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EP 172 | Navigating Market Complexities: Insights from the Trading Desk

[00:00:00] Rob Campbell: It's been a while since we've had a representative from the trading desk on our podcast, and so we thought we'd make up for lost time by having two of them join us today. Rita Tien trades the Americas out of our Toronto office, and Peter Dmytruk trades Asia out of Singapore. Special thanks to Peter for joining us at 10 p.m. on a Friday night local time. The topic of this podcast came as a suggestion from a listener. You'll know who you are, and thank you. The idea was this: What are some of the undercurrents that our trading desk has detected that may be under the radar, that could be pretty niche, but that global investors may underappreciate and are worthwhile knowing about? As you'll hear, there aren't a ton of tangible to-dos that come out of our discussion. But as we often talk about from a risk management perspective, all genuine signal usually starts as noise, and the first step in a good risk management program is the identification of a risk or fragility itself. And so with that said, here are Peter and Rita with a view from the trading desk, aspects of market structure and beyond, that are catching their eye today.

[00:00:36] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

[00:01:23] Rob Campbell: Rita and Peter, welcome.

[00:01:25] Rita Tien: Thank you.

[00:01:26] Rob Campbell: Thank you.

[00:01:28] Rob Campbell: There are a lot of topics that I'm hoping to cover with you today. But before we get to that, because it's been probably five years since we featured any of the members of our trading desk on the podcast, can I ask you to provide a bit of a reminder: As long-term investors, we're buying businesses, but the way that we do that is by buying stock. So what is the trading desk's role in our investment process?

[00:01:53] Rita Tien: Once the investment decision is made, once research makes an investment decision, the trader's job is to make that dream come true. Basically what we're doing is they've decided they want to buy or sell a stock, but that doesn't happen the instant the decision is made. Someone needs to go and click that button and interact with the market to make sure that we can indeed buy or sell that stock. Due to the nature of our holdings, that can be more or less difficult. We hold some small cap names. We hold a lot of large cap names and those trade in a very different way. The trading team's job is to know how those different stocks behave, what the best way is to execute them.

[00:02:38] Rob Campbell: Got it. I can imagine that another aspect of that is just some of the regional differences. Rita, I know you cover the Americas. Peter, you cover Asia. Peter, you're one of the OG traders at Mawer. What are some of the more differentiating aspects of our approach to the trading desk that you perceive?

[00:02:55] Peter Dmytruk: I'm not sure “differentiating,” because I think a lot of global investors would have presence in Asia or Europe, but I think that as an investment manager, having people in Asia to trade Asia and having traders that focus on Europe and having traders that focus on North America allows us to somewhat

specialize and be aware of those market mechanics that Rita was talking about. There are nuances between the regions. The sell side does not have the same people for every country. Having relationships with all the various brokers across the world, those are things that are important, and I believe that if you want to have a global trading desk, that's what you have to have. The market mechanics are important because the rules change between all the markets, especially in Asia. Asia has the highest differentiation in terms of what the market is. The cost structure is different. All of these little things add up to the requirement to have expertise and understand how these things work. Obviously with the EU, the European markets have become more harmonized, meaning they have similar rules, they have similar opening times, similar structures. MiFID II has driven out some of the requirements around systematic internalizers, so the market there looks a little bit more similar between the markets. Asia is just different. There's different regulators, there's different investors, there's different requirements, and so that leads to many differences and nuances and it's tougher to trade.

[00:04:34] Rob Campbell: Got it. Rita, you mentioned not only is the job to focus on the execution once the investment decision is made, but there's also being in the market and reflecting information back to the team. We're recording this the week of the U.S. election. I can imagine there's a lot out there to follow day-to-day, and I'm just curious how you manage that and specifically how you decide what's relevant to pass back to the investment team.

[00:04:59] Rita Tien: It's been a busy week, for sure. We had the U.S. election and then followed immediately after that, there was the U.S. Fed rate decision. U.S. Fed rate decisions have had a very meaningful impact on market moves recently. Normally, the large events are anticipated, and generally, there are predictions as to what will happen. For example, for this election, we knew it was very close. The outcome could have been either way, and the market had been positioning for that. Versus back in 2016, the Trump win was a surprise, and there was an extreme move and extreme reaction to that. A lot of the time, if it's an extreme move or an extreme reaction, or it's a surprise, then you know it's not noise, it's signal.

[00:05:45] Rob Campbell: I can imagine this is stressful, emotionally difficult. It's like those notifications you get on your phone, you're constantly being pinged and it can drain your adrenaline. Peter, do you find in that way? What's the process for weeding out what's important and what's not?

[00:05:58] Peter Dmytruk: It's extremely difficult. I think at times, sometimes we become, or at least I become, numb to it, because you're getting constantly fed these small pieces of information that might be important. Sometimes it moves stocks and you're like, is that important? Is it not? There is a lot of judgment involved, and it can be, I won't say draining, but it's definitely when you're “be boring, make money,” and you're forced to be in that noise, it's tough to pull back and say, what are we really trying to do here? We're intentionally being put in the noise. Whether that's a stock is up 5% for no reason, because of something that's going on on the macro side, which is something that we don't necessarily try and forecast or predict on. I agree. I think that what we do rely on is that our investment process is more long-term oriented, so we know that when we are trading or when we are making trades for clients, that we're really implementing long-term strategy. We're not focused on the short-term movements. But, like Rita said, our job is to execute around those small-term movements.

[00:07:09] Rob Campbell: I want to spend most of the rest of the podcast just going through some topics that are probably pretty front and center and clear for you guys in the day-to-day execution of your jobs that may not be as obvious to many listeners who aren't in your role, but that you think are worth highlighting for investors in this realm of situational awareness. Peter, I want to start with you, just given your focus on Asia. This one might not be totally in the shadows. Lots of investors are aware of the Japanese carry trade. We did get some interesting movements in Japan earlier this summer. Can you provide us with a recap as to what that is, it's scope

and basically how that influences your job trading stock.

[00:07:49] Peter Dmytruk: To go back, what is a carry trade? A carry trade is when you have a low-yield currency that people will short to go buy a high-yielding currency and make an incremental spread between the two currencies. What was talked about a lot was people shorting the Japanese yen and investing that money into the U.S. dollar, which had a higher interest rate at that time. What's maybe unknown to people is that when you talk to currency traders, a lot of people are actually investing in the Mexican peso and the Brazilian real, so it wasn't just U.S. dollar necessarily, because they want to maximize the spread that they can earn in a carry trade. It's not just necessarily the safe-haven currencies.

[00:08:41] Rob Campbell: Just to interject, for so long, you could borrow basically for nothing in Japan, just given where yields were, and you're saying not only were U.S. rates higher, but thinking of Brazil, almost double digits in some cases in terms of what you can invest, assuming you don't get blown out by the currency.

[00:08:56] Peter Dmytruk: That's correct. That was what a lot of people were actually using as the offset for the currency trade. Now that's the currency trade element. There's different perspectives or different angles on the currency trades. For example, companies will go issue samurai bonds and they will issue debt into Japan, take that yen and go invest it elsewhere. So they're doing it for operational purposes. They could be doing it to buy a business, and so it's a business need that they're doing the carry trade for. So it's not just FX. You're going to have actual businesses doing this. Then there's simple insurance businesses that have liabilities in Japan, but they can earn a higher rate of return outside of Japan, so they will invest the money outside of Japan. They could just be simply buying bonds, for example. So there are a couple of different flavors of the carry trade. It's not just FX-oriented. When the Bank of Japan signaled to the market they were going to be increasing interest rates by about 25 basis points, we started to see some of this get unwound. Now, from my perspective, it was still only 25 basis points. It wasn't a massive increase in interest rates. I don't quite know why it got the attention of the markets as it did at the time that it did. But that's what markets are. Markets are a little bit unpredictable. Nobody knows on the timing side of how markets move and when they did move on that specific day, there are some other market factors or other market forces at play. For example, ETFs or leveraged ETFs: Once the stock started to trade or once the index started to trade past a certain point, and in terms of negative performance, it became very clear that you were going to get a compounding effect from ETFs and structured products. All of a sudden it's not just the carry trade; it's other products that invest in the index that start to react to that market movement. This is where sometimes these trades can start to run really quickly. It's because all of these factors are at play when you're dealing with capital markets. It's no longer just buyers and sellers of stocks or companies. There's many different actors or agents in the market pushing around it. What it boils down to is what happens to the incremental buyer seller. Once those incremental buyers on that day start to get exhausted, then the price starts to really move and that's when it takes on a life of its own. In Nikkei terms, I think it closed down 12%. It was basically the largest one-day loss since the ’80s or ’90s in Japan. It has a life of its own.

[00:11:38] Rob Campbell: But I think it reversed pretty quickly, too. In retrospect, thinking back to late July, this was a blip, I suppose, although I can imagine what your day was like on that particular day. Do you have a sense though? Like you said, rates in Japan have gone up. Rita spoke about the latest Fed decision, and the direction is down. The conversation with the research team, and we certainly own a number of Japanese businesses, some more domestically oriented, others more global in nature. How does this risk or this awareness influence those conversations?

[00:12:08] Peter Dmytruk: Whenever we get these big moves that happen or sudden market movements that happen, the most important thing is to communicate because the first thing is that I don't think we make

investments around the carry trade, and so I'm not sure it changed our investment decisions on any specific companies. But the first thing is to make our investment team aware that this is going on and the facts of the event, and then they are able to listen to that and make decisions if it's going to change the investment thesis of any of our companies, and it might. I don't think in this situation it did, but sometimes you have importers and exporters and if the currency is moving around or something is going on that could change the economics of their business, especially if their advantage was being eroded because of something that was going on in a macro event. The most important thing is to communicate and then allow the team time to make the decision of whether that is going to impact the investment thesis or not.

[00:13:09] Rob Campbell: Rita, can we shift to you, a little closer to home for you, the U.S. market structure. A couple of niche things that have happened over the last little while, one of which some clients might be aware of and some might not, but the shift to T+1 earlier this year. Can you talk about what that actually means? At least for my seat, everything seems to have gone just fine. But how has that changed the nature of how stocks get traded?

[00:13:33] Rita Tien: For sure. In the U.S. and Canada, we moved from a T+2 settlement cycle to T+1. Let's say for example, you're selling a stock. You sell a stock on Day 1. Then you don't get your money until it used to be two days later, but now you'd get it one day later. That is what the settlement cycle is. If you are selling stock, you don't get your money until T+1, which would be the next day. If you're buying stock, you don't actually see that stock in your account until the next day. That change happened on May 27 in Canada and then happened in the U.S. on the next day. What's interesting is actually seven years ago, we had moved from a T+3 settlement cycle to a T+2 settlement cycle. This wasn't a completely new thing in North America. We've done it before in recent memory. I think that a lot of the mechanisms and there were a lot of lessons learned the first time that we made the move over, which is probably why it seemed a lot smoother to a lot of the many different teams that this affected. It not only affected trading, but it affected settlements. In terms of management of the funds, they were also affected because in global funds, the settlement dates might no longer match up as they used to. For example, Europe is now on a different settlement cycle and if you're, for example, selling U.S. or Canadian stocks to fund buying in Europe, you have to keep that in mind, that settlement cycles don't necessarily line up and how you're going to meet your cash requirements inside a particular fund.

[00:15:03] Rob Campbell: I see. If you're trying to buy a U.S. stock and you're trying to fund that by selling a European stock, you've got to plan ahead.

[00:15:10] Rita Tien: You do have to plan ahead.

[00:15:12] Rob Campbell: Effectively, a day ahead of time.

[00:15:14] Rita Tien: Yep, so there is a lot of planning going around on this, especially because if you're holding different securities in different currencies as well, you have to keep the settlement cycle as well. Currencies also have a separate settlement cycle. So there are a lot of different moving parts. Why was this done initially? Why did they compress the settlement cycle? They were looking to reduce margin requirements and to reduce settlement risk.

[00:15:41] Rob Campbell: On reducing settlement risk, I think that one's more intuitive to me. By moving from T+2 to T+1, you're reducing half the chance that your counterparty evaporates while you've executed the trade, but you don't have your money yet. On the margin side, can you dig into that one a little bit more?

[00:15:57] Rita Tien: If you go back to the meme stock craze and Robinhood, they couldn't meet their margin requirements when the height of the meme stock craze, and they just didn't have enough money on hand. But if

the settlement cycle had been shortened at that time, that might not have been an issue. You're getting your money sooner, and it reduces the funding requirements and the margin requirements.

[00:16:19] Rob Campbell: OK, so are you suggesting that the move to T+1 might exacerbate excesses in the market?

[00:16:26] Rita Tien: Good question, Rob. There is talk about the move to T+1 perhaps sending more signals. For example, if you need to borrow a stock and that stock is hard to borrow, in the U.S. you have to be certain that you can borrow a stock before you short it, and it's all public. People know what's hard to borrow and whatnot. But if you need it on a T+1 basis and you fail to deliver, it sends that signal earlier. So is there information leakage because they've compressed the timeline to a T+1? I don't know if that answers your question, but I don't know that I know the answer to your question.

[00:17:06] Rob Campbell: Well, that's part of the fun of the job, I suppose, is just watching to see how some of these impacts might play out over time. We've sort of danced around one of these already in the discussion about leverage and I suppose my question on stability. Can you talk a little bit about that? It seems like markets have become quite a bit more volatile. I think I read somewhere that fixed income markets are expected to be more volatile with the recent election results. I don't know if the same is true for equities, but just in general over the last several years, are there aspects of market structure that have either increased or decreased volatility? Are there structural reasons for this or is it just uncertainty? What other aspects of market structure are contributing to that?

[00:17:47] Peter Dmytruk: I think there are several things. You have these zero-day options that will increase volatility. You will have HFT that will try and pick up signals from long-term investors and actively buy it ahead of them, so that increases volatility.

[00:18:04] Rob Campbell: HFT being the high-frequency trading.

[00:18:08] Peter Dmytruk: High-frequency trading, zero-day options trading. I think those are probably the two biggest ones in terms of moving stocks in the short term.

[00:18:15] Rob Campbell: Zero-day options, Peter, for those who are less familiar with this: Is this effectively a coin flip on what will happen to a stock over the course of a single day?

[00:18:22] Peter Dmytruk: Yes, 100%. Sometimes I think there's even some regulation issues on these zero days in terms of the brokers that are offering them, and so there's issues around that. Finally, we know that during COVID, we had retail investors or meme stock investors that came in, pushed around stock prices in a single day that weren't necessarily there say six months before that, or a year before that, or a time period before that. So you have retail investors that are more likely to push around a stock or more willing to, is maybe a better way to say that. I would say that there's certain, I'm not sure that's a microstructure, but there's definitely been a change in some of the actors as well as some of the products that are available and who invests in those products as well. Even just the ETFs: There's the two-time or the three-time leveraged ETFs, and they're very structured in how they operate. They square up over the course of the day, and that changes how a stock will trade during that day. It has to.

[00:19:25] Rob Campbell: I want to come back to the ETFs. I definitely want to come back there, but just your comment on the meme stocks, the retail trade. You're trading Asia. I presume that there are markets there that are quite retail-driven. I'm curious what those are and if there are lessons from those markets and the work that you do in Asia that you think Rita and others who trade more in North America, if there is this shift towards more of a retail influence, what are some of those lessons?

[00:19:52] Peter Dmytruk: Yeah, there are markets in Asia that you see more volatile swings. In Korea, Taiwan, and India, those are three markets that retail investors can have a large impact on what stocks are doing that day. We have seen, and we own companies that will be up 10%, so the limit up on a day. We don't really know why. We know that there's a day trading element in some of these markets, and we know that sometimes they will trade on things that we don't necessarily care as much about from an institutional investing point of view. Now, all those markets are really different. India is a very tight spread. It's a T+1 market now. It has a massive retail influence. Korea is high spread, has massive retail influence, but also has decent institutional or foreign investor influence. And then Taiwan can be retail, not as much local institutional, and a lot of foreign investors. Those all come together a little bit differently. And why stocks react, I think they're the same. There's a bit of a different mentality with some of these retail investors and what they look at and how they invest in things. I'm not sure they're different than North America. Because I just don't think humans are that different, but there are certain structural differences, like in all three of those countries, they have different reporting requirements. In Korea, there are foreign and a local investor reporting requirements every day. So those are ID markets. Same in Taiwan. You can track if foreigners are buying or selling every single day in these stocks. In India, you have a delivery notification, so you know how much stock is actually delivered at the end of each day, so you can calculate how much of it was day-traded and how much of it was bought by a big institutional investor. If your goal is to front-run an institutional investor and take advantage of those momentum swings, the higher that number is, the more likely it is you have a long-term investor that's buying a stock versus day trading.

[00:21:58] Rob Campbell: You mentioned momentum. That's the word that came to mind with respect to these markets. Presumably really important if you're trading in those markets to be aware of which way the momentum is blowing, perhaps incrementally more than in other markets around the world.

[00:22:10] Peter Dmytruk: Yes, I would agree. I think in some of these markets like Taiwan and Korea, they fit in that EM bucket. When you have EM funds or investors that are trading on an EM strategy, they will move for reasons that other markets may or may not, like Japan or what the U.S. is doing, or they can be contra. So I agree. The momentum shifts can be quite different and they can be long-lasting, like in India, when you had demonetization with gold wanting to be tracked. What that causes is a lot of investors to invest into local mutual funds, so Indian equities have been essentially well-bid for five years, and it's been one of the more expensive stock markets in the world because you've had this large retail participation indirectly via funds, but you've had a large bid being put under those equities in that market. That momentum has been ongoing for years at this point. Sometimes it sells off, sure, but for the most part, the big picture is you've had a strong momentum.

[00:23:13] Rob Campbell: Got it.

[00:23:14] Rita Tien: Recently, the SEC has announced a lot of new rules, and these rules are set to come in place. It really talks to the importance of the retail investor. A lot of these new rules actually have been put in place mainly to protect the retail investor. They've come in with a minimum tick size and so they're going to reduce that. Basically, stocks that were quoted at a penny will move to half a penny, and they're thinking that that is going to benefit the retail investor. It leads back to this idea of accessible versus inaccessible liquidity. What happens in the U.S. is lot of the retail flow gets bundled, and it's actually inaccessible. As an institutional investor, it’s hard for us to access that liquidity because it gets wholesaled, it gets bundled off, and they get shipped elsewhere. You can't really interact with it. They're trying to reduce the incentives to do that so that it becomes more accessible so that you can interact with those trades, and it just really highlights the importance of the retail investor and how valuable people consider that flow.

[00:24:24] Rob Campbell: Keeping on the topic of momentum, and returning to ETFs, Rita, lots more ETFs today,

as Peter said, increasingly versions that can actually really turbocharge your trade through leverage. Can you talk a little bit about the impact of ETFs on markets?

[00:24:41] Rita Tien: I pulled some numbers from my friends at TD on ETFs and how much is managed by ETFs right now. In the U.S. it's almost a trillion dollars that are held in ETFs right now, and in Canada, that number is about 487 billion. So that's huge. It's a huge number. I'll take you to three ETFs that follow the S&P 500: Spiders, IVV, and then there's a Vanguard product as well. The AUM of Spiders is about $600 billion. IVV, which is the iShares equivalent, and Vanguard are both about $550 billion. When you think about that, you think about what these ETFs hold. The S&P 500, the weighting of those is about 7% NVIDIA, 7% Apple, and then a little over 6% is Microsoft. These are pretty recent figures, and obviously as these names move and trade, those numbers will change, but that's a huge number, and there is a lot of crowding in the space. We talk about how there's the Magnificent Seven, and when you're looking at markets move, it's really just a handful of names that are moving markets. I think that that really hammers that home. It's important to remember as well, when you're buying an ETF, you're buying the underlying stocks. You might be buying the 500 index, but really you're buying NVIDIA, Apple, Microsoft, and it really gets into this thought of overcrowding again as well.

[00:26:13] Rob Campbell: On that, we've heard Magnificent Seven, I've also heard Magnificent One with respect to NVIDIA. If I'm understanding what you're saying on the overcrowding side, you’ve got more volume that's concentrated in these particular stocks. How do the mechanics of ETFs work and does it influence the timing of trading throughout your day?

[00:26:32] Rita Tien: These vanilla ETFs, the ones that follow these well-known indices, the calculated closing price of an ETF is benchmarked to the close of these individual names, and they will rebalance at the end of the day. If someone wants to buy a million dollars worth of Spiders, it's benchmarked to the close, so they'll put those trades in at the close so that there's no risk in terms of benchmarking.

[00:26:58] Rob Campbell: In terms of volume throughout your day, I can imagine that there's a spike at the beginning of the day as markets open, but are you saying there's increasingly more liquidity and volume at the very end of the day now than previously?

[00:27:10] Rita Tien: Absolutely. Closing volume continues to increase as a percentage of total market volume as well. Currently it's about, with S&P 500, those names, it's about 16% of the total market volume is benchmarked, is trades in the close. When you think about that, that's huge. That's one point in time in the trading day.

[00:27:30] Rob Campbell: Are we talking like the last five minutes, the last half hour? What are we talking here?

[00:27:33] Rita Tien: It's a separate auction in the U.S. and in Canada.

[00:27:36] Rob Campbell: OK.

[00:27:36] Rita Tien: So, you can put stock into buy or sell at the close and it pairs off and that's the closing price, and there's different mechanisms for different MOC markets as well. Globally it's different, but in the U.S. and Canada, it's a separate auction, and it's one print at the end of the day, essentially, for a price.

[00:27:56] Rob Campbell: What does that mean? Is it better to trade midday or end of day or what does this mean?

[00:28:00] Rita Tien: For our purposes, I would say it's more looking for liquidity at a price. If the close is happening, but it's not at a price that I'm interested in, then maybe I don't care, but I am always interested in that liquidity that's happening there. That is when it's happening, and it tends to be concentrated towards the end of the day as well, so it's not necessarily just the closing print, but the lead up to it as well.

[00:28:21] Peter Dmytruk: They're impactful. I didn't say anything, but Japan is 20%. If we don't participate in the closing auction, our participation numbers drop substantially.

[00:28:30] Rob Campbell: OK, so it's a really big deal.

[00:28:33] Peter Dmytruk: The way the closing price works in Japan is (it no longer is), but it used to be a snap close, so it could close at any price and there's market on close. ETFs are market on close. So there's an imbalance. They move the price. You have no idea which way that's going, unfortunately, and that's 20% of the day's volume is going at a price that you don't really know where it's going to land necessarily.

[00:28:53] Rob Campbell: I guess that's the trade-off. You miss out on this big bout of liquidity at a less-known price, versus trading at other times of the day where you might have a better sense of your price, but only be able to take small nibbles of whatever you're trying to work at.

[00:29:04] Peter Dmytruk: The trade-off is not necessarily so clean. Let's say something trades at a million—there's a million shares that are going to go up in the auction. So then I go, I want to be 20% of that. I'm going to go put 200,000 shares or 100,000 shares at market because I want to participate and I want to get that liquidity. But then I influence the closing price. Then what happens is the next day, everyone's going to see that. If somebody that is not like us sees this, like RenTech or Citadel, somebody in there is like, hey, something funny happened in this particular stock. It wasn't us. It's probably a long-term investor. The next day they're going to jam the stock up on us. I get good participation one day, but the next day I'm going to just impact the stock.

[00:29:46] Rob Campbell: That's fascinating.

[00:29:47] Peter Dmytruk: It's really hard to know where you're at, whether you're getting the liquidity or you're just influencing price. It's really hard to know that difference.

[00:29:55] Rob Campbell: Putting aside smaller, well, maybe including smaller cap stocks, if you've got to trade you've got to get through, presumably that influences you knowing that there are—I don't know if this is the right word—but predators out there. You kind of want to go big on day one. Am I thinking about that right?

[00:30:10] Peter Dmytruk: Depends how long you're going to trade for. It's a true dilemma because we don't know. We don't know where it's going to trade tomorrow. We don't know where it's going to trade five days from now. If you take liquidity, yes, you're going to have to move up the price because naturally there's no liquidity there. You have to move the price to get the liquidity. My opinion is, is that auctions, you can hide a little bit better in them because you don't know who's there. It's ETFs, it's fund A, fund B, it doesn't matter. Whereas if you go during the day and you have an abnormal pattern, the computers are going to pick up on you. They're going to say, why is the volume up all of a sudden? Well, there's somebody there, and the somebody is going to be a retailer or us. It's probably not an HFT necessarily. That's the hardest part about buying. You could put it in an algorithm, algorithms are pretty smart, but you don't necessarily know that.

[00:30:59] Rob Campbell: Back on overcrowding, pod shops. I've heard a little bit about these recently, effectively these multi-strategy hedge funds. What's been their influence on markets?

[00:31:08] Rita Tien: I can start. When we're talking about pod shops, they're also called multi-strategy hedge funds. Multi-strategy hedge funds. Let me say that sentence again. Pod shops are also referred to as multi-strategy hedge funds. They're not new. We've all heard about hedge funds. We've been hearing about them for years. I think just the term pod shop seems to have come out relatively recently. A bunch of groups will work in different strategies, so they're very siloed. Some examples that I pulled from Bloomberg of different strategies that these pod shops might employ include an equity long-short or a share-class arbitrage between different

classes of shares or a risk arbitrage strategy. So you're looking at M&A.

I'll take an example from our Canadian small cap universe or strategy, OK, small cap strategy. We had a holding in Sleep Country, and that recently got taken out by Fairfax. That was an all-cash deal. They knew that it was going to price at a certain price, and it traded very close to that deal price for several weeks. For example, at a pod shop, they might take advantage of that. As the day gets closer, it trades closer and closer to that price because there's a reduction of timing risk that the deal won't fall through, but it gets to be a very crowded space. People are very aware that this is happening. It's not a secret, and the more people that are in that space, the more crowded it gets and the tighter the spread gets, which is a good thing, I suppose, but there is this idea of overcrowding. These aren't strategies that are secret. People do know about these. The other thing that I might say is a lot of them are employing the same strategies as well, so it does tend to get a very overcrowded. What happens when a strategy does well? They pour more money into it, and the same strategies do well. Everybody's looking at the same dataset. They're looking at the same dataset. They're employing the same kind of risk management tools as well. So when does the big explosion happen? I guess is the question. If everybody pulled out at the same time or if too many people have piled into something, I think people are waiting for what might happen.

[00:33:23] Rob Campbell: OK. Just to pull on that, to make sure I understand: In your Sleep Country example, that means that the margin between the proposed price and the price in the market has gotten really, really, really tight because a significant portion of the market through these multi-strategy hedge funds is effectively betting that the transaction is going to go through. So the risk is that it doesn't, and you have a bunch of leverage in this particular trade, and especially if they've done this well historically, algorithmically, that will send further floods. But outside of your Sleep Country example, are there other trades that either you know or perceive that these strategies are really coalescing around?

[00:34:01] Rita Tien: They're pretty secretive about what they do. I'm using that as an example as a well-known strategy that someone might employ. Another strategy might be, for example, index rebalance events. Index rebalances happen. They're widely announced, and there's a whole business created around predicting what these index changes are going to be as well. They might pre-position something, a position ahead, an anticipated event. For example, when Tesla was added to the 500, that was a huge event and people weren't sure what the timing was going to be, but they knew that most likely it would eventually be added and had a very good idea of the kind of size that would be added. People were pre-positioning ahead of this. That might be, for example, something that a pod shop might do as well. Again, they're very secretive, so I can't say for sure.

[00:34:55] Rob Campbell: Yeah, presumably they're going to things that do well. Peter, as someone in the market, does this concern you? The prevalence or the influence of these types of players in the market? Does it make your job easier? Does it provide more opportunity? How does this impact you?

[00:35:08] Peter Dmytruk: That's the mystique of trading. That's for sure. I mean, we're talking about secret models and what these guys are doing and who's blowing up and what country are they in. The reality is when you look at some of the strategies that are employed, like the long-shorts or the market neutral events, the reality is, that most of these guys are employing leverage and they're piling on risk, so it creates more risk in the market. I would assume that there's probably a bit of a cycle with the risk, so when the market gets over-complacent, prime brokers are lending out more money, these guys are getting more capital to do more trades. Their investors want them to make more money, so they're using more leverage and taking on more risk. Then it's a house of cards, and when it hits, it falls apart really quickly.

[00:35:56] Rob Campbell: Because they've got to manage that risk if something turns.

[00:35:59] Peter Dmytruk: Yeah.

[00:36:00] Rob Campbell: Pretty tight stop loss.

[00:36:02] Peter Dmytruk: What ends up happening, and this has happened so many times in history, is that people haven't managed their risk properly. That's when we read about it. This is something that keeps coming up in the market, so it's probably going to happen again in the future. I think it leads more to human behavior, complacency or humility. Those are some of the things that I think about. Momentum. Even going back to Japan and the carry trade, I think some of that was just over leverage. People just were borrowing money, so when the tide turned against them, they have to sell. There's margin calls that are happening. It's when things surprise people, that's when the market seems to turn and go quickly. Now, as long-term investors, sometimes these are opportunities for us, so volatility can lead to opportunities. The toughest part about trading or buying something when everything else is down is, is this the time? Is this the day you should be doing it? It's hard for a lot of investors to do that, but that's the opportunity it creates. If we didn't have volatility, we probably wouldn't need traders. Computers could just do this for us. We haven't spoken about algos and stuff, but there is a lot of computer trading today in the marketplace. They're sophisticated and good.

[00:37:15] Rob Campbell: I was going to bring that in because you mentioned humans. I could also imagine as a long-term discipline investor, sure, this might create opportunities at some point, but could it probably be pretty painful for a while too, if these really crowded trades that are perhaps artificially bolstered through leverage, momentum, success, flows. Markets don't meet either retail that really chase some of these trades. It can be really painful not to be on that side of it. Then you brought in algos, which effectively are regression models based on what's happened in the past. If these models have been very successful in the past, they'll extrapolate going forwards. Do you have that sense too, that it's also actually really hard in that type of market?

[00:37:55] Peter Dmytruk: For sure. I think if you look at who has been successful long-term with quant models, so like Renaissance or RenTech. What strategies they have employed and how have they been able to have strong returns over a long period of time? Some of them are systematically and have done very well for long periods of time, but then we don't talk about all the ones that haven't worked out and have left the marketplace because they failed and they weren't good at what they were doing systematically. The market is very smart, it's tough, it's a tough game, it's a tough job out there to get these things right all the time, it just is. I think any investor out there should use the tools that they can to help them, whatever their approach is. Even though we don't necessarily trade on quant models or use stats to trade, we are open to learning about that, to try and do that for clients. I think just going back to an example where sometimes the NVIDIA, if you're not involved in that, it's painful to be not involved while all the fund flows and ETFs start to carry some of those names. We've also seen it on the reverse where it's been a benefit, so we have securities that get added to the index and for fundamental reasons, we think they're good companies and then we get incremental investors that come in and push the price up. We've seen on both sides. I mean, NVIDIA, when you get one stock that might be outperforming the market, there are other examples out there that have benefited our clients over time. It's just how the investing side of things works out sometimes.

[00:39:30] Rob Campbell: Rita, I want to give you the last word, if I might. Markets are basically at all-time highs, yet what I'm detecting from our conversation is that there are structural, perhaps, fragilities that might be higher than they were in the past. How do you reconcile the two and what's your advice to clients? What do they do about that?

[00:39:49] Rita Tien: Well, I think one of the great things about our funds is that we are looking at individual companies and there's always an opportunity to find that trade or to find that name that hasn't just been piled into

because it's popular. We're looking at unpopular or unknown companies and just to be aware that sometimes you're just following the herd and maybe that's not the best strategy.

[00:40:14] Rob Campbell: Very good. Short and sweet. Peter, Rita, thank you so much for coming on the podcast today. Peter, I'm sure it's close to time for bed for you.

[00:40:23] Peter Dmytruk: Yeah, it's late.

[00:40:24] Rob Campbell: Enjoy your Friday evening, enjoy the weekends, and Rita, time for you to get back on the desk for the Friday here in North America.

[00:40:31] Rita Tien: Thank you.

[00:40:34] Rob Campbell: Hi, everyone, Rob here again. To subscribe to the Art of Boring podcast, go to mawer.com. That's M A W E R dot com forward slash podcast, or wherever you download your podcasts. If you enjoyed this episode, leave a review on iTunes, which will help more people discover the “be boring, make money” philosophy. Thanks for listening.