Capturing upside while providing a downside cushion

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With market dispersion near historic highs, we have rarely been so positive in the last two decades about the prospects for both the long and short sides of our portfolio.

When investors ask what is different about our approach to long investments, it is that we look for undervalued, owner-operated businesses where management teams earn more from the stock they own than the compensation they are paid. We believe this creates a solid alignment of incentives. We also do our company analysis with a longer investment horizon than most, typically three years, but we'll occasionally hold positions much longer. Our approach often leads us to under-followed, out-of-favour, publicly listed companies.

For the short part of the portfolio by contrast, we look for two specific company profiles: either young companies with unproven business models, or mature, over-leveraged firms that are likely to need restructuring and often facing highly specific headwinds. To express these positions in the portfolio, the Fund almost exclusively uses single-name put options. These offer the advantage of capping the downside risk while offering positive leverage and a tool to manage volatility. This uncommon approach to shorting allows us to build positions in areas of the market that many other short-focused funds cannot.

From 'junk' to opportunity

In the first half of 2023, we saw both a resurgence in mega-cap momentum and a sharp 'junk' rally in lower-quality stocks following their downturn in 2022. As investors began broadly anticipating a peak in the rate cycle, many covered their short positions in the highly leveraged companies that came under pressure in 2022 and early 2023. Between them, these forces drained capital from higher-quality small and mid-caps, creating both a challenge and opportunity for us.

We took the opportunity presented by expiring put options to replace some with higher strike prices. By capitalising on earlier proprietary research, we were able to rebuild positions in a select number of stocks that appear poised for another downturn. These are often lower quality, cash-burning businesses. We believe that our put portfolio can benefit from rising rates, persistent inflation, a consumer recession, and the less-forgiving environment that young, cash-burning firms find themselves capital-raising in.

We also sold long positions in a handful of large caps that reached our fair value assessment and added investments in other companies left behind by the tech stock rally. The long side of our portfolio is therefore positioned to benefit from improvements in the many small and medium-cap businesses whose valuations were little changed by this year's concentrated rally.

Commercial bank credit card rates

Source: Board of Governors of the Federal Reserve System (US), fred.stlouisfed.org

Braced for impact

At the macroeconomic level, we see areas where it may pay to be wary. Historically, high inflation has proven very challenging and slow to control. While there are signs that price rises are decelerating, we do not believe that we have yet seen the full impact on the cost of capital and corporate balance sheets. As their debt matures, highly leveraged companies will have to refinance at much higher rates. At best this reduces profits, and at worst, forces a restructuring that undermines equity values.

There is also a real danger from declining corporate earnings and increasingly squeezed discretionary consumer spending. Credit card interest rates have reached levels not seen in decades and the number of missed payments is rising (see chart). Higher prices for essential goods, as well as mortgage rates and home price inflation may all take a toll on consumer spending. The boost from excess savings in the wake of Covid, and the massive stimulus during the pandemic, which until now have cushioned the worst effects of inflation on households, have nearly been depleted. All of which creates some risk around second and third quarter earnings; we believe that it is a good time to have hedges in place to shield portfolios.

The views and statements contained herein are those of Crawford Fund Management LLC in their capacity as Investment Advisers to the fund as of 24 August 2023 and are based on internal research and modelling.

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