UB’s Focus on Antifragiles

Stockholm (HedgeNordic) – Known as the architect of HCP Focus – one of the most consistently top-performing long-only equity hedge funds in the world for many years, Ernst Grönblom *(pictured right)* parted ways with Helsinki Capital Partners last spring to later launch a fund employing the same philosophy under the umbrella of United Bankers. The recently-launched **UB Thales Argo** applies the same strategy and investment principles Grönblom relied on throughout most of his investing career. “Don’t fix something which isn’t broken,” says portfolio manager Tom Wiik *(pictured left)*, who co-manages UB Thales Argo with Grönblom.

“UB Thales Argo is based on the same strategy and philosophy Ernst has been successfully running for many years,” Wiik tells HedgeNordic. “There is absolutely no need to change something in Ernst’s approach,” he continues. Launched on December 1 of last year as a Finnish non-UCITS fund, UB Thales Argo “rests on two main pillars,” according to Grönblom. “The first one is the optimization of diversification, and the second one is Jack Treynor’s concept of slow-traveling ideas.”

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Optimizing Concentration

Conventional investing wisdom holds that diversification is the only free lunch in investing and that the safest portfolios are highly diversified across a large number of securities. The team running UB Thales Argo seeks to optimize diversification by maintaining a targeted number of 12 holdings in the portfolio. "There is no magical thinking behind the target of 12 names in the portfolio," says Grönblom. "On one hand, we try to maintain sufficient concentration for the individual stock picks to have a meaningful impact on portfolio returns, and on the other hand, we aim to achieve a level of diversification that keeps volatility and risk at an acceptable level."

> *"There is no magical thinking behind the target of 12 names in the portfolio. We are neither maximizing concentration nor maximizing diversification."*

"We are neither maximizing concentration nor maximizing diversification," further explains Grönblom. "Portfolio volatility decreases with increased diversification, but when it comes to diversification, the law of diminishing marginal utility is very much present," he continues. "For a ten-stock portfolio, for instance, the marginal utility of increased diversification by adding more positions is negligible." According to Grönblom, UB Thales Argo's first pillar involves maximizing the benefits of diversification and minimizing the downside effects of over-diversification.

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And the downside effects of over-diversification for actively-managed portfolios are plenty, warns Grönblom. "There is numbing silence about the negative effects of diversification, starting with the dilution of each position's contribution to portfolio returns and the dilution of portfolio manager resources," he emphasizes. Like all humans, fund managers and analysts have a limited amount of resources at their disposal, the most important of which is time. Other downside effects of over-diversification include higher operating costs, trading costs, among others.

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However, the most severe risk with increasing diversification is creeping closet-indexing. “Each additional position represents a tiny step towards the market-portfolio, a passive portfolio,” says Grönblom. “There’s nothing wrong with passive strategies. On the contrary, identifying genuinely talented portfolio managers is probably just as difficult as identifying genuinely mispriced securities. Consequently, nine out of ten investors should probably just stick with passive strategies,” he adds. “However, once you have decided to go active, closet-indexing is the boogey-man to look out for. Right after gross under-diversification, over-diversification in the form of closet-indexing is probably the second-most stupid mistake any investor can do. Fortunately, it’s easy to avoid.”

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Slow-traveling Ideas

Notable financial economist Jack Treynor distinguishes two types of investment ideas: quick-traveling ideas and slow ideas. In one Financial Analysts Journal article, Treynor wrote that “when one talks about market efficiency, it is important to distinguish between ideas whose implications are obvious and consequently travel quickly and ideas that require reflection, judgment, and special expertise for their evaluation and consequently travel slowly.” Grönblom seeks to find “slow ideas” that travel unhurriedly across the desks and minds of market participants and are not fully reflected in market prices.

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“Deviations from market efficiency are the exception, not the norm,” considers Grönblom. “Given this premise, I have come to embrace Jack Treynor’s concept of slow ideas,” he continues. “One of the most sensible ways to conduct active strategies is to consciously attempt to identify slow-traveling ideas and aggressively exploit them.” One slow-traveling idea Grönblom has been trying to exploit for almost 20 years is the “winner-takes-all” phenomenon – the accelerating concentration of market shares, profits and investment returns to a handful of “superstar” companies. “This is the most interesting source of investment ideas for me,” says Grönblom.

Winner-Takes-All and the Covid Pandemic's Antifragiles

"The slow-traveling ideas that I found attractive one, two, or five years ago are just as attractive as before, perhaps even more attractive," argues Grönblom. The demand-side economies of scale (also known as network effects) enjoyed by two-sided-market platform-companies such as Match.com and Etsy fuel a winner-takes-all economic shift, where a platform's new users create value for existing users as the network expands.

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Even before the coronavirus pandemic, a structural shift towards digitalization and the winner-takes-all transition had already been underway. According to Grönblom, "the pandemic has been accelerating and continues to accelerate a lot of the trends that I have been trying to exploit, including the winner-takes-all trend and the shift to digitalization." Grönblom cites professor Hendrik Bessembinders' research that shows the astonishing skewness of the distribution of equity returns to only a tiny minority of "superstar" companies.

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"The Covid crisis creates a lot of pain and suffering for existing businesses and their employees, and on a human level, it is a tragedy," points out Grönblom. "However, from an investor perspective, the pandemic dramatically accelerates change in many areas, leading to astonishing investment opportunities for those who have the knowledge and guts to act aggressively."

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Many holdings in UB Thales Argo's portfolio can be ascribed to the Nassim Taleb-coined term "antifragile," a category of things, including businesses, that not only withstand shocks and chaos but actually benefit from them. "The volatility experienced by businesses, industries, and financial markets is likely to increase going forward because of accelerating change," considers Grönblom. For that reason, "we will sharpen our focus on identifying antifragile businesses for our portfolio."

Launching at the Right Time?

With UB Thales Argo launched in December of last year as stocks were hitting all-time highs, one may perceive the seemingly high equity valuations around the timing of the lunch as a headwind to near-term portfolio returns. Tom Wiik encourages potential investors "to closely look at the fund and its holdings to try to understand the real nature of the fund and strategy." According to Wiik, the focus on finding "winner-takes-all" companies says everything about UB Thales Argo and its place in a portfolio. "UB Thales Argo owns a set of companies one would like to own no matter the stage of the market," says Wiik.

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"Our holdings are undervalued if you discount our confidence that of all them have much higher than average probabilities that they will either reach superstar status or maintain their current superstar status much longer than the market considers," emphasizes Grönblom. "The market in general misunderstands and underappreciates the power of the winner-takes-all phenomena."