2023 Year End Letter

RAVENSTONE
CAPITAL MANAGEMENT

As of December 31, 2023, the Ravenstone Equity Portfolio[1] generated a twelve-month positive return of 17.6%, net of expenses. Longer-term, annualized results are as follows:

	3 Year Annualized	5 Year Annualized	Since Inception[2]
Ravenstone Equity Portfolio[1]	6.9%	14.7%	12.4%

As of December 31, 2023, the Ravenstone Balanced Portfolio[3] generated a twelve-month positive return of 12.0%, net of fees. Longer-term, annualized results are as follows:

	3 Year Annualized	5 Year Annualized	Since Inception[4]
Ravenstone Balanced Portfolio[3]	2.8%	6.8%	5.9%

This letter is unusually long, so please bear with us while we share our thoughts on the following important topics related to your Ravenstone portfolio:

1. Alternatives
2. 60/40 Portfolio

Alternatives

Alternatives (Alts) seem to be all the rage these days. We ask ourselves, why? Are they a must have? Do they do what they purport to do?

It had been a while since we participated in an industry conference, so we decided to RSVP to a well-known, local event this past fall. The idea was to attend with open minds, hoping to learn something valuable about current trends in the investment world. We are always interested in educating ourselves on ways to better serve our clients.

Unsurprisingly, the dominant theme throughout the day was *Alternative investing*. The term *Alternative* (Alt) is used to label investment strategies that do not include traditional securities like stocks and bonds. The general thesis underpinning the Alt movement suggests that allocating capital to mostly private, non-correlated investments, helps increase diversification, smooth volatility, and generate higher returns. Most of our day was spent listening to why investors should adopt the Endowment Model[5] by accessing complex, private investments that, until recently, have only been available to institutions and ultra-wealthy investors. While this was somewhat expected, it was surprising to witness the seemingly, unquestioned acceptance of Alt products and their utility in professional investing circles. Accordingly, presentations and panel discussions on the subject sounded as if Alt managers and supportive advisors alike discovered a "magic bullet" method of delivering higher returns with lower risk (volatility). Sounds like a no brainer, right? Wrong. Like the old saying goes, "*If it is too good to be true…*"

During the day, we participated in two round table discussions with industry professionals sharing information on various investment strategies. As the baton made its way around one of the tables, we were asked what Ravenstone does. In a cheeky way, we replied "Ravenstone is an Alternative investment manager - we invest primarily in stocks and bonds." They looked at us like we were from another planet and chuckled. This was OK with us, because the fact remains, we represented the alternative by virtue of our core investment approach being focused on marketable securities. The others at the table were either positioning an Alt product or seeking new ideas to sell to their clientele. Now, assuming this small sample size is somewhat representative of the industry at large (we believe it could be), it appears public market investors like Ravenstone are, ironically, becoming a true alternative.

Private Credit is a hot commodity these days. It is so popular, the market for this sort of debt has grown threefold since 2015[6]. While investors cannot seem to get enough of this under-regulated product, UBS Chairman Colm Kelleher warned against growing risks in

[1] As of December 31, 2023. Ravenstone Equity Portfolio performance data above is for Ravenstone Equity Trust I series (before fees and after expenses).
[2] Ravenstone Equity Trust inception date was April 1, 2016.
[3] As of December 31, 2023. Ravenstone Balanced performance data above are composite returns (net of fees) for our 60% Equity/40% Fixed Income Composite taking into consideration accounts' entries to and exits from the list.
[4] Ravenstone Balanced Portfolio Composite inception date was June 1, 2018.
[5] Pioneering Portfolio Management. David F. Swensen
[6] UBS Chair Kelleher Warns Bubble is Forming in Private Credit. https://www.bloomberg.com/news/articles/2023-11-28/ubs-chair-kelleher-warns-bubble-is-forming-in-private-credit?sref=FUEeBw5j

private credit as the market continues to boom. Kelleher is quoted in a November 28th, 2023, Bloomberg article on the subject[7] :

> *"There is clearly an asset bubble going on in private credit," Kelleher said at the FT Global Banking Summit in London on Tuesday. "There are many other asset bubbles building. What it needs is just one thing to trigger a fiduciary crisis."*

Here are two other notable comments from a January 28th, 2020, Institutional Investor article titled, Investors are hooked, and it won't end well[8] :

> *"If high-yield bonds were the OxyContin of private equity's debt binge, private credit is its fentanyl. Rising deal prices, dividend recaps, and roll-up strategies are all bad behaviors fueled by private credit."*
>
> *"As yields have fallen, direct lenders have cooked up leveraged structures to bring their funds back to the magical return targets that investors demand. Currently, we suspect that a significant number of private equity deals are so leveraged that they can't pay interest out of cash flow without increasing borrowing."*

Before we continue, let us take a moment to say, we are not opposed to the existence of Alternatives. We are also not saying they are necessarily all bad – in fact, we are open to selectively investing in private market opportunities. We are, however, suggesting, that it would be wise to maintain a healthy dose of skepticism. Numerous Alt managers have a tall order of delivering on expectations.

Let's turn your attention to breaking down three widely accepted arguments supporting the use of Alternatives in portfolios:

1. Alternatives provide superior performance.

   Many (not all) Alternatives are likely to fail to deliver higher returns. Most Alternatives are illiquid and cannot be marked-to-market like public investments, due to the nature of the underlying assets. The idea that Private Equity investors earn an *illiquidity premium* as compensation for capital lockups is flawed and we question whether this premium actually exists. Let us explain:

   From an academic perspective, there is research showing no added value in private equity. One study backing this claim, comes from Lukas Schmid, professor of finance at the Marshall School of Business at the University of Southern California. His work shows that private equity investments are riskier, and don't offer superior returns compared to publicly listed stocks[9].

   It appears that Warren Buffet is also highly skeptical as can be determined by his recent quote:

   > *"we've seen a number of proposals from private equity funds where the returns are not calculated in a manner that I would regard as honest," Buffett said. "If I were running a pension fund, I would be very careful about what was being offered to me. It's not as good as it looks,"* [10] *the Oracle of Omaha warned.*

   Volatility in public markets causes investors to act emotionally and do the wrong thing at the wrong time. It is this behavior that provides us with opportunity. Our investment process quickly becomes an advantage because being liquid when others are not affords us the flexibility and agility to quickly deploy capital and swing at the "fat pitches". Illiquidity can come with opportunity costs. While some see the benefit of not marking-to-market, it can also be costly in terms of the inability to invest cash at the most opportune times. The absence of volatility can handcuff private funds, especially when saddled with high levels of debt. We would argue that being

[7] UBS Chair Kelleher Warns Bubble is Forming in Private Credit. https://www.bloomberg.com/news/articles/2023-11-28/ubs-chair-kelleher-warns-bubble-is-forming-in-private-credit?sref=FUEeBw5j
[8] High-Yield Was Oxy. Private Credit Is Fentanyl. https://www.institutionalinvestor.com/article/b1k369v2lg69qt/High-Yield-Was-Oxy-Private-Credit-Is-Fentanyl
[9] Credit Market Equivalents and the Valuation of Private Firms by Niklas Hüther (Huether), Lukas Schmid, Roberto Steri :: SSRN
[10] Warren Buffett won't go near it, so why has CPP Investments placed a third of our pension assets with 'private equity?
https://www.thestar.com/business/warren-buffett-won-t-go-near-it-so-why-has-cpp-investments-placed-a-third/article_8a43c21d-016d-5b1b-ab06-2b2f29b6b647.html#:~:text=Michel%20Leduc%20says%20that%20since,be%20well%20compensated%20for%20it

liquid puts us in a position of strength by allowing us to purchase cheap, publicly traded assets, thereby setting the stage for earning a future *liquidity premium*. Our purchase of Apple shares in March 2020, amongst others, is an excellent example of this concept at work. During the sharp selloff at the time, some of the best businesses in the world, including Apple, Microsoft, VISA, and Home Depot, sold off dramatically, providing us the best entry point in years.

Internal rate of return (IRR) is the most common performance measurement used by Private Equity firms. IRR's are complex and, without a clear understanding of the variables affecting the return calculations, investors can be easily misled. The crux of maximizing the internal rate of return lies in the total amount of leverage used to finance a transaction - the less equity a buyout firm hand's over, the better the potential gains on the deal. Herein lies the incentive to use significant amounts of leverage. Internal rate of return calculations assume investors earn precisely the same return on capital that is returned to them, even though they cannot control when or how much capital will be returned. Another consideration is that most investors do not factor in the return on cash reserves set aside for future capital calls. These lower cash returns are not accounted for in IRR calculations; however, they should be included when determining the actual return on committed capital throughout the investment's life cycle. Finally, it is important to keep in mind that, when evaluating the performance of many private funds, prices can be somewhat subjective, as reported valuations tend to be sourced by sponsoring firms who manage the fund(s).

2. Alternatives diversify traditional portfolios.

Most Alternatives do not add diversification benefits. The idea that private assets are uncorrelated and, therefore, increase portfolio diversification, is presumptuous - volatility is understated. The assumption that fundamental values of private companies are unaffected by market forces, like changes in interest rates, is misguided. Choosing to ignore this fact might feel good, however, the reality is that smoothing prices is nothing more than an optical illusion. We turn to Buffet again on this subject:

> *"PEs are a great way to hide volatility," he said in an interview. "That's why asset managers like them. But there's a lot of hidden risk in these investments, and they're getting into trouble now when interest rates are higher."* [11]

Adding layers of Alternatives to a traditional portfolio may, in fact, result in the undesired outcome of reducing diversification and increasing risk. To summarize our thoughts on the diversification argument, we turn to an excellent comment below from Cliff Asness, Managing Partner and Chief Investment Officer at AQR Capital Management:

> *"Liquid, truly uncorrelated alternatives actually diversify a portfolio both short- and long-term. They offer real diversification, not the diversification that comes from not reporting actual returns. But, when they have very painful periods (as you may have noticed!) you have to live through it in all its excruciating glory. This is perhaps a better portfolio than very correlated alternative assets possibly at an expected return discount."* [12]

3. Alternatives deserve to charge higher fees.

Alternatives tend to be expensive, lack transparency and, for the most part, are not worth the cost. Risk is always a function of the price paid. The hype has driven valuations of many Alternatives to nosebleed levels and encouraged a flood of capital and competition into the space. Fee transparency tends to be very low and

[11] Warren Buffett won't go near it, so why has CPP Investments placed a third of our pension assets with 'private equity? https://www.thestar.com/business/warren-buffett-won-t-go-near-it-so-why-has-cpp-investments-placed-a-third/article_8a43c21d-016d-5b1b-ab06-2b2f29b6b647.html#:~:text=Michel%20Leduc%20says%20that%20since,be%20well%20compensated%20for%20it

[12] The Illiquidity Discount? https://www.aqr.com/Insights/Perspectives/The-Illiquidity-Discount

accounting for costs is difficult in most cases. The “2 and 20”[13] fee model is prevalent – this includes Private Equity, Private Credit, and Hedge Funds. It is also common to see multiple layers of fees that can add up to prohibitively large numbers. Given the significant rise in popularity of Alternatives, it is conceivable that investors either choose to ignore the high costs or are willing to accept the illiquidity and opacity of private investments and pay up. Either way, we think this is a bad idea.

For the most part, Alternatives are opaque, illiquid, may use excessive leverage, may not increase diversification, and come with substantially higher fees[14]. Pursuing Alternative strategies might be fine for a small population of investors who understand the risks involved, can handle the illiquid nature of the investments, and are willing to incur higher fees.

As a rule, Ravenstone’s approach is to always think and act like a business owner. We reject the notion that a portfolio must always consider allocations to Alternatives. There is no doubt that economic conditions over the last few years have created headwinds for traditional portfolios. Today, these conditions are likely causing dislocations in certain Alternatives, much of which has yet to materialize and be recognized in reporting to date. Capital lock ups and the absence of marked-to-market accounting can “smooth” asset prices only for so long.

To this end, we want to share a recent comment that we came across, that sums up our thoughts on the subject:

> *“Returning to the core principles of prioritizing liquidity, transparency, and simplicity is a good way to build an enduring investment portfolio that serves you and your family, taking the power out of the hands of an investment industry designed to serve itself first.”* [15]

Back to the Basics: The 60/40 portfolio

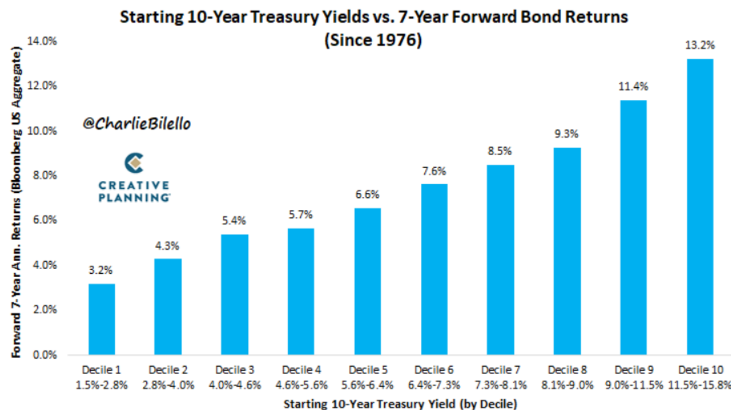
The 60/40 portfolio is a well-known investment framework, consisting of a 60% allocation to equity and a 40% allocation to fixed income. Nobel Laureate, Harry Markowitz, is credited with uncovering the model as an ideal balance of risk and return.

It has long been an important investment strategy, acting as a trusted guidepost for investors with a moderate risk profile. However, because of recent economic conditions, bonds failed to provide the ballast one would expect in a balanced portfolio. Aggressive interest rate hikes decimated total returns across the bond market with government and corporate bonds suffering dramatic price declines. In fact, until the recent rally, the 10-Year US Treasury Bond was headed for a third consecutive year of declines. Additionally, the long US Treasury Bond declined by approximately 50% during the bond rout, reflecting the sensitivity of the inverse relationship between interest rates and long duration asset values. To put this into perspective, the S&P 500 index declined by approximately 52% during the Global Financial Crisis. Clearly, fixed income, especially long-term bonds, have experienced declines almost equivalent to their equity cousins during the drawdown of 2008-2009.

The recent hit to bonds, has caused widespread concern about the efficacy of a 60/40 investment strategy, while stoking the fire of Alt supporters. We have witnessed an onslaught of articles with headlines such as *“The 60/40 Portfolio is Obsolete”*[16] and *“Is the 60/40 Dead?”*[17]. We see things differently at Ravenstone. Calls to abandon a 60/40 investment strategy are short-sighted. In our opinion, recent bond price declines should be looked upon as an opportunity to increase cash flow and generate attractive total returns in relatively safe, liquid debt securities. It is important to recognize that, in the short run, the direction of interest rates drives bond returns; however, in the long run it is the starting yield that matters most.

[13] 2% base management fee plus 20% incentive fee over a specified hurdle rate (sometimes zero).
[14] Private Equity Won’t Diversify Your Portfolio. https://www.bloomberg.com/opinion/articles/2023-09-22/personal-finance-private-equity-won-t-diversify-your-portfolio?sref=FUEeBw5j
[15] Low Risk Rules Blog: Clear Thinking principles for investment success. https://lowriskrules.substack.com/p/clear-thinking-principles-for-investment?utm_source=post-email-title&publication_id=1114981&post_id=139631031&utm_campaign=email-post-title&isFreemail=true&r=sur41
[16] Is the Traditional 60/40 Portfolio Obsolete? https://www.crossingwallstreet.com/archives/2020/08/is-the-traditional-60-40-portfolio-obsolete.html
[17] Is the 60/40 Dead? https://www.gsam.com/content/gsam/us/en/institutions/market-insights/gsam-connect/2022/is-the-60-40-dead.html

We are currently seeing the highest starting bond yields since 2007 so the long-term future should be much better than the recent past.



Source: The Week in Charts (10/8/23) – bilello.blog

Now is a good a time for reviewing your asset mix to determine if increasing fixed income allocations makes sense. For those seeking both, safety and yield, bonds now offer a compelling solution when considering the potential benefits of increased income, total return, and portfolio diversification.

The primary reasons for investing in bonds are as follows:

1. Capital Preservation

   Unlike equities, the key features of bonds are a contractual obligation of the borrower to pay a specified annual rate of interest to the lender and to repay the loan on a predetermined maturity date in the future. Bond holders (investors) rank higher in the capital structure and therefore have a senior claim on the borrowers' assets. In the event of bankruptcy, bond holders are paid back before common equity holders.

2. Diversification

   Bonds have historically served as anchors in a balanced portfolio. This is accomplished, when bonds either hold or increase in value, offsetting equity declines during corrections or prolonged bear markets. The defensive characteristic inherent in bonds broke down recently when inflation surged. The breakneck speed of recent rate hikes led to a dramatic repricing of bonds, across all maturities. An anomaly occurred in 2022 when both stocks and bonds declined in tandem. Going forward, high-quality bonds are well-positioned to resume their fundamental role as a portfolio diversifier.

3. Income

   Until recently, interest rates have been in secular decline for decades. Numerous high yield products were created to fill a void because of anemically low market rates. Low rates penalized savers and failed to provide the security required to generate reliable income. As a result, reaching for yield and taking unnecessary risk (sometimes at any cost) became common place. A famous quote comes to mind: ***"More money has been lost reaching for yield than at the point of a gun."***[18] Today, we are happy to say that taking a more conservative fixed income approach by investing in high quality bonds offers investors a combination of attractive yields and capital gains potential.

[18] Raymond DeVoe Jr, Wall Street Analyst

Nothing is guaranteed in financial markets. Having said this, a traditional portfolio of publicly traded stocks and bonds is better positioned today than at most times in recent memory, mainly because of the dramatic spike in bond yields and declining inflation. The previous decade witnessed an extended period of historically low interest rates that compressed bond yields and income. This is not the case today. Now is likely to be an excellent time to build a balanced portfolio, as bond yields are close to the highest levels seen in years.

There is value to keeping things simple, transparent, and liquid. A balanced strategy will form the bedrock of a successful investment framework for years to come and continue to be a superior strategy to most opaque, illiquid, expensive, higher risk Alternatives.

Please feel free to reach out with any questions or comments, or if you would like to arrange a time to meet. We are always available to you.

A special thank you to our clients and partners for referring friends and/or family members to Ravenstone over the past year.

As always, we are grateful for your ongoing trust and support.

Sincerely Yours,

Daymon Loeb Adam Donsky Paul Bleiwas

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