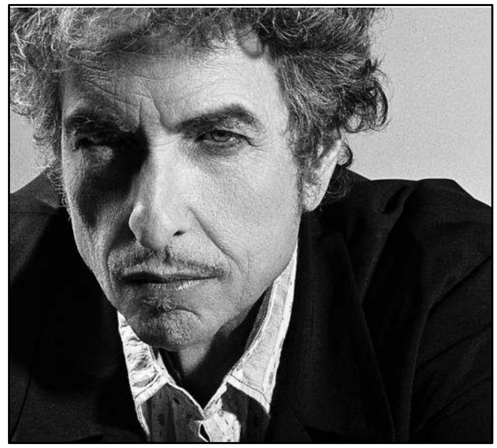
Epsilon Theory

Tell My Horse

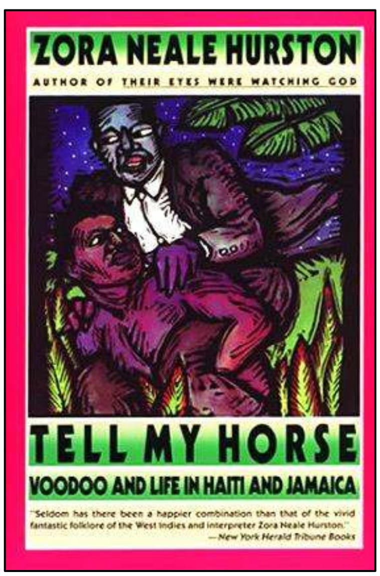
June 12, 2017



You may be a business man or some high-degree thief
They may call you doctor or they may call you chief

But you're gonna have to serve somebody, yes you are
You're gonna have to serve somebody
Well, it may be the devil or it may be the Lord
But you're gonna have to serve somebody

— **Bob Dylan, *Gotta Serve Somebody* (1979)**



Guede is a powerful loa. He manifests himself by "mounting" a subject as a rider mounts a horse, then he speaks and acts through his mount. The person mounted does nothing of his own accord. He is the horse of the loa until the spirit departs. Under the whip and guidance of the spirit-rider, the "horse" does and says many things that he or she would never have uttered un-ridden.

—**Zora Neale Hurston, *Tell My Horse* (1938)**

In voodoo, the loa are intermediaries between humans and gods, similar to saints or angels in Western theology. But here's the big difference with Western theology. You don't just pray to the loa to receive its help. Belief is a necessary but not sufficient condition. You must *serve* the loa.

Erzulie Freda requires her champagne and perfume. Baron Samedi his rum and cigars. Voodoo is an intensely transactional theology, which makes it the perfect religion for the Age of Trump.

The wind came back with triple fury, and put out the light for the last time. They sat in company with the others in other shanties, their eyes straining against crude walls and their souls asking if He meant to measure their puny might against His. They seemed to be staring at the dark, but their eyes were watching God.

— **Zora Neale Hurston, *Their Eyes Were Watching God* (1937)**

Zora Neale Hurston, William Faulkner, and Cormac McCarthy are my indispensable authors. Why? Because they teach us how the human animal responds to The Storm.

Hurston was born in 1891 and grew up in Eatonville, Florida, one of the first all-black towns in the U.S. She moved to Baltimore when she was 26, working as a maid, pretending to be 16 so that she could go to high school. She went to Howard University, where she studied Greek and started the school newspaper, and from there went to Barnard College in 1925 for post-graduate studies in anthropology. She was the only black student at Barnard. In the 1930s, Hurston published three novels, two anthropology books, and dozens of articles and short stories. She wrote a Broadway musical. She won a Guggenheim fellowship.

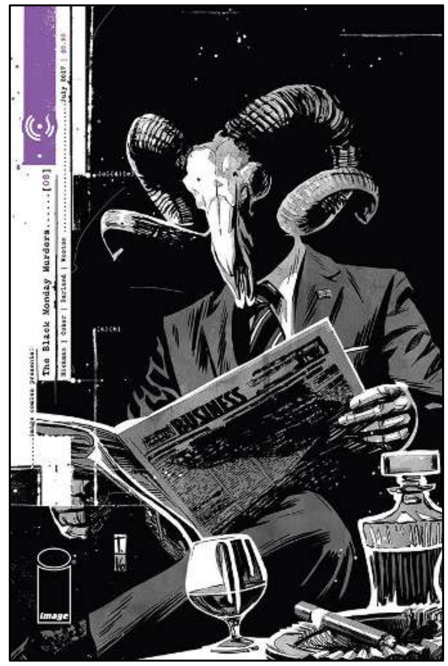
20 years later, Hurston was working as a maid outside of Miami, having been fired as a librarian at Patrick Air Force Base for being "too well-educated". She died alone and penniless in the St. Lucie County Welfare Home in 1960, buried in an unmarked grave.

What happened? Hurston was black. Hurston was a woman. Hurston was a libertarian. Strike three! Hurston rejected the notion that "black literature" should "uplift the Negro" (yes, this was a thing), making her anathema in mainstream white culture, not to mention unfit for librarian work in Brevard County, Florida. But Hurston faced as sharp a rejection in black counterculture, where her refusal to kowtow to black men of letters (and they were ALL men) and their vision of art (and women) in the service of socialist political dogma ultimately made her an outcast in every social circle she entered. Hurston was nobody's fool, and she was nobody's bitch. That's a hard road to travel in any age.

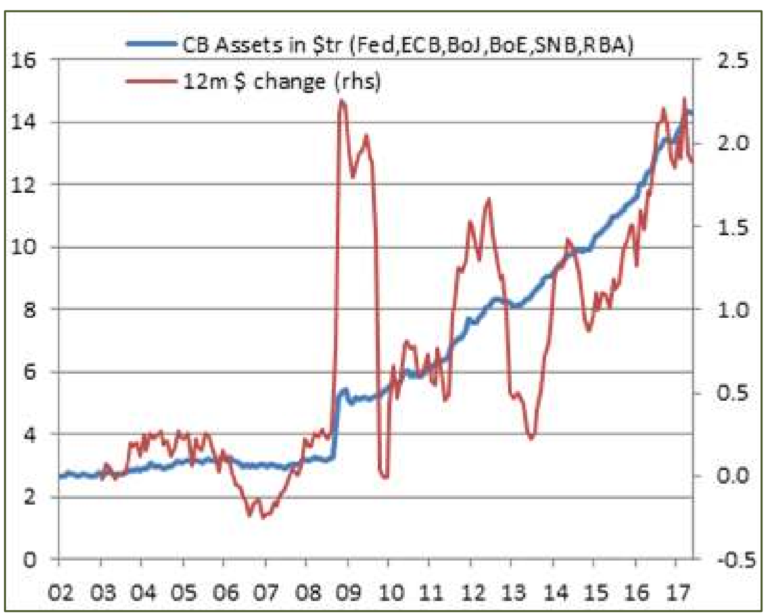
1st-year Banker: Look. I wanna be rich. I admit it. I want the car, the house, the whole show. But the idea that some global financial *whatever* exists independent of public and political accountability seems … naïve at best. Public opinion matters. Government regulations matter.

Viktor Eresko: Young man … We finance culture. We buy entire nations.

—**Jonathan Hickman, *The Black Monday Murders* (2017)**



In his day job, Jonathan Hickman is responsible for orchestrating pretty much the entire Marvel Comics universe. Ever wonder how all those superhero movies tie in with each other? It's Hickman's story line. His best work, though, is found in indie comics far away from the Borg cube that is Disney.



Source: UBS Multi-Asset Sales, as of 06/07/17. For illustrative purposes only.

And in entirely unrelated news to the fictional notion of some global financial *whatever* that exists independently from public and political accountability, central bank assets recently topped the $14 trillion mark, growing at $2 trillion per year.

And speaking of endoparasitoids …

Wasps of the genus *Glyptapanteles*, also known as "voodoo wasps", lay their eggs inside various caterpillar species. The eggs hatch and most of the wasp larvae eat their way out of the body of the caterpillar host and begin to pupate.

But some larvae stay behind and take over the caterpillar's nervous system, effectively transforming the host into a zombie. The half-eaten-from-the-inside zombie caterpillar then proceeds to starve itself to death while protecting the baby wasp cocoons.

No, I'm not making this up.

Louis Cyphre: Alas … how terrible is wisdom when it brings no profit to the wise, Johnny.

—***Angel Heart* (1987)**

Tell me about it. Story of my life.

I'm having a hard time with this market, because I can see **what a powerfully stable social equilibrium is being established around this transformation of capital markets into a political utility**. I'm having a hard time with it because, like any powerfully stable social equilibrium, to be truly successful in that world you must give yourself over to that world. You must embrace that world in your heart of hearts. As Winston finally learned, to be happy you must love Big Brother. Or in our case, lever long, sell volatility, and love the Fed.

I can't do it. I can't embrace the machines and the vol selling and the ETF parade and the central bankers' "communication policy". So I'm NOT happy. I'm 20+ pounds overweight. I don't sleep well. I DON'T trust the Fed, much less love them, and I never will.

I know, I know … boo hoo. First world problems and all that. No doubt Don Corleone would slap me around a bit for my Johnny Fontane-esque whining. You can act like a man! But here's the thing. There are *tens of thousands* of people in this business who feel exactly like I do. Yeah, we're privileged. So what? This is OUR existential crisis and we're going to deal with it in the only way we can, by talking it through. Capisce?

So here's my question. How do you survive, both physically and metaphysically, in a market you don't trust but where you must act as if you do? How do you pass? How do you reconcile the actions and beliefs necessary to be successful in this market with the experiences and training of a lifetime that tell you NOT to act this way and believe in all this?

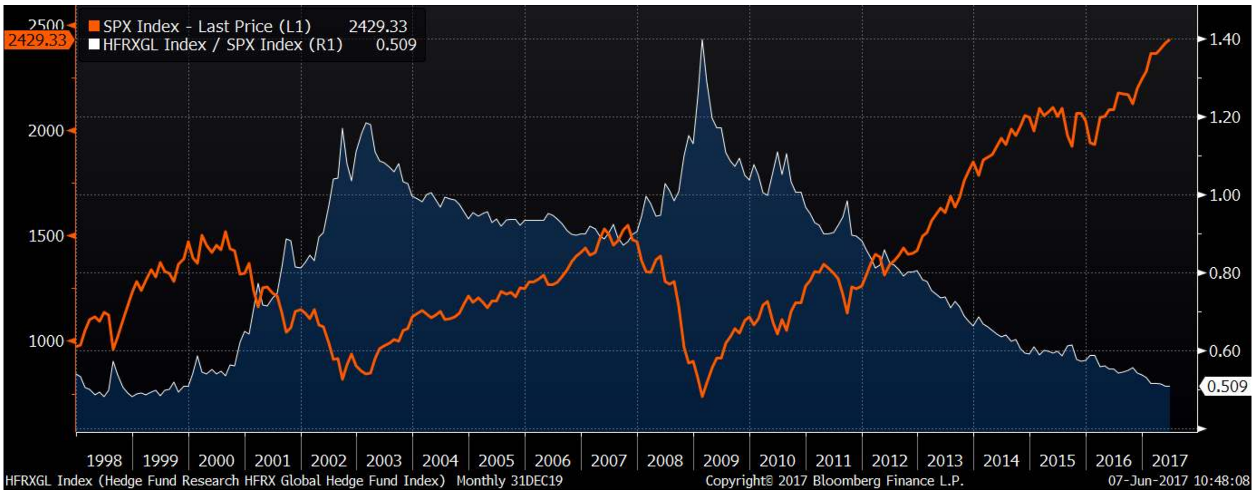
Here's what most people do. Here's the human answer. You make accommodations. You surrender little by little to the new religion and its transactional catechism. It starts off easy enough. At first it's just staying quiet while others talk. Then it's simple superstitious behavior that you can laugh off. Who does it hurt to pour a shot of rum and leave it out on the table for Baron Samedi? Ha ha ha. But then a friend testifies to you in a private moment. You can see with your own eyes the earthly rewards his faith has brought, while your caution and doubt have brought you nothing but portfolio underperformance and difficult conversations with unhappy clients. And then one day you feel it. Yes, I, too, can purchase Big Data. I, too, can purchase Cloud Computing. I, too, can purchase an ETF Model. ***I don't need ideas of my own.*** **I can transact for whatever ineffable machines or models I require to succeed in this market of ineffable machines and models, so that I can tend to more important things like "building my business" or "interacting with clients."**

And that's where we are. By far the most common coping mechanism for a market we don't like and we don't trust and we don't understand — but a one-way up market for all that — is to become smaller in spirit even as we become larger in scale. To become transactional. To collaborate with the forces that turn markets into utilities. To become positioners rather than investors. To become model followers rather than idea generators. **To hedge out our most pronounced career risk — which is not a large portfolio loss, because so many others will be in the same boat, but is rather a *small* portfolio loss from independent decision-making while others are making non-independent, collective gains.** How do we accomplish this hedge? By eliminating independent risk-taking and embracing collective risk-taking, that's how. By blindly serving the loas of the market — sometimes ancient ones like Value Investing but more frequently new ones like Modern Portfolio Theory or Passive Investing — and letting them ride us like a horse.

Management fees doth make cowards of us all.

This gradual but massively widespread behavioral accommodation to what I've called **the Hollow Market** — where a shell of normalcy hides vast depths of faux trading volume, faux securities, and faux people — has different impacts in different parts of that market.

For discretionary stock pickers, particularly hedge funds, the Hollow Market has been a plague of Biblical proportion. The orange line in the chart below is the S&P 500 Index from 1998 to today. The white line and blue-shaded area is the HFRX Global Hedge Fund Index divided by the S&P 500 Index. It represents the relative underperformance or outperformance of hedge funds versus the S&P 500 (h/t to Howard Einhorn at Barclays), and today we are almost back to all-time underperformance lows, last seen in 1999.



Source: Bloomberg LP, as of 06/07/17. For illustrative purposes only.

Okay, you say, that's the S&P 500, but this is a global hedge fund index. What about a global equity index? Below is the same plot against the MSCI World Index instead of the S&P 500. Oh yeah, that's better. Merely a 17-year low in underperformance.

Source: Bloomberg LP, as of 06/07/17. For illustrative purposes only.

Accommodation to the Hollow Market is a miserable experience for discretionary stock pickers (and the same is true for any security selectors, whether it's bonds or commodities or currencies or whatever), and the higher your fee structure the more miserable it is, which is why hedge funds have been particularly hard hit. Why is accommodation so difficult? Because the point of discretionary stock picking is taking independent, idiosyncratic risk. Seriously, that's the whole, entire point. But if that's where career risk squarely sits — and trust me, it does — then to survive the Hollow Market you have to give up your reason for being.

For the past eight years, whenever you've stuck your neck out with idiosyncratic risk sufficient to differentiate yourself and move the needle, more often than not you've been slapped around brutally for your trouble. So you stop doing that. So you make an accommodation by reducing your portfolio volatility to mimic a 50% allocation to the S&P 500 and a 50% allocation to cash, with a teeny-tiny idiosyncratic position here and there in order to have a good enough war story to keep your investors from redeeming (you hope). So you effectively lock in your underperformance and pray for the Old Gods to return and unleash their mighty wrath on global equity markets. Of course, you'll be down 50% of the market in The Storm, just like you were in 2008, but hey … at least that would give you a reason to come into the office. Anything but this.

Or … you can convert to the new religion. You can reinvent yourself as a quant fund. It's not who you really are, of course, so you'll need to go out and buy the team and the computers and the data. But you can do that, and today it feels like every old school hedge fund is doing exactly that and only that. Because everything is for sale in the Hollow Market. Everything is transactional. *IF I buy the team and the data and the computers, IF I perform the proper ritual in the proper way, why THEN I will start to generate uncorrelated positive returns again*. That's the promise of the modern loas of Big Data and Artificial Intelligence and Machine Learning. You don't have to understand, you just have to believe. And serve.

What goes wrong here is what always goes wrong when too much money goes too fast into what is both the greatest creator of wealth in the modern world and the greatest destroyer of wealth in the modern world: financial innovation. And by financial innovation I don't just mean the quants. In fact I probably mean the quants least of all. More pointedly I mean the financial innovation embedded in the Brave New World of ETFs and index products — of which there are now more such aggregated securities listed on U.S. markets than the company stocks which comprise them! — and more pointedly still I mean the financial innovation embedded in the Brave New World of massive central bank balance sheets and the massive-er quantities of sovereign and corporate bonds that are priced off those balance sheet dynamics.

The crowding inherent in the accommodations we all have made to the Hollow Market — particularly our collective embrace of ETFs + index products and our collective tolerance for **central bank magic spells** — has the same enormous drawback that global crowding always has: it dramatically increases our collective risk. We don't care about that collective risk today because we're all so consumed by our idiosyncratic risks of not fitting into the modern market zeitgeist. I get that. There's no career risk in collective risk. But as a thinking, feeling human being I am focused on the collective risk. And here's specifically what I'm focused on.

First, the notion that ETFs and index products are somehow "passive" investments in the buy-and-hold sense of the word is just utterly and disastrously wrong. If you've gotten nothing else from Rusty Guinn's brilliant *Epsilon Theory* notes, please get this: **there's nothing "passive" about ETFs and index products**. They are, on the contrary, the very instantiation of active portfolio management, where investors are making an inherently and completely "active" decision on this sector versus that sector, this asset class versus that asset class, this geography or factor versus that geography or factor. What this means is that the big risk to market structure and the big potential for feeds-on-itself selling pressure during a market downturn isn't "risk parity" or some other small-fry bogeyman de jour, it's the active trading decisions of the holders of TRILLIONS of dollars' worth of active trading instruments — ETFs and index products. There's your bogeyman.

And the same thing goes for the $14+ TRILLION in central bank assets. These are not buy-and-hold portfolios. *These are trading portfolios.* I mean, even the act of maintaining these portfolios at their current levels, much less the $2 trillion per year current growth rate, is an active trading decision of massive proportions. Depending on the average duration of the bonds these banks hold, they will be forced to buy $1 to $2 trillion of new bonds each year *just to replace what's running off*. Will central bankers jawbone their tapering and selling every which way to Sunday? Will they buy more if markets get really squirrely? Of course they will. Of course they will because … once more with feeling … these are trading portfolios!

Okay, Ben, so they're trading portfolios. So what? The so what is that there's one thing that central bankers are even more committed to than propping up financial asset prices, and that's preventing wage inflation from getting a full head of steam. That's because central bankers are, in fact, bankers, and bankers gotta serve somebody, too. Or as Zora Neale Hurston would say, their eyes are watching God. It's just — and I don't mean to get **all Marxist here** or anything subversive like that — but their eyes are watching Capital, not Labor. Central bankers think they're on the side of the angels with this one, the big struggle between the Old God Capital and the Old God Labor. I mean, it's their "mandate", after all. Their Mandate of Heaven, so to speak. Who can argue with that?

I know it sounds ludicrous today to suggest that wage inflation might be gearing up to make a run, what with it holding at a very sticky 2.4% or thereabouts in the U.S., and Europe and Japan unable to sniff inflation despite all their central bank purchases (wait a second … is it possible that that all this balance sheet expansion is deflationary rather than inflationary? Nah, that's crazy talk. Forget I even said it.). But I don't think a new regime of wage inflation is ludicrous at all. In fact, I think it's pretty darn inevitable with the current swing of the populist pendulum, and I think it's not just inevitable in the U.S. but in China, as well. And when it happens, the Fed is going to be waaay behind the curve, or they will think they are, which is worse. So they will tighten. They will sell assets. Regardless of whether the market is down a little or a lot, the Fed will tighten and sell a lot more and a lot more quickly than people imagine, and that's going to beget a lot more selling of … everything. Because we all gotta serve somebody.

You know, the first time I really thought about the Dylan lyrics was back in my headstrong younger days, when the notion of professional autonomy was pretty much my highest goal and I was particularly chafed at what I perceived at the time as the unjust limitations on the full exercise of my natural investment genius <sarc>. The company I worked for provided a corporate shrink, and she was wonderfully insightful. Much more Wendy Rhoades than Dr. Gus, for any *Billions* fans out there. The most impactful observation, among many: "Ben, no matter who you are or what you do, if you stay in the investment business you gotta serve somebody. Maybe it's not a portfolio manager or a senior partner. Maybe it's your clients. Maybe it's a Board. But you gotta serve somebody." She wasn't trying to talk me out of leaving. Which I did. She was trying to talk me into opening my eyes. Which I also did … kinda sorta. That's the problem with youth. It's wasted on the young. And I wasn't that young.

Well, I'm older now, I have my eyes wide open, and here's how I think about this Truth with a capital T today. I am truly happy to serve *the people* I care about. In a business capacity, these are my partners and my clients. And yes, I know that my clients are often institutions, not natural persons, but Mitt Romney wasn't completely wrong when he said that corporations were people, too. The point being that I'm NOT happy to serve an *idea*. I'm NOT happy to serve a market loa like Value Investing or Artificial Intelligence. I'm NOT happy to serve The Man or The Fed or The Party. I'm NOT happy to serve the interests of the Missionaries that barrage us with their Narratives day in and day out. As Vito Corleone put it, I refuse to be a fool dancing on the strings held by all of those big shots. And what makes my business world work is that the people I serve, my partners and my clients, give as good as they get and do not require me to serve another Master. That hasn't always been the case in my professional career, and I'm sure it's not the case for many people reading this note. **But if I can give one piece of advice for how to make one's way through this petty, accommodationist, transactional, voodoo wasp-infested world, it's simply this: find your Tribe.** Work with people who value you as an end in yourself, not as a caterpillar host for whatever voodoo wasp eggs — i.e., zombie-fying endoparasitoid IDEAS — they or others are looking to implant.

So yeah, I'm overweight and I need to get more sleep. I'm not happy about the market, and I'm anxious about living up to my obligations to my partners and clients. But I wake up every morning thinking independent thoughts about idiosyncratic risks. I've got a Tribe. I'm nobody's horse. And that's about as good as it gets here in the Hollow Market.

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