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ELM RIDGE

"Mo Money Mo Problems"

March 31, 2026

"Graham and Dodd investors are people who place a very high value on having the last laugh. In exchange for the privilege, they have missed out on a lot of laughs in between."
 – Michael Lewis, *The New New Thing*, 2000.

ELM RIDGE	1ST QUARTER 2026	2025	INCEPTION-TO-DATE ANNUALIZED
NET PERFORMANCE	22.7%	9.4%	6.5%
GROSS LONG CONTRIBUTION	19%	20%	12%
GROSS SHORT CONTRIBUTION	4%	-9%	-5%
AVERAGE NET EXPOSURE	24%	13%	18%
S&P 500	-4.3%	17.9%	7.8%

We had a good quarter and are now up more than 30% (v -4% for the S&P) since the megacaps peaked at the end of October. And while the Mideast War Excursion did provide our energy-related names with an added boost, we were already 16% to the good by the end of February, with our performance at that time about evenly split between energy and industrials (the latter led by LyondellBasell, Chemours, ArcBest and ArcelorMittal).

As most of you know, or have endured, I've been in the predicting/pontificating business for a long time: enough to know better at that. This tendency has combined with a lifetime of trash talking¹ (my hometown gave no quarter to the nice) produce a writing style implying a great deal more certainty than I could ever possess or believe is possible.² Perhaps it was only fitting that I joined Sanford Bernstein in 1988, a year before *Institutional Investor* ran an article, "Sometimes Wrong, But Never in Doubt," on the hits we suffered at the beginning of a very successful bet on beaten-down financial stocks.

The above is just a wordy preamble to some crowing that, while we're nowhere near the point where we can claim victory, it looks as though our big picture prognostications from five or so years ago may finally come to pass. In fact, in contrast to Wall Street dogma (or bubbe meise as my mother would say),³ we did argue that: long rates were due for a big jump from their 1.5% plateau in mid-21;⁴ the love affair with private investments might end very

¹ We called it "snapping" or "selling woof tickets" back then, and unfortunately, I was a lot better at that than the real fights that often followed.

² As a professor scribbled across one of my earliest term papers: "it is better to dissect an argument with a scalpel than an axe."

³ "Grandmother's tale" in Yiddish. My dad was much more direct with his disdain for most newly popular wisdom: "horse \$#!%, cow\$#!% and bull\$#!%."

⁴ "Imagine," Elm Ridge 2Q21 letter.

badly;⁵ and excessive crowding in asset-light "compounders" would give way to a stampede for the exits and maybe toward our stuff as the horde flees its formerly comfortable surroundings.⁶

Rates Get New Traits

"When rates were zero, everyone was Warren Buffett. Now they're Googling who he is."
–Unknown

With the 10-year Treasury comfortably above 4%, it's hard to imagine that consensus once held that rates would stay in the sub 2% level for the foreseeable future. Back then *Goldman*, *BlackRock* and *ARK Invest* all echoed Jerome Powell and Janet Yellen's "inflation is transitory" thesis and had no problems positing that investors would accept miniscule real returns as well. Hence, "TINA," there is no alternative. We, on the other hand, thought continued shortages of both productive capital and labor in the real world would sustain inflation, while hazarding the outrageous guess that, at some point, fixed-income investors might want to be compensated for their largesse.

Since investors and corporate executives had been the beneficiaries of repressed rates for so long, there was no incentive for them to think the party would end. All sorts of financial institutions reached outward for more yield. As a result, I have a hard time thinking of a bank or life insurance company that isn't sitting on a large unrealized loss (found in the Accumulated Other Comprehensive Income line on their balance sheets) in its fixed income portfolio. Even now, despite the sustained rise in rates, Wall Street still seems to think "Those Were the Days"⁷ is around the corner. A day doesn't go by without us having to read a new research report pushing some stock with the "when [not if] rates fall" support.

Alts Have Their Faults

"I calls 'em as I sees 'em, and if I don't see 'em, I make 'em up."
–Judge Roy Bean

"You want the Truth? You can't handle the truth."
– Jack Nicholson, *A Few Good Men*⁸

Our view that a reckoning was due in private credit and equity was also based on a simple premise: success breeds excess. Private investors were rewarded with supranormal returns as they filled the gap left by regulated financial institutions after the GFC, but the flood of new capital was bound to depress those going forward. Private Credit fund assets quadrupled in the past ten years, and now account for 30% of the leveraged loan market, up from 13% at the start of that period.⁹

Coming after a decade of ever-lower interest rates supporting impressive performance, agents were happy to suspend disbelief and appeared to turn what used to be a "bug"¹⁰ (not being able to readily sell private holdings at their quoted value) into a "feature" (not having to confront mark-to-market volatility). They were just too happy to

⁵ "Say it Ain't So," Elm Ridge 4q22 letter.

⁶ "Bad is Good," Elm Ridge 1q21 letter and "We Have Met the Enemy and It is Us," Elm Ridge 2q22 letter.

⁷ https://www.youtube.com/watch?v=GI46_zBGv1A

⁸ <https://www.youtube.com/watch?v=5j2F4VcBmeo>. Yes we used this in 4q22.

⁹ See *Morgan Stanley*, "Connecting the Dots Around Private Credit" 4/2/26.

¹⁰ See <https://www.aqr.com/Insights/Perspectives/The-Illiquidity-Discount> for more on this topic.

report "Tell Me Something Good"¹¹ pricing to their bosses and investment boards. It was only a matter of time until the public wanted in on this racket and the managers happily obliged. We then made the outlandish assumption that not only would returns normalize, but that investors would have to pay the piper for all the excesses reported to that point as well.

At first, we passed on the pushers (so-called alt managers: Ares, Blackstone, Blue Owl, etc.), who had become asset-gathering machines, and targeted the addicts who had loaded up on the stuff. Too bad, we couldn't short our university endowments who copied Yale's "Swenson Model," with private allocations reaching half their portfolios. But we soon found an attractive target in the big public life insurance companies that needed to back the high guaranteed rates necessary to compete in the crowded annuity and pension risk transfer markets.¹² While they didn't devote the same share of their investment books to privates as had the universities, they ran much more levered enterprises, so that their allocations to private managers and direct non-market priced investments could still run more than half their book value. These insurers had been (and still are) assuming that they would earn 9% or so on their alternative investments versus a sub 4% risk-free rate, reporting multiples of those assumptions in 2020 and 2021. We started by buying puts in late 2022 (that often turned into shorts as we exercised them) and have since built up a decent short position here as well.

While the insurers have been dramatic underperformers since we put them on (trailing the S&P by 60% or so and allowing us to run much bigger and profitable long positions in AerCap, Citigroup and OneMain), we do need to thank one of our investors and readers, who convinced us late last year to also take a run at the alt managers who sold at much higher valuations, and would be just as vulnerable to the bloom coming off the rose. Unfortunately, we could never size them up as much as we would like, as widely reported liquidity issues in the public funds have continued to crush the stocks, leaving us unable to come back for refills. We're just hoping that their main line of defense, "we have the good loans, go worry about the other guys," can catch on and give us another chance.

We are quite aware that it is too early to declare victory on this one: as the most publicized problems have stemmed more from the funds' inability to meet redemptions rather than the few visible cockroaches¹³ (e.g., BlackRock marking down a couple of loans from 100 cents on the dollar to zero, or a \$35 billion Blue Owl fund posting its first quarterly loss) turning into a swarm. But more folks are waking up to the threat. UBS strategists recently warned that private credit default rates could surge to 15%. And Morgan Stanley, limiting those loss levels to the software sector, just came up with an 8.5% figure. We'll see. And if you think it's just the credit side that's vulnerable, you might want to know that private credit funded an estimated 80% of all LBO deals in the past year¹⁴ and is almost always cited as the outlet for getting troubled commercial real estate off the Regional Banks' loan books.

Let's just take it from Apollo's Co-President of its investment arm, who got caught making these offhand comments to some investors.

"I literally think all the marks are wrong." Those dismissing concerns by pointing to strong results from public companies are missing the point, he said. "Most of the businesses that were bought from 2018 to 2022 are lower quality than those companies, smaller than those companies and were trading at a much higher valuation than those companies and so I am concerned about many of [those] take-privates... "There's . . . unlimited demand for secondary private equity but they are worried about private credit which

¹¹ https://www.youtube.com/watch?v=cm_cFzVAoo8. We lifted this clip from our 4q22 letter.

¹² As the *Financial Times* 3/24/26 reported, despite all the threats, life insurance companies are still piling into private credit as a "a senior director at the insurance ratings agency AM Best, told II that the "strong growth in the annuity market, which is largely a spread-based business as opposed to underwriting mortality and morbidity returns, has driven the growth into private credit overall including direct lending and real assets."

¹³ See Howard Marks' "Cockroaches in the Coal Mine." <https://www.oaktreecapital.com/insights/memo/cockroaches-in-the-coal-mine>

¹⁴ See *Morgan Stanley*, Op. Cit.

finances 80% of those portfolios . . . I can't compute, but I'm the dumb guy. I don't understand. I start saying this and I get these blank stares back at me like OK, I don't know."¹⁵

We (with admittedly much less data at our disposal) have experienced the same thing.

Pay-Low to HALO

*Light Beer everywhere
They're giving up drinking, they just don't care
Baggy sweaters on the girls, loafers on the boys
I'd make them all chug Drano if I was given the choice*
—Grandmaster Noot, 1988

While our diatribes have often taken issue with popular themes driving market excesses, we need to remind everyone that we really make our money on the long side. We do best in those concentrated periods when investors trample over the velvet ropes surrounding the beneficiaries of the last dominant narrative/bubble and a venturesome few start ripping the yellow tape around our low-priced holdings.

Five years ago, we lamented how investors had been rewarded over the previous decade for concentrating their portfolios in those "good businesses" that had received the "Certified Bonafide Good Business" (CBGB) seal of approval from their peers. These "compounders" needed to run "asset-light" and relatively economically insensitive businesses and generate high returns on what little tangible capital they deployed. Of course, this ticked us the wrong way. In addition to my aversion to joining the In-crowd, I was never cut out to be a fan of anything light. I like my beer strong, liquor brown, coffee black and would take a Mickey D's #4 (Double QP with cheese) over a Chipotle Salad Bowl any day. But enough of that digression. As we noted then:

the CBGBs are due for a comeuppance (although we expect they'll fare a little better than the club). For one, they may not be as invulnerable as their adherents think. Of course, technology changes over time, but so does competition, capital flows and the results of playing to the short-term interests of an ever-broadening base of investors. High returning businesses are bound to attract new capital designed to get across their moats, and years of growth leave the inhabitants of the castle pushing outward beyond them.

And whaddyaknow, it finally happened. Asset-light spurned just too much imitation and faced an existential threat from new technology as well. And now we read how the private capital firms that bid up anything and everything software have tuned to the so-called Heavy Assets with Low Obsolescence (HALO) trade. To quote Blackstone President Jonathan Gray, "people are looking for terra firma. There is a lot of interest across public and private markets in real, tangible assets —medical supplies, energy, real estate, industrials."¹⁶ There goes the neighborhood. Mac's Club Deuce is giving way to Carbone;¹⁷ but we're getting paid.

¹⁵ *Wall Street Journal*, "Top Apollo Executive Sounds Off on 'Arrogance' in Private Markets," 3/15/26.

¹⁶ *Bloomberg News*, "Private Capital Turns to Old Economy as Software Trade Dims" 3/23/26.

¹⁷ We used to traipse down to Miami Beach, where our good friend lived on 2nd and Ocean, a few times/year in the late 80s and early 90s, when it was fun and cheap, that is before it became trendy.

Mo Money Mo Problems

*I don't know
What they want from me
Like the more money we come across
The more problems we see
—The Notorious B.I.G., 1997¹⁸*

As asset-light was tumbling, I, with a little help from some rum, boasted to some friends that we'd been "saying some sooth." But then I turned curious and learned that "soothsayer" derived from the 14th century sooth, meaning "truth" or "reality." One might guess that predictions back then were taken as advance knowledge of the future, maybe stemming from an in with the gods, as opposed to what we were spraying.

But it's not like we threw down a Triple Lindy¹⁹ of prediction in positing that: money isn't usually free; if you throw more of it at a successful strategy, purveyors will relax standards to get it out the door (and if you encourage them to report optimistic returns and tell you something good, they might stretch the truth in doing so); and finally, if you pay excessive rewards to companies to rid themselves of assets (or too much to do anything for that matter, perhaps splurging on more data centers), they'll take it too far. We're just rehashing what Adam Smith figured out with his "Invisible Hand" some 250 years ago. Or, as Biggie would say, Mo Money Mo problems.

So here we are. While we got the rates thing correct to this point, we haven't vanquished the lower-rate hopes that have lifted growth stocks over their value counterparts for the last 15 years. There seem to be more barbs poking holes in the Privates-outperform-with-lower-volatility fantasy nearly every day. HALO has started to work, but we need multiples of the last five months to make our out-of-favor terra firma bet worthwhile.

We're getting there. But we've got a long way to go before one can say we hit on some "sooth."

DISCLOSURES AND NOTES TO PERFORMANCE

Past performance should not be construed as an indicator of future performance. Inception is January 2000.

(a) The performance figures are estimates and unaudited. (b) All returns presented are calculated on a time weighted, total return basis (include all dividends, interest, accrued income, realized and unrealized gains and losses and commissions). Gross Returns do not reflect the deduction of a 1.5% management fee, applicable fund expenses, or a 20% performance allocation. Net Returns include dividends, net interest, and reflect the deduction of a 1.5% management fee plus applicable fund expenses; they are also net of a 20% performance allocation, if applicable; (c) These returns are not GIPS compliant. These returns are not AIMR compliant as they represent only the performance of the Series A, Class 1 shares. Individual investor returns may vary due to several factors, which include but are not limited to: the timing of subscriptions and redemptions; differences in fee structures; individual investor account high water marks, and differences in tax treatment. Because of certain governmental regulations, not all accounts are New Issue eligible. New Issues contributed approximately 9.6% gross to the performance figures presented for the year 2000, 0.6% gross for the year 2001, 0.09% gross for the year 2002, 0.48% gross for the year 2003, 0.47% gross for the year 2004, 0.30% gross for the

¹⁸ <https://www.youtube.com/watch?v=gUhrKVijJtw>

¹⁹ <https://www.youtube.com/watch?v=rDMMYT3vkTk&t=5s>

year 2005, 0.17% gross for the year 2006, 0.24% gross for the year 2007, 0.03% gross for the year 2008, 0.01% gross for the year 2009, 0.03% gross for the year 2010, 0.05% gross for the year 2011, 0.00% gross for the year 2012; 0.05% gross for the year 2013; 0.05% gross for 2014; 0.01% gross for 2015 and 0.00% thereafter; (e) All performance figures are before-tax returns. Actual after-tax returns depend on an investor's individual tax situation and may differ from those above. (f) All historical performance and exposure statistics reported in this letter prior to October 1, 2001 refer to Elm Ridge Value Partners, L.P., a 3(c)1 limited partnership. (g) All S&P 500 performance percentages are shown with dividends reinvested. The S&P 500 has not been selected to represent an appropriate benchmark to compare Elm Ridge Management's performance, but rather is disclosed to allow for comparison of Elm Ridge Management's performance to that of a well-known and widely recognized index and is not intended to imply that the fund's portfolio is comparable to this index either in composition or elementary risk. The S&P 500 Index is a market-capitalization weighted index containing the 500 most widely held companies chosen with respect to market size, liquidity, and industry. The index is calculated on a total return basis with dividends reinvested. (h) The Form 13F that is filed on a quarterly basis by Elm Ridge contains the required details concerning our portfolio.

Where indicated, select performance results included in this document are hypothetical returns which have been compiled by Elm Ridge Management. Hypothetical performance results may have inherent limitations, some of which are described below. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. One of the limitations of hypothetical performance results is that they are prepared with the benefit of hindsight. There are numerous other factors related to the markets in general or to the implementation of any specific trading strategy which cannot be fully accounted for in the preparation of hypothetical performance results and all of which can adversely affect actual trading results.

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Contribution figures are estimated and may not sum due to rounding and compounding effects. Estimated Gross Long and Short Contributions are calculated independently by compounding the respective monthly returns.

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