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Betting Big and Winning

Highland Global Allocation is
up 29% in the past year
investing a concentrated dose
of alternative assets.

Jim Dondero,
Highland Capital Management

(over please)

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Making Bold Bets on Alternative Investments—and Winning

Highland Capital's Dondero says his strength is thinking through debt deals, turnarounds, and trends.

By SARAH MAX

Jim Dondero's bio paints an imposing picture. An early investor in collateralized loan obligations, he parlayed successes in fixed income into a \$15 billion alternative-asset powerhouse, Highland Capital Management, which he co-founded in 1993. He has made bold calls on everything from American Airlines to Argentina, and found value in a bankrupt Texas energy company after Warren Buffett lost money.

Yet, Dondero defies the stereotype of a Texas-based heavy hitter. Myers-Briggs tests put him squarely in the category of introversion, intuition, thinking, and perceiving, or INTP, and the 54-year-old portfolio manager is hesitant to talk about himself. When pressed, he allows that his biggest strength as an investor is "puzzle solving"—thinking through complex debt deals, turnarounds, and emerging trends that are at the core of Highland's investment approach.

Highland offers mutual fund investors liquid and relatively inexpensive access to some of its best investment ideas, curated by Dondero, via the \$894 million Highland Global Allocation fund (ticker: HCOAX). The fund, which is up 29.6% over the past 12 months, sits in Morningstar's world allocation category, but it bears little resemblance to most of its peers.

While the average world allocation fund holds nearly 400 securities, this fund holds just under 200, and as much as 40% of the assets can be concentrated in a handful of themes, ranging from a single company to a dozen companies in the same sector. "We could put them in the overall portfolio and not call them a theme, but then you are kidding yourself," says Dondero. Recent themes include master limited partnerships, Argentina, and the restructuring of Vistra Energy (VSTE).

Dondero's top-heavy portfolio can produce big performance swings. The fund ranked at the top of its peer group in 2014, but its early move into energy pulled it to the bottom in 2015, only to send it to the top in 2016. While those extreme swings are unusual, volatility comes with the territory. "We didn't want to offer a me-too product with muted volatility and performance," says Dondero, who is also the lead manager of the Highland Small-Cap Equity (HSZAX) and closed-end NexPoint Credit Strategies (NHF) funds.



Jim Dondero says his biggest strength as an investor is "puzzle solving"—thinking through complex debt deals, turnarounds, and emerging trends.

Born in Hoboken, N.J., Dondero studied accounting and finance at the University of Virginia, with aspirations to pursue real estate investing. A tough economy took his career in a different direction—to credit. Within five years of graduation, he was managing \$1 billion in fixed-income assets for American Express.

In 1993, Dondero and co-founder Mark Okada partnered with an insurance company to launch what is now Highland Capital Management. Early in the firm's history, the pair relocated from Los Angeles to Dallas, a move that helped minimize what they called “the three Ts”—traffic, taxes, and time zone—and got them closer to their parent company at the time. “We came here sight unseen from California with six or seven people,” says Dondero, who has put down deep roots in his adopted city, commissioning local art for Highland's headquarters, and focusing much of the firm's philanthropic activities on local causes. In 1997, Dondero and Okada bought out their parent and have since grown the firm's assets and resources. Highland employs 165 people, most of whom are based in Dallas.

ALTHOUGH THEIR INITIAL FOCUS was credit— they structured one of the first nonbank collateralized loan obligations in 1996—they soon expanded into other areas in the alternative space, launching their first alternative mutual fund in 2000. Even so, Dondero says that he and his team continue to size up investments through the lens of a credit investor. “We like defined cash-flow streams versus build it and they will come,” says Dondero. “If you look at a lot of our equities, they look like bonds.”

The investment process is a two-way street, with the firm's roughly 50 investment professionals recommending ideas to Dondero and other portfolio managers, or, as is sometimes the case, Dondero and other portfolio managers flagging ideas for the research team to vet. While most of the research team is organized by sector, the firm designates “alpha analysts” who cover up to a dozen high-conviction ideas in detail.

Dondero allocates roughly half of the fund's assets to a diversified basket of ideas—typically less than 1% positions each—with the balance earmarked for a handful of high-conviction ideas. “We expect the big themes to drive the alpha,” he says, adding that new ideas may start as smaller positions, while themes that have played out may gradually graduate to the diversified bucket.

DONDERO AND HIS TEAM turned their

Highland Global Allocation

	Total Returns*		
	1-Year	3-Year	5-Year
HCOAX	29.64%	1.67%	8.06%
FTSE All-World Index	16.06%	6.33%	9.02%

Top 10 Holdings	Ticker	% of Assets**
Vistra Energy	VSTE	11.4%
TerreStar	Private Equity	8.9
TerreStar	Loan	4.0
Republic of Argentina	Sovereign Debt	3.6
Westchester CLO	CLO	2.8
Twitter	TWTR	2.7
Targa Resources	TRGP	2.6
K12	LRN	2.5
Plains GP Holdings	PAGP	2.3
Enterprise Products Partners	EPD	2.2
Total:		43%

* All returns are as of 3/21/17; three- and five-year returns are annualized. ** Holdings as of 12/31/16.
Sources: Morningstar; company reports

focus to Argentina in 2012, as its debt debacle started coming to a head. Following many trips and nearly two years of research, they concluded that the country's natural resources, developed infrastructure, and educated population would ultimately limit losses. In 2014, Highland took a significant position in Argentina's sovereign debt, which at one point accounted for 24% of the fund's assets. Mauricio Macri's election in late 2015 set the wheels in motion for economic recovery; bonds that Highland bought for 70 cents on the dollar appreciated to 120 cents on the dollar.

AROUND THE SAME TIME that Highland moved into Argentina, the firm started shopping for deals among hard-hit master limited partnerships, which own oil and natural-gas refineries, storage facilities, and pipelines. “In the best of times, MLPs trade as a yield alternative, and in the worst of times they trade in sympathy with oil and gas prices,” he says. “The downdraft of 2015 was beyond any correlation they have had with oil and gas historically.”

Even so, he saw MLPs as a defensive play on the plunge in oil prices. Most midstream MLPs collect fees based on volume, not the price of the commodity. Highland invested in roughly a dozen MLPs and related midstream companies—to the tune of about 15% of the fund's assets—including Targa Resources (TRGP) and Enterprise Products Partners (EPD).

In 2016, the MLP index returned 18.3% with prices in some of Highland's positions

nearly quadrupling. Going forward, he says, “even if oil prices bounce along, MLPs should not have the overcorrelation they had in 2015.”

As an alts-focused firm, Highland frequently participates in deals that might be off limits for traditional fund managers. Case in point is Vistra Energy, formerly known as TXU. The company, which owns the largest power producer and retailer of electricity in Texas, was taken private in 2007 following a leveraged buyout that left the company with more than \$40 billion in debt; Berkshire Hathaway (BRK.A) invested \$2 billion in the debt and in 2013 lost nearly half of its investment. Plunging natural-gas prices tipped the company into bankruptcy in 2014.

That's when Highland went in, buying Vistra's senior secured debt that eventually converted to equity. “As it traded down, we looked at the worst-case value and, based on that, entered at different price points, some in the 60s, 50s, and 40s” on the dollar, he says. Things have turned around. Vistra is slated to hold its first postbankruptcy earnings call on March 30 and is expected to debut shares on the New York Stock Exchange in May.

As the bigger themes of the past couple of years start to play out, Dondero is turning his attention to emerging themes, ranging from wind power to nonopioid pain medication. The fund has small positions in three companies developing abuse-deterrent treatments and nonopioid painkillers: Collegium Pharmaceutical (COLL), Nektar Therapeutics (NKTR), and Heron Therapeutics (HRTX).

Dondero is also passionate about supporting emerging nonprofits. Highland's now \$300 million donor-advised fund directs \$3.5 million a year in what Dondero describes as an approach similar to that of the Global Allocation fund. “We give to many organizations in the community, but if we see something we think could be transformative, we make meaningful contributions,” he says.

One of Dondero's high-conviction philanthropic themes is Reasoning Mind, which develops technology-based math curriculum for pre-kindergarten through the seventh grade. “They are able to bring this technology to poor schools in remote places where, in some cases, they haven't had math teachers,” he says, noting that one school boosted its math scores to the equivalent of some of the top schools in Dallas. “That's what we're looking for—to make the biggest impact with our giving.”