Rewin Pataibanlue, Senior Associate, The Quant Group – Investment Banking,
rewin@thequantgroup.com Rewin Pantaibanlue has a Bachelor degree in Civil Engineering from Chulalongkorn University and an MBA from the Sloan School of Management at MIT.

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Profiting From Black Swans

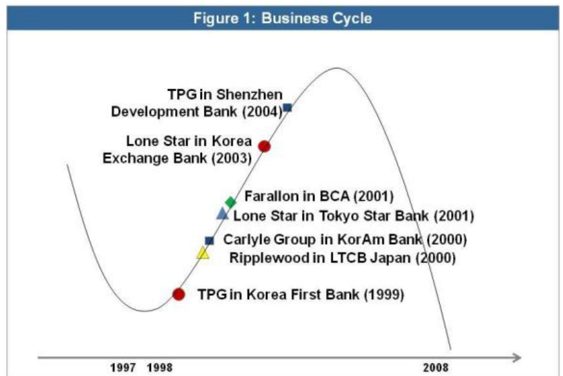
In case you haven't heard this one before: "if you are going to invest, then invest after a crisis and not before it". If only someone gets this right they'll save themselves a lot of money and possibly make much more from it. A recent literature on this strategy is the preparation for what the mathematical trader Nicolas Nassim Taleb calls The Black Swan. The term Black Swan was an unpredicted and unpredictable event that resembles the finding of black swans in Australia by the seventeen-century Dutch explorer Willem de Vlamingh when his studies indicate that there are more sightings of black swans than what many believe to be their absence as most swans are white. And by the same token a crisis, the type that takes such a shockingly unexpected deep-dive or what Nassim Taleb statistically term Tenth Zigma or The Black Swan, occur more frequently than most people think they do. Tenth Zigma or The Black Swan suggests that such probability of its occurrence is once in every 1E24 years – that is the number 1 followed 24 zeros expressed in years. But we only have to go back a few decades let alone 1E24 years to find that spots of these Black Swan events have popped up in different crises, reverse-chronologically, Subprime crisis, LTCM, Dotcom Bubbles, 1997 Asian Crisis, Japan Crisis, Savings & Loans crisis to name just a handful.

They say "nothing hurts more than to see your neighbors get rich". Since his first bestseller, Fooled By Randomness (2003), Nicolas Nassim Taleb has been waiting for this elusive Black Swan. In Fooled By Randomness, he sulked and brewed after seeing his fellow trader neighbors change their cars into something bigger or faster as rewards for their relative short-term trading successes. And the more he trashed them and their strategies, the more money they kept making. His point then was that "even a broken clock is right twice a day". It seemed like sour grapes as markets kept going up, that is, until recently.

Finally, Nassim Taleb is vindicated. The fund that Nassim Taleb advises was up 54% Year-To-Date October 2008 using preparations to counter the Black Swan strategies. Basically Nassim Taleb doesn't care much if and when he loses or gains on market ripples but his strategy makes a killing on large market movements. The trick in directional bets of course is to get the direction right. However, Nassim Taleb uses a bunch of options to bet both ways so his key trigger to making money is not so much which direction the market moves but that it moves big. Nassim Taleb trained many students in his trading strategies since the days he taught at the Courant Insititute, the mathematics department at New York University (he is currently a professor at University of Massachusetts at Amherst). One of these students is a Thai, Mr. Pallop Angsunan, who graduated and went on to become a fund manager at Universa – a Santa Monica, California-based hedge fund- using strategies in preparations for the Black Swans. The performance of Pallop's funds, advised by Nassim Taleb, has posted gains of between 50 and 110 % in recent months, even as the S&P is down 40%.

Private Affairs

In the private market, that is, the private equity market, the fund performance has much to do with when such funds make their investments. Investments made after crises contribute so much more to the overall returns. This is really the practice (rather than the theory) of the buy-low-sell-high.



The chart above illustrates some of the selected Asian financial institution deals completed by that buyout funds post the 1997 Asian crisis. These banks had perfectly good franchises but were plagued with large write-downs from their exposures to markets facing precipitous falls in asset prices. In effect, their equity investments were asset-price resets whose terms included strong governance via control of the votes, board, and invariably with changes in the management.

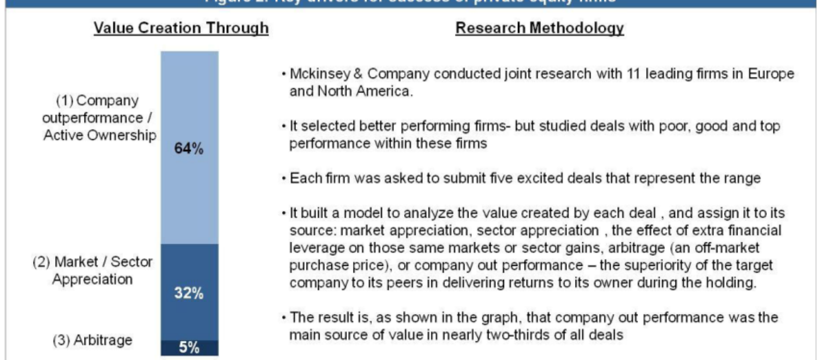
Take Koram Bank which The Carlyle Group and JP Morgan Consair acquired a 40.7% stake in the bank for US$446 million in May 2000. KorAm began as a joint venture between Korean Chaebols (conglomerates) and Bank of America. KorAm specialized in small and midsize businesses. When Daewoo Group, a major borrower and a shareholder, collapsed in 1999 amidst the Asian Crisis, KorAm held $1 billion of the chaebol's loans. Within four years, The Carlyle-led consortium turned around the bank, built its consumer loans franchise, and maintained its sixth largest bank in Korea position. The Carlyle consortium sold their stake to Citigroup in May 2004 which paid US$2.73 billion for 100% and saw its original capital increased by 2.5 times.

Around that time, TPG Newbridge Capital (rebranded TPG Capital) acquired a 51% stake in Korea First Bank (KFB) from the South Korean Government for a total consideration of KRW500 billion. TPG held it for five years and sold it for more than a 3 times return when Standard Chartered Bank acquired 100% of KFB for a cash consideration of KRW 3.4 trillion or about US$ 3.3 billion in April 2005.

In Japan, LTCB was sold by the Japanese government to a group led by US-based private equity Ripplewood Holdings for US$ 1.1 billion in March 2000 and the bank was renamed Shinsei Bank. Long-Term Credit Bank of Japan (LTCB) was one of the major financiers of the postwar economic development of Japan. After extensive problems with bad debt in the 1990s, the bank was

Successful PE firms do not only provide capital to the target firms but also bring additional value to the firms they invest in. The study conducted by McKinsey & Company shows that by far the most important component that drives value creation in the target firms is **"Company Outperformance / Active Ownership"**. In order for the portfolio companies to outperform its peers, PE firms can take active ownership roles in those companies by getting involved in the operations and management of the target firms, drafting new business plan (a 100-Day plan), and ensuring that the implementation actually happens as expected. Figure 2 shows the importance of each factor that has an impact on the success of private equity firms.

Figure 2: Key drivers for success of private equity firms



Successful investment is not all about market timing says consultant McKinsey & Co. Actually it is. We beg to differ. If you have a profit motive, it's always better to buy low and sell high. The problem is: how do you know that you've bought low and that you will be able to sell higher? Investing while the market is tanking is like catching a falling knife and one does not always catch the handle and sometimes – Ouch! - the blade. Besides, whether you get the buy-low-sell-high right or not, it's always better to create more value – "more money is better than less".

McKinsey says that 64% of the value-creation is derived from company outperformance and active ownership. Strategic and operational improvements matter.

While down markets can be unsettling, it is important to realize that this is just a normal part of the investment cycle. In the short term, there could be more bumps along the roads. The market seems to be near trough or possibly will trough in 2009 by most forecasts and will begin staging a recovery by 2010. Therefore, this might be the time for all PE firms to do the things they are supposed to do: Buy something cheap, fix it up and sell it at a profit.