should one trend-follow? What works in countertrend trading? Over the past 30 years, hedge funds practicing the art of trend following have become increasingly popular, particularly after they avoided the slaughter of the bear market years of 2000–2002 and racked up 20 percent-plus years during that time when other hedge funds failed or closed. We'll look at some of the techniques and results I presented in my book *Trade Like a Hedge Fund* and update some strategies.
- The myth of the index. Most efficient market theorists are big believers in index investing, the idea of investing in exchange-traded funds (ETFs) that broadly represent the market by investing in a basket of stocks such as the S&P 500, the Dow 30, or the NASDAQ 100. In this chapter, I look at how deletions from the NASDAQ 100 and S&P 600 have fared as well as take a look at the grandfathers of all deletions, the fine companies that were deleted from the original Dow Jones Industrial Average.
- Watching out for fraud. Investing in hedge funds is like going out and digging for gold in the Wild West—you might strike it rich, but unless you're extremely thorough and careful in your research, you might get robbed. Chapter 12 looks at some actual cases, including a discussion with a hedge fund manager who uncovered a fraud at her own fund, and describes some ways to avoid fraud when possible.
- Starting a hedge fund? It's not easy to start up a hedge fund in today's environment. I examine the common pitfalls hedge fund managers make, including thinking they can get by on the salary and risk provided by running a moderately successful fund.
- Classic investment reading and new media sources. Turning cash into supercash is not just a style of investing but a way of life. Striving to maximize the value of every dollar, and to find actual customers for the services your dollars can provide, requires nonstop research, patience, courage, and fortitude. Going down the supercash path can be very frustrating as well as rewarding. For me, it is helpful to constantly review the classics as well as read the latest blogs, books, and finance materials out there. In Chapter 14 I provide a reading list that

reviews a few of the information sources, be they books or blogs, that I couldn't live without.

- The data dump. Every investment strategy requires testing and study. Random guesswork and theorizing are fine, but ultimately one needs to find the data and test the theory. Chapter 15 identifies where the best data sources are and how to test using that data.

CHAPTER 1

Hedge Funds Are the New Banks

In testimony before the Senate Banking Committee in February 2004, Federal Reserve Chairman Alan Greenspan expounded on why he thought hedge funds should stay, for now, beyond regulation: "The value of these institutions is to create a very significant amount of liquidity in our system." When he says "liquidity," I don't think he means it in the traditional sense that hedge funds are simply providing more buyers and sellers for stocks in order to make a more efficient stock market. Rather, I think he's referring to all the illiquid areas within traditional banking where, because of risk aversion or just plain fear, the banks are losing valuable opportunities to generate returns and the hedge funds are stepping in to take their place.

Trading strategies obey the same laws that particles do in quantum physics: When you observe them (i.e., index a hedge fund strategy) they change. By definition, funds are alternatives. To institutionalize them is to damage them. The reality is, for fund of funds managers (I'm one of them) looking to diversify into a group of uncorrelated hedge fund strategies, the traditional strategies of merger arbitrage, fixed income arbitrage, and convertible arbitrage are no longer good enough. With market-neutral strategies I'm getting half the return at twice the risk. The market-neutral, trading-oriented hedge funds that have typically been uncorrelated with all other assets are now correlated with a flat line or worse due to the enormous amount of inflows combined with the lack of volatility in the market. However, with the overall decline in interest rates since the late 1990s, the risk aversion of trading-oriented hedge funds and banks alike, and the dot-com bust, which also flushed out