PENDULUM
ASSET MANAGEMENT

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How does Pendulum Asset Management look at prospective investments?

As a general rule, most investment advisors and managers who invest in single-name securities, whether it be stocks, preferred stock, bonds or other esoteric investments, tend to have some sort of methodology that they follow or copy as an investment framework. Meaning, they follow a set of steps or rules to make investments.

With so many financial management firms in the market, the biggest question that I have received is what makes Pendulum Asset Management ("PAM") different? Yes, we invest largely in securities that we believe are income-producing (paying dividends or interest), but what framework do we use to make those investments? In other words, what kind of value do we bring to current and potential investors?

For my framework, it is something that I have developed over my career as an investor for a variety of firms (including a hedge fund and money manager). Through many years of experience in the industry, I believe that I have created a system that addresses the main upsides and downsides of investments that allow me to evaluate if an investment is worthwhile.

Outside of screening for quantitative metrics such as price/book value ratios, leverage, etc., ***the below are the following criteria that I focus on that I believe add the most value to investors:***

1. **Company Management**
   a. Company management is the most important factor when evaluating the potential for an investment. You can have the greatest assets in the world, the best proprietary information or the smartest employees, but at the end of the day, the buck stops with the team leading the company. Certain aspects that I focus on are:
      i. **Track Record:** What does their history show us in terms of how they lead and how they manage? Do they have a history of failure or success?
      ii. **Transparency:** Are they transparent with investors? Are they communicative in their goals, and do they communicate concerns in a reasonable manner?
      iii. **View of the Business:** What is their view of their core business? Does it align with PAM's? What is their long-term plan?

The above questions are obvious to most, but here are two quick examples that showcase competent (or incompetent) management, one being a very recent development:

Boeing (BA): Clearly the biggest recent case of company mismanagement. What happens when a firm that has everything going for it, being essentially a private monopoly guaranteed by the US government, focus on short-term profitability over long-term quality of their product? Cutting corners, being run by MBA-types instead of engineers and the like results in poor product oversight, leading to the issues plaguing the company today. That does not necessarily mean that Boeing will not be a good long-term investment, but until there is a management change, returns may continue to suffer.

TPG RE Finance (TRTX): Here is a not so-obvious recent example. TRTX is a commercial real estate mortgage REIT, focusing on the origination and management of first-lien loans collateralized by commercial real estate. Losses have plagued banks and these commercial mortgage REITs, especially on office and multifamily collateral. Barry Sternlicht of Starwood Capital has even said that the US Office market is sitting on roughly $1.2 trillion of losses, and is worth around $1.8 trillion currently[1], implying a 40% haircut from previous levels.

[1] Source: Bloomberg

So why focus on TRTX? It is because of how they are actively managing their loan portfolio. Management has been incredibly transparent and conservative in their desire for managing their capital, and their actions demonstrate it. Recently, they sold all their currently non-performing loans, allowing them to use that capital to recycle into future originations. TRTX took losses from doing so, but at this point it is better to have the ability to redeploy capital in this environment than to carry non-performing assets in the hopes that they recover, all while getting eaten alive by the carrying cost of said capital. Despite the uncertainty in the commercial real estate market, well-balanced, conservative management should be able to navigate the volatility and come out in a stronger position compared to peers. *This is not an investment recommendation in TRTX.*

Current clients of Pendulum Asset Management will be receiving significantly more detail on TRTX. Please reach out to me if you have any questions.

2. **Asset Quality:**
   a. Another important factor, without good assets, then how can investors ascertain any sort of positive future result? If the company is invested in poor assets or the business itself is run poorly (clearly hand-in-hand with management quality), then at best the only chance for any sort of positive outcome is if the macroeconomic environment gives the firm in question some sort of boon. I do not bet on any sort of macro condition improving as the sole investment thesis for any company I invest in.
   b. Certain questions I focus in on when evaluating Asset Quality are:
      i. **Firm Investments:** What is the firm invested in? Does PAM agree with these investments?
      ii. **Firm Funding:** How is the firm funding said investments?
      iii. **Investment Outlook:** What is the outlook on firm investments? Both from the firm's perspective and PAM's

Again, all of these basic questions appear on the surface level, but they all have surprising depth. For example, let's say I am investing in a firm that invests in Agency Mortgage-Backed Securities ("Agency MBS"). I would want to know, what kind of MBS? Are they pass-through securities? Collateralized Mortgage Obligations ("CMOs")? Interest-Only ("IOs")? ***What is the forward return profile of these assets? How is the firm funding these assets? Does the structure of these investments inhibit or enhance forward returns? Does the invested asset align with PAM's long-term view?***

This is one basic example, but with every question, you can ask more questions, peeling the proverbial onion layer by layer.

3. **Business Quality**
   a. Again, this is intrinsically tied to Management and Asset Quality. This comes down to understanding the business and its historical and future growth. Typically, I like to focus on the highest quality businesses per sector. Questions I focus in on are typically:
      i. **Catalysts:** What catalyst(s) will drive an already good business into an even better one?
      ii. **Levers:** What are the main revenue and cost levers?
      iii. **Liquidity and Solvency:** How liquid is the firm versus what are its upcoming liabilities?

Again, these are not the only questions I focus on. At the same time, each question while basic on the surface has a surprising amount of depth to it.

To emphasize to current and future investors, I focus on these three factors that constitute a core part of my investment framework, but they do not drive all of my decision-making. Rather, these are important factors that I, on behalf of my investors, evaluate before doing more due diligence. However, like I mentioned above, these three factors I believe do add the most value to investors during the due diligence process and beyond.

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