

Padowitz harvesting the GameStop exuberance

Monday fundie Giving up some upside ensures less downside.

Jonathan Shapiro



Chad Padowitz, of Talaria Capital: "Shares are tremendously more volatile than the companies you're investing in." PHOTO: EAMON GALLAGHER

Talaria Capital, which has \$500 million under management.

"So if we can get paid based on the volatility of the share price but take the risk based on the earnings of a company, then there is a substantial and sustainable advantage."

The GameStop circus may have rolled out of town. But for Chad Padowitz the incredible drama surrounding the gaming retailer's surging share price and the forces that caused it have justified the fairly unique way he invests in the global sharemarket.

For 15 years, Padowitz has been using options to derive income from the equity market and lower the cost of buying into expensive markets.

The strategy is based on the insight that the market doesn't reward investors for the risk they're taking and punishes investors for getting their timing wrong.

"Shares are tremendously more volatile than the companies you're investing in," says Padowitz, who is chief investment officer at

GameStop is a case in point. Investors that bought at the bottom became very rich, very quickly. Those that bought at the top suffered a rapid draw-down. As for GameStop's operations, its last three quarterly profits – of around \$US250 million (\$322.2 million) – weren't all that different to justify a \$28 billion round trip in its sharemarket value in a matter of days.

GameStop is, of course, an extreme example of how a share price can become unhinged from the underlying fundamentals of a company.

But Padowitz says "the cash flows of companies are a lot less volatile than the volatility of share prices".

He says if dividends are used as a proxy for corporate cash flows over time, they have proved to be relatively stable, with a volatility measure of 1 per cent, compared to the volatility of equity markets of 17 per cent.

He believes investors should get a higher return for that volatility, or get similar returns for lower risk. And that is why he's spent the past 15 years applying his own relatively unique approach to global equity investing.

"Investors were being sold funds on the expectation that the kind of longterm returns from equities are there for everybody, at every point in time," he says. "The reality is that in very expensive markets, your expected return would actually be very low but your expected risk would be very high."

Investors who bought shares in 1929, the early 1970s, or even in 2000, would have done so when the risks were high but the prospects of returns were low. They've been discriminated against by their entry point. To solve for that, Padowitz has used the options market to change the return outcome – by giving up some of the upside from a bull market in return for more protection from the downside of a bear market.

The strategy effectively involves selling insurance against a falling share price of a stock the fund would be happy to own. That derives an income, and if the share price falls the option contract kicks in and they buy the share at the lower price of the options contract. For example, if Talaria is prepared to own a stock at \$100, rather than buy it at that price, it sells a put option. That contract is a commitment to buy the stock at \$95 and protects a buyer of the put from a sharp fall in the share price.

The writing of the put generates an income of about \$3 over a two-month period. If the share price falls, Talaria will then buy the stock at \$95 by honouring the contract. The sum of this means in a rising market the fund will get reliable income but won't capture the upside. In a down market, it will be protected somewhat by a lower entry point.

Padowitz co-founded Talaria in 2018 after management bought the stake owned by Wingate Group. But he has run the strategy since 2005.

He says, on average, it has captured about 80 per cent of the sharemarket's gains for investors and shields them from about 50 per cent of the fall. It's been a reliable way to earn income and ride the

sharemarket.

But this year the game has changed. The combination of share trading platforms such as Robinhood – which have made it easy for retail investors to speculate on options – coupled with stocks that have surged in value, has led to a dramatic increase in options trading volumes.

The ramp-up in activity has in turn triggered more volatility in the sharemarket. The options “tail is wagging the dog”.

Once again, GameStop was a case in point as options market makers scrambled to hedge their exposures by purchasing the physical stock, driving it higher.

“Options are a more important component of the equity market and it probably drives higher volatility,” Padowitz says.

The new retail participants aren't exactly discerning about the premiums they're paying.

“Retail investors are far less sophisticated, so they will pay a price that is arguably not linked to the underlying volatility of the share,” he says.

The net outcome is that funds such as Talaria are earning about 30 to 40 per cent more income from selling puts. And Padowitz is convinced that retail investors will stick around, creating a structural benefit to the optionswriting strategy.

“Once you bring an asset class to a wide audience, I think it stays there.”

Padowitz is a value investor through and through. He prefers to own the likes of Total, the French energy company, US insurance firm Prudential, and German pharma giant Bayer rather than Amazon, Tesla and GameStop, which was arguably a value stock.

“We will pay for sustainable earnings and sustainable margins and pay a fair price for that,” he says. “What we won't do is take a very optimistic view of long-term growth rates and assume them to happen.”

Like many value investors, Padowitz's near-term fortunes are being driven by the bond market.

As long-term bond rates have fallen, money has rushed into growth stocks as lower discount rates are applied.

And more recently, as the market prices in the prospect of higher inflation, funds have rotated back into the cyclical value stocks Padowitz believes are better valued.

But he says it's too simplistic to pin the valuation disparities on low interest rates alone. “There's never just one reason. Japan has had low interest rates for 20 years, but there hasn't been the optimism, exuberance and the presence of certain types of highgrowth companies.” But he agrees interest rates are the dominant factor. That's evidenced by 40 basis point moves in the US 10-year bond rate swinging the valuation of the Nasdaq 100 by \$US1.5 trillion.

The maths makes sense. These companies are growing and so the market is valuing how large their profits will be in 10 years. When rates are low, those future profits are worth more because they are discounted to the present at a lower rate.

But Padowitz makes the point that discount rates don't tell investors anything about the quantum of future profits. "It's not that you will get higher returns going forward, it just means you've brought forward future returns up-front," he says.

Low bond rates are just one part of a powerful cocktail. The other powerful ingredient are those tech platforms such as Robinhood that are funnelling retail investors of all sizes to speculate in the market.

With 50 per cent of the market cornered by passive funds, 20 per cent retail investors and a decent share of what's left chasing the market, the amount of capital being allocated based on valuation models is marginal.

"There's quite a small proportion of the market that is focused on valuation as a determinant of whether you should buy an asset or not," says Padowitz.

"But we do know that over time that valuation drives returns. What you pay for an asset is the determinant of the return you will get."