5 Questions with Monachil Founder and CIO Ali Meli

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Introduction and Overview

As we prepare to enter 2024, I have decided to use this commentary as an opportunity to answer questions from my team. I hope you enjoy this brief foray away from markets and data. It was a pleasure putting it together.

What was your first introduction to finance and how did it influence your educational path?

I first became interested in financial news in late 1994. My family had a satellite receiver—a novelty given that they were then banned by the Iranian government—which allowed us to access English language news. At that point in time, my sole access to financial news was through CNN, which provided it in limited amounts.

When the Mexican debt crisis hit in late 1994, it received a lot of coverage on CNN Asia. I remember listening to US Treasury Secretary Bob Rubin, which was challenging as I was simultaneously trying to learn English and to understand the financial jargon being used. Alan Greenspan also received a lot of coverage at the time. By the onset Asian financial crisis in 1997 and Russian financial crisis in 1998, which also got a lot of coverage, I was a high school student who was following global financial events fairly closely.

A key development in my early finance "education" was the launching of CNBC Asia. The internet boom received a lot of coverage on CNBC Asia and they had dedicated programming to cover the phenomenon. In fact, one of the shows was actually called "dot.com". In light of my keen interest in engineering and computer science, I felt a connection to the internet stock boom. As a hopeful future electrical engineer, I believed part of that journey would be to become a telecom guru. I became so focused on financial news to the point that my family became frustrated with me. Dinner time in Iran was in the middle of the US trading day, so the inevitable market action often conflicted with my required attendance at the dinner table.

All of this motivated me to find a way to come to the US to go to university. My father had earned his bachelor's and graduate degrees at the University of Wisconsin, Madison, so he was very supportive of my goals, as was my mother who was also very kind and encouraging. A pivotal event in my pursuit was the gold medal at the national and international physics Olympiad, which I won. This victory helped me greatly as I sought permission to leave the country. I was fortunate enough to be offered admission at both MIT and Caltech. I ultimately decided to attend MIT and did so from 2001 to 2004. At MIT, I earned a degree in Electrical Engineering while also earning one in finance from Sloan School of Management, technically a Management Science degree with concentration in Finance.

Please tell the readers about the trades you made leading up to the 2008 Financial Crisis, why you made them and what you learned from that experience.

Being hired by Goldman Sachs in 2004 and subsequently being invited to join a very dynamic structured credit trading desk was one of my lucky breaks. I was trained by traders who took a very rigorous approach to risk and emphasized the importance of accurate marks, unwavering focus on risk management and attention to detail. An early iteration of transactions we executed were negative basis trades. In this type of transaction, we would buy CDS protection on senior tranches of CLO and ABS paper. The ultimate provider of the risk protection provided by a CDS were monoline insurance companies, which typically had a AAA credit rating. An important risk management policy for the desk was to never face those monolines directly and instead to find counterparties willing to intermediate the risk, a decision I did not, as a brand new trader, initially understand.

This made me curious to learn more about the monoline insurance companies and after some time I came to realize just how risky their business model was. Essentially, they were creations of the rating agencies which allowed them to provide credit wrap and financial guarantee products a capital base to support. They referred to this as "underwriting to zero loss."

A moment of clarity came to me on a weekend in 2006. I was working simultaneously on a financing for a Canadian healthcare company that performed lab tests in a highly regulated environment, while also updating marks on our trading books. As I began reading about how the ABS CLOs on which we had bought CDS protection were performing, I became very concerned about the health of housing markets and, importantly, about monoline exposure to them.

As a follow-up to this moment, I wrote a long email to my superiors explaining why the housing market could be in freefall and how purchasing CDS protection on the monoline themselves could be a cost-effective way to express a bearish short-term view on the housing market. Monolines were viewed by the market as having diverse credit exposure and, as a result, their CDS could be purchased for just a handful of basis points. At the height of the market euphoria, protection could be purchased for as little as 6-7 bps.

Those positions performed extremely well.

Perhaps the most important tool in my financial toolbox—which I learned from this experience—was the risk management ethos instilled in me by my bosses, for whom I had immense respect. I was also extremely grateful they were very open-minded about expressing a short-view that ran counter to views being taken by the entire market, which was going long.

I also noticed that the road to finding good ideas was paved with very hard work. The excess capacity, if you will, that I used to think about the weakness of monolines and to research how to express this bearish view with a large monoline short position was hatched while working weekends. The time I spent in the office on the weekends gave me the bandwidth to explore ideas that were not part of my formal job description. Over time, I found that working 70-hour rather than 50-hour weeks consistently allowed me to accumulate significant lateral knowledge and expertise.

What are the best lessons you learned in your nearly 15-year career at Goldman Sachs and how have they influenced how you set up and manage Monachil?

First and foremost, I learned the importance of respecting the mark-to-market process which begins with a pragmatic view of where you can exit a position and to use that to mark your book. This forms the foundation for running a trading and investing operation. It is absolutely necessary to have a view about "value" and upside potential, but the mark to market process always needs to be objective, and if anything, somewhat defensive. Much of what enables us to take aggressive action while managing our risk is the clarity that comes from knowing the marks and being able to approach any credit negotiation or enforcement action from a position of strength. That was true at GS and it remains true now.

The second thing is the value of building and being a part of a great team. Having harmony, clarity of objectives, strong communication and being a team player was culturally important at Goldman and I could easily see how it strengthened the firm. When people did not see eye to eye, or even when there were instances of interpersonal conflict, people understood there was a general sense of kindness and comradery among the group that needed to be maintained for the benefit of all as it made the firm run much better. I found that I was often the beneficiary of the generosity, kindness, and good nature displayed by my colleagues. That culture motivated me to work even harder and to better appreciate the opportunities that Goldman provided.

The other core lesson that I learned was the true value of rigor while developing an understanding of both the risk of transactions and the workings of a business. At Goldman, you would need to know both to succeed. Attention to detail, knowing and monitoring your risk, and being on top of the details was very important. I believe it is this discipline that provides the framework to keep losses small, while also making sure that the best positions perform well.

What is your outlook on the markets and economy for 2024? What will you be watching closely throughout the year?

Markets currently feel euphoric with irrationality abounding. One could argue that markets haven't felt this good since the fall of 2021. One could even argue markets haven't felt this good since 2007. After all, rates are expected to come down and employment is relatively high.

My outlook, however, is far more cautionary, and even arguably pessimistic compared to the consensus view in the market. Firstly, I do not believe that inflation has been tamed completely. Our view is that the disinflation of the past two months is in no small part due to lower commodity and energy prices. This, however, means that a high risk of volatility remains.

Many of the rent and wage increases that have recently been observed, have not yet been included as a part of the official inflation measurement., In fact, some have already begun dismissing these increases as backward looking. While they may have occurred in the recent past, they don't make up for the fact that some prior measurements of inflation were likely artificially lower.

Furthermore, the Federal budget deficit in the US is far from being stabilized. Deficits in the first 2 months of the 2024 fiscal year are almost 14% higher than the first two fiscal months than the 2023. Given recent improvements in financial markets, there is also a possibility that tax receipts could go higher. The issue here, however, is that outlays are moving higher at a faster rate. Absent some accounting gimmick, the deficit in fiscal 2023 will have been nearly $2trn and will likely have grown at an even faster pace faster than inflation.

This will, in turn, bring a greater supply of short-term and long-term Treasuries, which will compete with private investments. The market valuation for the S&P 500 is currently around $40trn, as compared to $3trn of new government securities coming to the market through new deficits and Fed's QT. New issuances of government securities are now almost 7% of S&P market capitalization, yet they will need to find a home within the balance sheet of US households.

Another interesting dynamic is the "rest of the world" recession. We are likely to see a recession in Europe and perhaps much slower growth in China. Interestingly, these could benefit the US by keeping commodity and import prices lower, thus helping to tame inflation.

What excites you most about the holiday season?

The holiday season is a chance to connect with family and friends. Mine comes from a broad array of traditions that celebrate many different traditions. Being Persian, the most significant cultural occasion for me at this time of year is the winter solstice, which is celebrated as the rebirth of the sun.

During the holidays, I like to study history. This holiday, I am looking forward to delving into the French and Indian wars leading up to the American Revolution. I saw an episode of a documentary called "The War That Made America" and hope to binge watch the whole series. I am also excited about having a chance to ski and play golf between Christmas and the New Year.

I wish you and your family a Happy Holidays and prosperous new year.

Ali Meli

Portfolio Manager

Monachil Credit Income Fund

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