

LESSONS FROM LEO: THE SITUATIONAL AWARENESS FUND BLOWUP

The mixed blessings of investment conviction!

THE LEAD IN

- Earlier this year, I was asked what I thought about Leopold Aschenbrenner and I admitted that I knew little about him other than what I had read about him, more in social media, than in the press - that he was a **25-year-old wunderkind who had started at OpenAI but had left to start a hedge fund.**
- That hedge fund, **built entirely around a bet that AI would pay off big time and near term, buying companies in the AI orbit and selling short on the businesses (especially software) that AI would disrupt,** had been able to raise billions of dollars from well-heeled and presumably sophisticated investors, and had posted eye-popping returns, up almost 450% through late June.
- In this case, the fall from grace was precipitous, and **over the course of four weeks, the fund not only lost more than two thirds of its value,** but was also **forced to liquidate, with Citadel buying almost all of its public equity holdings.**

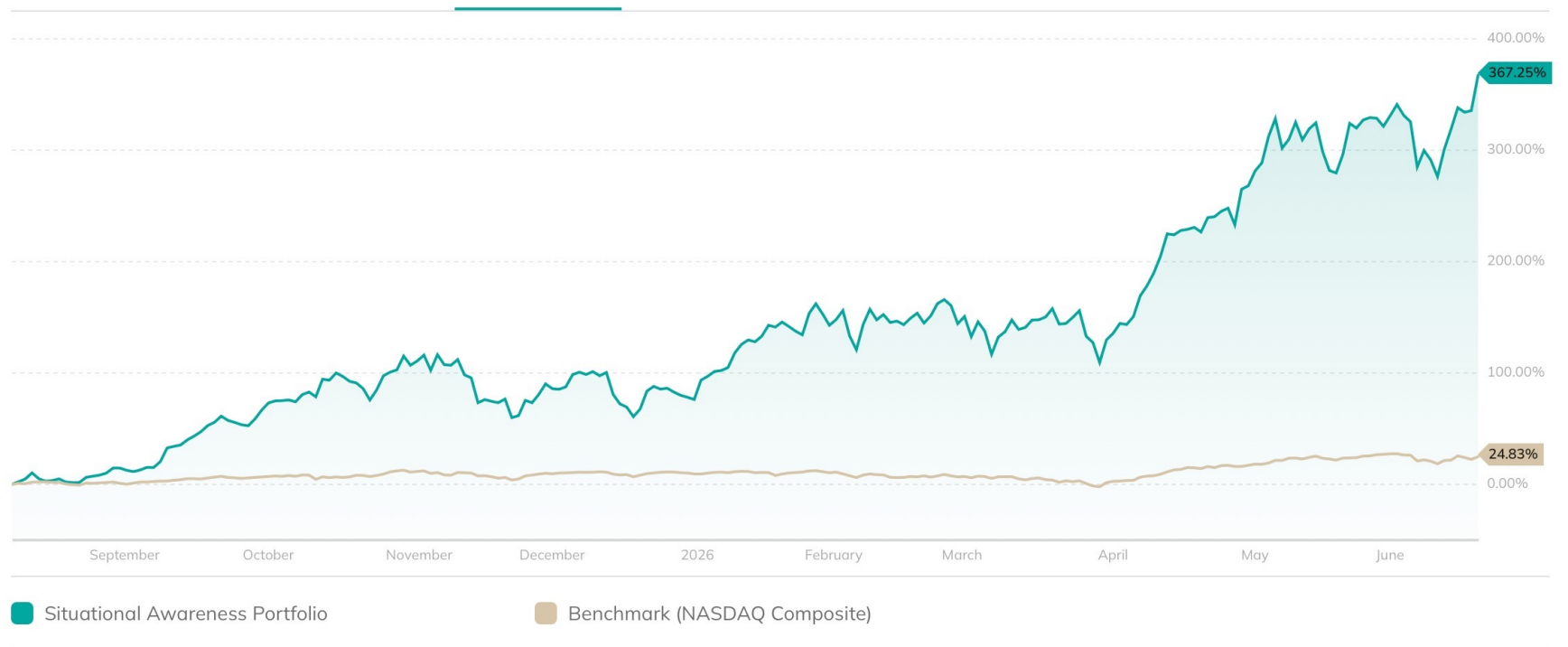
THE REACTION: A RORSCHACH TEST

- For **older investors**, the lesson was that you can be blessed with intelligence, but that wisdom required experience, which, at least in their saying, conveniently comes with age.
- For **value investors**, many of whom chafed at Leo being hailed as the next Buffett, there was vindication that there will never be another Buffett.
- For **AI skeptics**, who have long been on the lookout for catalysts that will break AI fever, there was at least brief moment of hope that this was the catalyst.
- There is **some truth and some overreach in each of these responses**, and I don't plan to rehash them. Instead, I would like to use this story to talk about **investing conviction**, words used mostly in a favorable way, when people talk about success in markets.

LEO'S STORY

- The short version of his life story is that he was born in Germany in 2001, and enrolled at Columbia University when he was 15.
- After graduating with a degree in economics in 2021, doing research briefly at Oxford University and working at Sam Bankman-Fried's FTX fund, Leo joined OpenAI as part of the team working on AI safety.
- He was fired in 2024 for leaking data on the firm, though his motivations for doing so are murky and he contests the allegation, and he published a long (167 page) paper titled "Situational Awareness: The Decade Ahead", which was not only widely circulated, but also became the blueprint for the fund that he created.

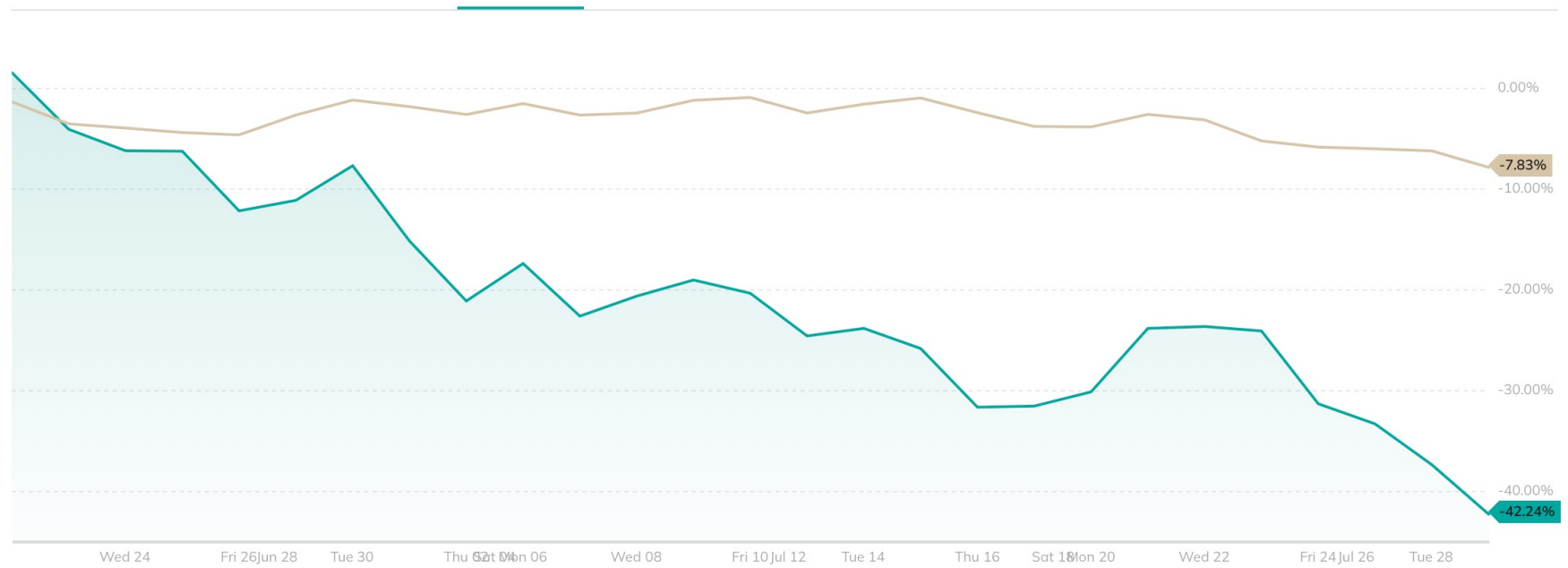
THE FUND RISES..



CAVEATS ON THE FUND (WITHOUT THE BENEFITS OF HINDSIGHT)

- In market time, where decades of over performance are needed to separate luck than skill, **a fund that has been successful for a little more than two years qualifies more as a shooting star** than as a beacon of light.
- To deliver returns of this magnitude, you not only have to be right in your guesses, but those **guesses must be super-charged by adding substantial leverage to your strategy**, either explicitly (by borrowing) or implicitly (by using options).
- The fund followed **the classic 2% (of funds under management) and 20 (% of specified upside) fee structure**, an abomination that not only creates an almost insurmountable handicap, in the long term, for investors in the fund, but also encourages reckless risk taking on the part of management.

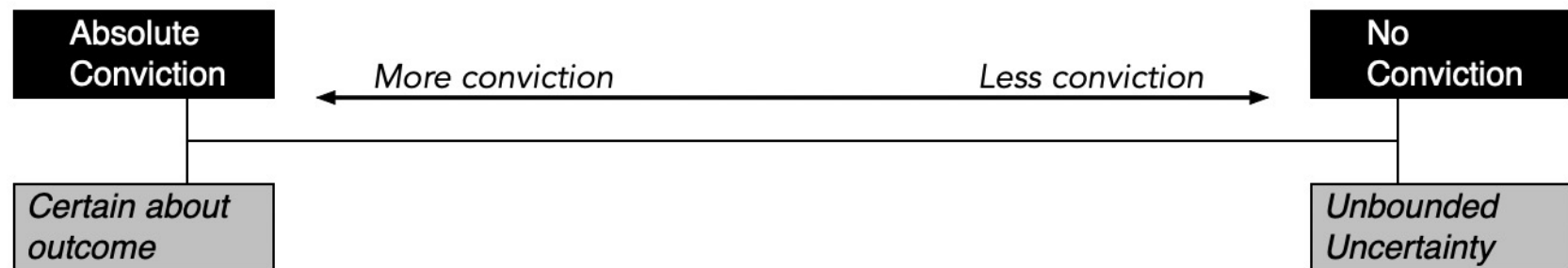
AND FALLS..



THE CONNECTION TO INVESTMENT CONVICTION

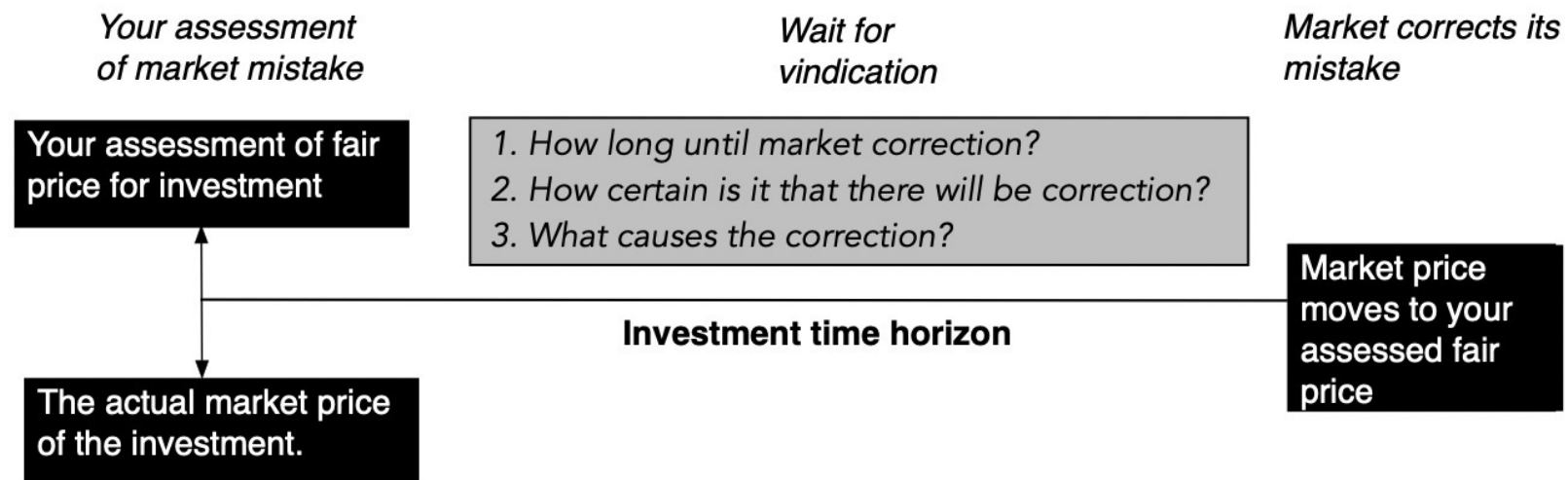
- Leo's core belief **that AI would win the battle with the status quo in most businesses, and that the win would be decisive and quick, was not unique**, and not only are there other investors who shared that view, but there are also companies that are investing in AI cap ex, driven by that view.
- That said, to get from that view to a hedge fund built entirely around buying AI winners and selling AI losers requires that the belief to be deeply set and using debt to magnify those returns **suggests strong conviction**.

WHAT IS INVESTMENT CONVICTION?



As you can see, the elevation of conviction as something to be sought after in investing is because **in the complete absence of conviction, you will not act and that paralysis can result in portfolios entirely or almost entirely held as cash.**

THE ANATOMY OF A “GOOD” INVESTMENT/TRADE



REQUISITES FOR (STRONG) INVESTMENT CONVICTION

- **Your assessment of "fair" price is right** (or at least more right than the market consensus)
- **The market will correct**, i.e., that the market price will move to, or towards, your fair price
- **This correction will happen during the time you plan to hold the investment (your time horizon)**, either because the investment has an expiration date (maturity) or because you feel that there will be a catalyst that causes the correction.

SOURCES OF INVESTMENT CONVICTION: INVESTMENT MISPRICING

1. Private information: You may be in possession of information about an investment that is not available (or at least widely enough available to the public to be priced in) that you believe will change its price.
2. Information processing: To the extent that private information is rarely available to investors, and even if available, difficult to act on legally, much of active investing is built around collecting and processing information that is available to the market. If you are using this information to assess a fair price, it is because you believe that you have found patterns in the data that others have not.
3. Business understanding: In some cases, your fair price will derive from your belief that you understand the business economics for a company better than other public investors do, with your superior understanding coming either from working in the business or from technical training.
4. Pricing mistake: There are some investment theses that start with a market mistake, whether it be in pricing an individual asset or a pair of assets. With a pair of assets, often with similar fundamentals, the mispricing manifests with one of the assets being mispriced against the other, and the correction take place when the mispricing disappears.

SOURCES OF INVESTMENT CONVICTION: MARKET CORRECTION

- *Finite maturity versus indeterminate end game:* An investment with a finite maturity date comes with a greater likelihood that prices will correct than one without. A bond that is mispriced, by itself, or against other bonds of equal maturity, comes with a greater chance of correction than a stock that is mispriced against its own fundamentals or a paired stock.
- *Market frictions:* Market mispricing can sometimes reflect market inattention or irrational trading, but they more often are the consequence of market frictions, including restrictions on selling short and exerting control over an investment (such as buying and liquidating a company).
- *Market liquidity and depth:* In equity markets, where there is no date by which mispricing has to disappear, corrections often require catalysts, i.e., events that lead market participants to reassess a market price, and to correct it. Those catalysts can come from corporate disclosures (earnings reports, for instance) by the mispriced company, corporate restructuring (divestitures and spin offs) or high-profile investors (activists taking a stake in a under priced company or selling short an overpriced one).
- *Investment time horizon:* Being able to wait for longer periods, for market corrections, should not only give you a greater chance of gaining from a market correction, but also give you more conviction in your investment, other things being equal.

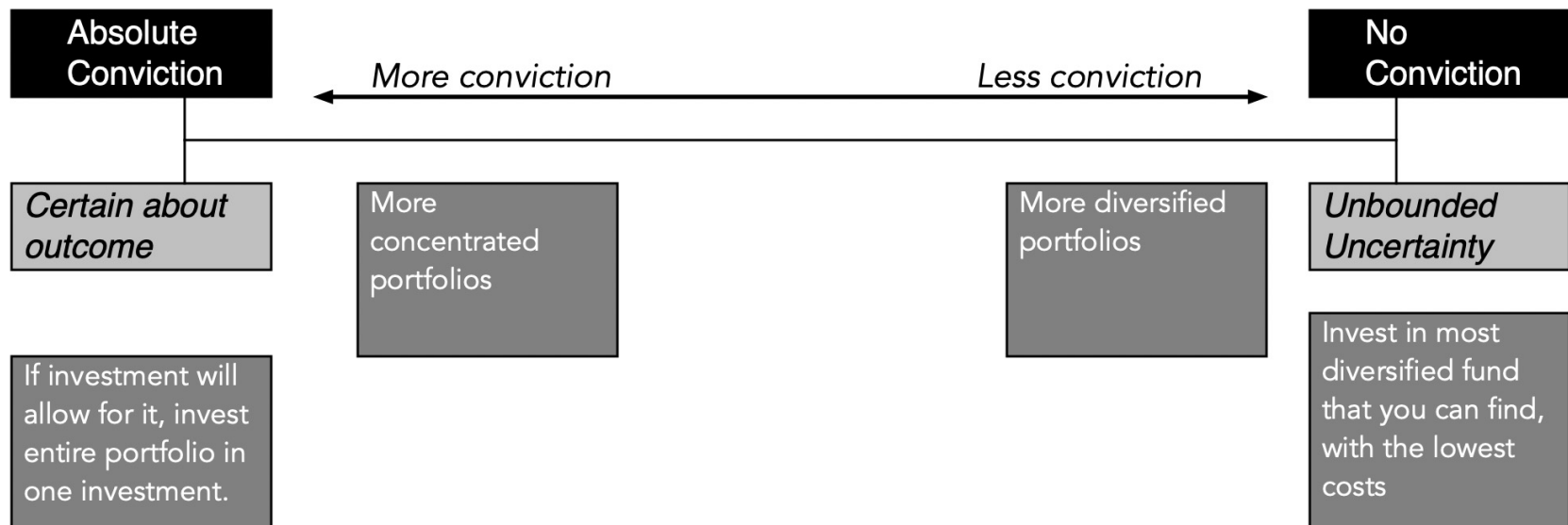
SOURCES OF INVESTMENT CONVICTION: INVESTOR CHARACTERISTICS

- Intelligence and educational background: The smarter an investor is, and the more exceptional his or her educational background (the right schools, credentials and certification), the greater the conviction that investor is likely to bring to investments. One reason is that **it becomes easier to attribute perceived market mistakes to the lack of intelligence of other market participants** than it is to take a closer look at real reasons why they may not be mistakes in the first place.
- Personality: Like conviction, **self confidence falls on a spectrum with wide differences across human beings**. Some investors measure low on the self confidence scale, and look to others for big decisions. Others measure higher on the self-confidence scale and are willing to make decisions with incomplete information and in the face of uncertainty and disagreement. Still others have so much self confidence and so little self doubt that they risk having convictions that are out of sync with reality.
- Track record: It is undeniable that some of the worst investment lessons are learned from that success. Much as Wall Street likes its adages of "not mistaking dumb luck for skill", **investors are quick to forget them when an investment bet that they make pays off, especially when their success leads to iconic and admiring profiles ("the next Buffett") and investor capital pouring in.**

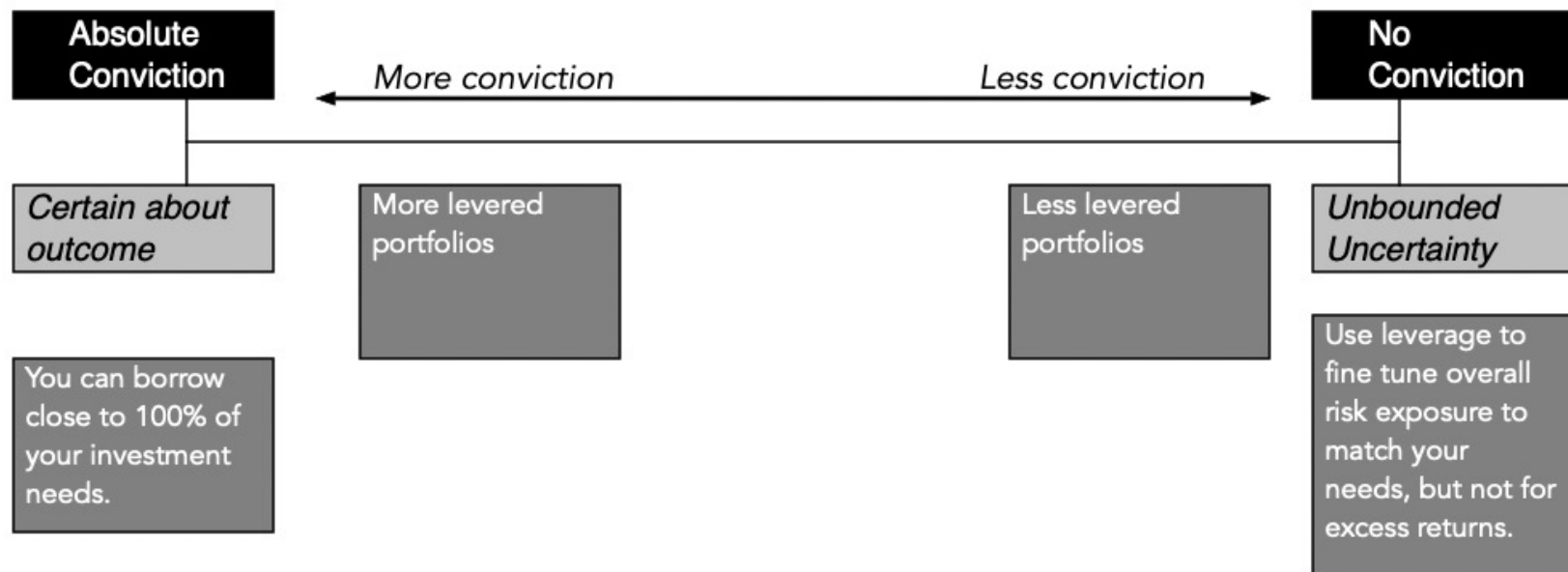
THE CONSEQUENCES OF CONVICTION

- Conviction matters in investing because it affects two choices that investors make
 - the sizing of positions (with more conviction leading to larger positions in the same investment) and the use of financial leverage (with more conviction often translating into a willingness to borrow more money to fund the investment).
- If the conviction is well-founded, there is nothing wrong with concentrating your investment or borrowing money to fund it, but if it is overstated (because you misread your initial pricing edge or overestimated the presence of market catalysts or are overconfident), the same actions (concentration and borrowing) can be deadly.

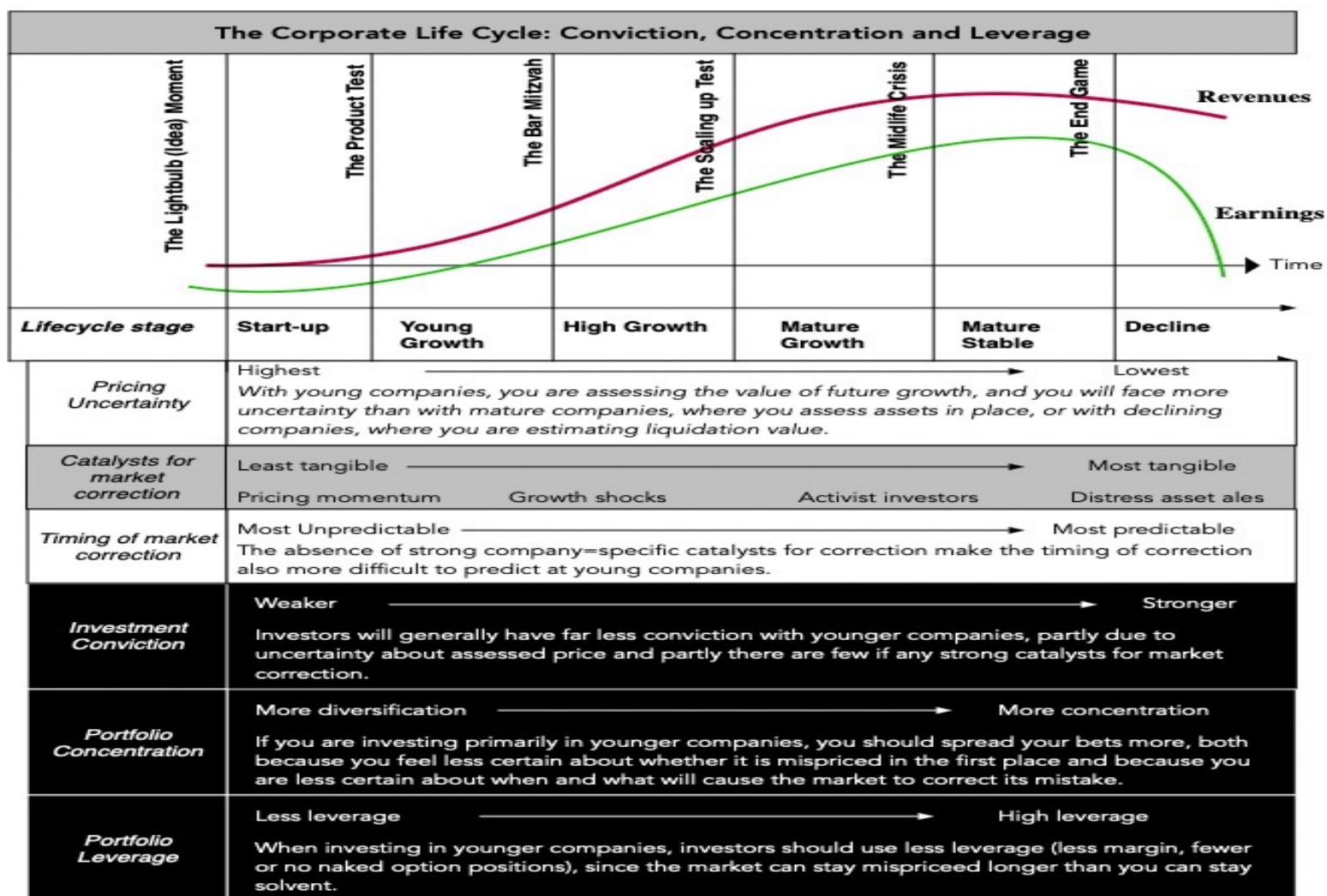
1. CONVICTION AND CONCENTRATION



2. CONVICTION AND LEVERAGE



A CORPORATE LIFE CYCLE VIEW OF CONCENTRATION AND LEVERAGE



A NUANCED VIEW OF CONCENTRATION AND DIVERSIFICATION

- Using a life cycle framework, you can see that you can be **more tolerant of concentrated portfolios, with debt added on, when you invest in mature companies** than you should be when investing in younger companies.
- By the same token, investors who **find pricing mistakes in younger companies**, but are daunted by the noisiness of their estimates or uncertainty about markets correcting, and thus are low on the conviction scale, can overcome their reluctance to act by spreading their bets across many such companies.
- As some of you may be aware, **I did value SpaceX at the time of its IPO at about \$100 a share**, and as the price has drifted down towards that price, I may very well be faced with an underpriced stock (where the market price drops below \$100). Given the uncertainty that is associated with my estimate, and you can see it [in the simulation that I reported in my post](#), it is unlikely that I would ever have sufficient conviction to make SpaceX the biggest or only investment in my portfolio, but I stand ready to buy the stock as part of a portfolio, where it is one of many bets that I make on markets.

1. MISMATCHING INVESTMENT ACTIONS WITH CONVICTION RISKS RUIN

- I have no issues with Leo's story of AI winning big in the near-term and buying the winners and selling the losers that will result. It is **macro story investing, and it has worked for some in the past and failed for others, but if timed right, it can deliver significant returns.**
- I also have **no bone to pick with investors using financial leverage** to supercharge their returns, albeit with low-risk investments, though I remain concerned that the (2 & 20) fee structure may lead them to use too much debt.
- My concern with Situational Awareness, as a fund, and this would have been true on June 19, even at it peak, is that combining a macro story about AI winning with maximal leverage creates a time bomb. **The AI story, no matter how well told, has multiple obstacles to overcome, some related to business economics and some to politics and regulation, and is a risky bet, and it makes sense to fund it with significant amounts of debt.**

2. MOMENTUM IS A WILD CARD

- If you look at the **composition of Situation Awareness portfolio through much of its rise and fall, the long positions were primarily in companies that benefit from the build-up of AI architecture, selling their products and services to the hyper scalers and LLM companies, and the short positions were in software and other businesses that would be disrupted by the rise of AI.**
- With both groups, Situational Awareness was **taking bets that were in line with what the market was pricing in already**, albeit in a more concentrated and leveraged form.
- While market observers were quick to link both the rise and fall of Situational Awareness to the AI story, you can make just as strong a case that **much of that happened at the fund over its brief existence can be explained by momentum**, with leverage acting as a super charger; continued momentum generated the outsized return though June 19, and the market reversal in July caused the correction.

3. THE LEGEND OF SMART MONEY..

- The **legend of smart money persists in markets**, where investors who are smarter than the rest of us, with access to information and capital that others do not possess, deliver supersize returns for themselves and those that they invite into their inner circle.
- That legend **serves everyone's interests**, since the smart money uses its reputation to attract more capital and the not-so-smart money has someone else (hedge funds, insiders, activists) to blame for investment setbacks.
- The problem with smart money is that **its self-regard makes it susceptible to attributing more precision to its own convictions**, than merited by the circumstances, and that, in turn, results in overreach.
- Investors, in my view, are **better served by humble money, quick to recognize that winning is often due to luck, not skill, and open to self doubt.**

CLOSING THOUGHTS

- I hope **that you don't view this as a hit piece on Leo or AI**, since that was not my intent.
- In fact, I hope that **Leo persists and perhaps even comes back as a fund manager**, since he strikes me as an original thinker who is willing to take a stand, both scarce qualities among active fund managers.
- I also hope that **he has learned some lessons**, especially on humility and restraint, for his next go around, and that he adopts a fee structure that gives his investors a chance of beating the market in the long term.