Epsilon Theory

THE FIVE THINGS THAT DON'T MATTER #4 | BY RUSTY GUINN

# And They Did Live by Watchfires

There are two kinds of stories we tell our children. The first kind: once upon a time, there was a fuzzy little rabbit named Frizzy-Top who went on a quantum, fun adventure only to face a big setback, which he overcame through perseverance and by being adorable. This kind of story teaches empathy. Put yourself in Frizzy-Top's shoes, in other words.

The other kind: Oliver Anthony Bird, if you get too close to that ocean, you'll be sucked into the sea and drowned! This kind of story teaches them fear. And for the rest of their lives, these two stories compete: empathy and fear.

**—Oliver Bird, *Legion,* Chapter 4 (2017)**

Skinner: What are you doing in here?

Linguini: I'm just familiarizing myself with, you know, the vegetables and such.

Skinner: Get out. One can get too familiar with vegetables, you know!

***—Ratatouille* (2007)**

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It's four in the morning, and he finds himself drawn to a hotel and casino that has been out of style for thirty years, still running until tomorrow or six months from now when they'll implode it and knock it down and build a pleasure palace where it was, and forget it forever. Nobody knows him, nobody remembers him, but the lobby bar is tacky and quiet, and the air is blue with old cigarette smoke and someone's about to drop several million dollars on a poker game in a private room upstairs. The man in the charcoal suit settles himself in the bar several floors below the game, and is ignored by a waitress. A Muzak version of "Why Can't He Be You" is playing, almost subliminally. Five Elvis Presley impersonators, each man wearing a different colored jumpsuit, watch a late-night rerun of a football game on the bar TV.

A big man in a light gray suit sits at the man in the charcoal suit's table, and, noticing him even if she does not notice the man in the charcoal suit, the waitress, who is too thin to be pretty, too obviously anorectic to work Luxor or the Tropicana, and who is counting the minutes until she gets off work, comes straight over and smiles. He grins widely at her, "You're looking a treat tonight, m'dear, a fine sight for these poor old eyes," he says, and, scenting a large tip, she smiles broadly at him. The man in the light gray suit orders a Jack Daniel's for himself and a Laphroaig and water for the man in the charcoal suit sitting beside him.

"You know," says, the man in the light gray suit, when his drink arrives, "the finest line of poetry ever uttered in the history of this whole damn country was said by Canada Bill Jones in 1853, in Baton Rouge, while he was being robbed blind in a crooked game of faro. George Devol, who was, like Canada Bill, not a man who was averse to fleecing the odd sucker, drew Bill aside and asked him if he couldn't see that the game was crooked. And Canada Bill sighed, and shrugged his shoulders, and said. "I know. But it's the only game in town." And he went back to the game.

**—Neil Gaiman, *American Gods* (2001)**

I had a dream, which was not all a dream.

The bright sun was extinguish'd, and the stars

Did wander darkling in the eternal space,

Rayless, and pathless, and the icy earth

Swung blind and blackening in the moonless air;

Morn came and went — and came, and brought no day,

And men forgot their passions in the dread

Of this their desolation; and all hearts

Were chill'd into a selfish prayer for light:

And they did live by watchfires…

**— George Gordon, Lord Byron, Darkness (1816)**

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## A Year Without Summer

In 1816 — 200 years ago — much of the world was experiencing a "Year without Summer." We now know this was a result of the 1815 eruption of Mount Tambora, a volcano on the sparsely populated Indonesian island of Sumbawa, an eruption which sent some 38 cubic miles of rock, ash, dust and other ejecta into the atmosphere. For reference, that's roughly 200 times the volume of material ejected in the eruption of Mount St. Helens, but only a tenth or so the size of the Lake Toba explosion off Sumatra that some researchers believe caused one of the most perilous bottlenecks in human genetic history.

At the time in 1816, the world didn't know the cause. Well, except for maybe the people living on Sumbawa. The effects, on the other hand, couldn't be missed.

In New England, the clouds of ash that blocked the sun led to remarkable drops and extraordinary variations in temperature and precipitation. In the Berkshires, there was a deep freeze in May. It snowed in Boston as late as June 7. Cornfields in New Hampshire were ruined by frost on August 14. The Dartmouth University campus was blanketed by snow as late (early?) as September. It caused as near a true famine as the U.S. has ever experienced. Hardy crops — some strains of wheat, potatoes and the like — got most of the nation through the year, as did a culling of wild game that likely came as a bit of an unpleasant surprise to the squirrels, hogs and possums that were usually spared a place on the American table.

The situation was not much better in Western Europe, where average temperatures fell as much as 3-4°C. On the British Isles, failed wheat and potato crops meant famine for much of Ireland, Wales and Scotland. Germany had food riots. And in Switzerland, where Lord Byron was in residence with Shelley, the constant rain and cold led each to create a great deal of poetry, which, depending on your opinion of early romanticism, was either more or less catastrophic than the torrential rains that accompanied it. Under the circumstances, it is not surprising that Byron was inspired to write about the heat death of the universe some 35 years before Lord Kelvin proposed it rather more formally (and perhaps less melodramatically).

Byron's poem, *Darkness,* envisions a world in which the sun has been extinguished, in which morning never comes. In this time of desperation, the world is literally tearing itself apart. Palaces are ripped to pieces for firewood, forests are set alight and people gather "round their blazing homes" just so they can see their own hands and the faces of their family and friends. Everything the world has built is pulled apart piece by piece in search of a solution to the problem of darkness.

The stories we tell about such times of desperation tend to fall into the two archetypes Jemaine Clement's character describes in *Legion*: stories of fear and stories of empathy. Byron gave us a story of fear. Empathy stories, on the other hand, follow the usual trope of necessity as the mother of invention. But even this is often just a fear story with a different outcome, not uncommonly summoning a sort of *deus ex machina*. Luke listening to Obi Wan's disembodied voice instead of the computer as he aims his last shot at the Death Star. Gollum showing up to bite off Frodo's ring finger and take a dive into Mt. Doom, saving the hobbit from the now too-strong temptation to wear the ring and return it to Sauron. And maybe there's a story where Byron's humanity finds a real solution to the coming darkness instead of tearing their homes and businesses apart looking for something else to burn.

The investment environment we face is not so dire as all this, but it does feel a bit grim, doesn't it? Market returns have continued to defy the odds, but the data, our consultants, our advisors, our home offices and our instincts are telling us that the combination of demographic slowing, stagnant productivity, limited debt capacity, low rates and high valuations isn't going to end well. Or at a minimum, we remain optimistic but confused. I'm sure we've all asked or heard clients and constituents asking us, "What the hell do we invest in when everything is expensive and nothing is growing?" In this call to action, are we successfully turning this into an empathy story? Or are we just ripping apart our homes for tinder so that it looks like we are doing something?

When it's hard to see what's two feet ahead of our own noses, when the game feels rigged, sometimes it feels like we have no choice but to stay at the table and play. After all, it's the only game in town. And so instead of walking away and taking what the market gives us, we tweak, we tilt, we "take chips off the table," we "go all in" and we hack, hack, hack at the beams and joists of our own homes for the great bonfire.

This bias to action is a road to ruin. That's why the endless tweaking, trading and rebalancing of our portfolios takes spot #4 on our list of *Things that Don't Matter.*

## Of Priuses and Passive Investors

In 2011 a group of researchers at Berkeley examined an age-old question: are rich people driving expensive cars the asshats we all think they are? The findings? Yes, indeed they are! The study found that drivers of expensive cars were three times more likely than drivers of inexpensive cars to fail to yield to pedestrians at crosswalks requiring it, and four times more likely to go out of turn at a stop sign. The team performed similar tests in other non-traffic areas (e.g., cheating at games of chance, etc.) that arrived at the same conclusion, and furthermore identified that simply making people believe that they were part of the 2% Club made them behave more rudely.

My favorite discovery from the research was the odd outlier they discovered: the moderately priced Toyota Prius. Fully **one third** of Prius drivers blew by intrepid Berkeley grad students (taking a night off from throwing trash cans through the windows of some poor Wells Fargo branch, perhaps) who stepped into a busy crosswalk for science. This put it very near the top of the tables for rudeness. Most of you will recognize this as our old friend moral licensing: the subconscious tendency to feel empowered/entitled to do something bad, immoral or indulgent after having done something to elevate our estimation of our own value. The Prius owner has earned the right to drive like a jerk, since he's saving the world by driving a hybrid car, after all. Alberto Villar of Amerindo Investment Advisors, who was the largest opera donor since Marie Antoinette, could easily justify stealing his clients' money to make good on charitable pledges. Of course I can eat that Big Mac and large fries when I sneak over to the McDonald's across the street from our San Francisco office — I ordered a Diet Coke, after all.

And so on behalf of insufferable hipsters, fraudulent philanthropists and Big Mac dieters everywhere, I would like to extend a gracious invitation to our club: ETF investors who pride themselves on being passive investors while they tactically trade in and out of positions over the course of the year.

Now there's a lot of old research protesting too much that "ETFs don't promote excessive trading!" A cursory review of news media and finance journals will uncover a lot of literature arguing exactly that, although the richest studies are several years old now. You'll even find some informing you that leveraged ETFs aren't being abused any more. Those of you who are closest to clients, are you buying what the missionaries are selling on this one?

I hope not.

Even when some of the original studies were published (most of which said that mutual funds were held around three years on average, while ETFs were held about two-and-a-half years), it was plainly evident to anyone who works with consumers of ETFs that basing claims on the "average" holding behavior was a poor representation of how these instruments were being held and traded. The people with skin in the game who weren't selling ETFs were aware that holders fell by and large into three camps:

1. The long-term holders seeking out market exposure,
2. The speculators trading in and out of ETFs to generate additional returns, and
3. The increasingly sad and depressing long/short guys shorting SPY to hedge their longs, telling the young whippersnappers stories from a decade ago about "alpha shorts" before yelling for them to get off their lawn.

The mean holding period in the old research was still pretty long because Group 1 was a big group. I think that it was also because a lot of the ETF exposure that Group 2 was swinging around was in smaller, niche funds or leveraged ETFs. Both of these things are still true. They're also becoming less true. A few weeks ago, Ben Johnson from Morningstar published this chart of the ten largest ETFs and their average holding period. There's all sorts of caveats to showing a chart like this — some of the causes of ETF trading aren't concerning — but if SPY turning over every two weeks doesn't get your antennae twitching, I'm not sure what to tell you.

| Name | Ticker | Avg. AUM ($Bil) | Avg. Holding Period (Days) |
|---|---|---|---|
| SPDR® S&P 500 ETF | SPY | 204.40 | 15.4 |
| iShares Core S&P 500 | IVV | 82.58 | 149.6 |
| Vanguard Total Stock Market ETF | VTI | 65.94 | 354.2 |
| iShares MSCI EAFE | EFA | 59.80 | 70.3 |
| Vanguard 500 ETF | VOO | 52.44 | 172.9 |
| Vanguard FTSE Emerging Markets ETF | VWO | 42.26 | 111.7 |
| iShares Core US Aggregate Bond | AGG | 40.19 | 187.4 |
| PowerShares QQQ ETF | QQQ | 39.86 | 22.3 |
| Vanguard FTSE Developed Markets ETF | VEA | 37.31 | 185.7 |
| SPDR® Gold Shares | GLD | 35.98 | 43.7 |

Source: Morningstar For illustrative purposes only

There are a lot of reasons to believe that we are lighting our houses on fire with the almost comically active use of "passive" instruments, and trading costs are one of them. Jason Zweig wrote an excellent piece recently highlighting research from Antti Petajisto on this topic. Petajisto's work in the FAJ estimates that "investors" may be paying as much as **$18 billion** a year to trade ETFs. Zweig, perhaps feeling rather charitable, concedes that as a percentage of overall trading volume, this number isn't really all that high. And he's technically correct.

But who cares about trading volume, at least for this discussion, which isn't really about the liquidity of the market? If — as so many investors and asset managers are fond of saying — the ETF revolution is but a trapping of the broader active vs. passive debate (insert audible yawn), we should really be thinking of this in terms of the asset size of the space. And in context of the $3 trillion, give or take, that is invested in ETFs, $18 billion is a LOT. It's 60bp, which would be a lot even if it weren't impacting investors who often make a fuss over whether they're paying 15bp or 8bp in operating expenses.

And then there's taxes. Now, actively managed strategies, especially those implemented through mutual funds, have plenty of tax issues and peculiarities of their own. But the short-term gains taxable investors are forcing themselves into by timing and day-trading ETFs are potentially huge. If we assume, say, a 6% average annual portfolio return, the investor who shifts 100% of his return from long-term gains into short-term gains is costing himself 60-120bp per year *before* we consider any time value or compounding effects of deferring tax liabilities. Given that the largest ten ETFs all have average holding periods of less than a year, this doesn't seem to be all that inappropriate an assumption.

The growing Group 2 above, our day traders — oops, I mean, our "passive ETF investors" — may be giving away as much as 1.2%-1.8% in incremental return. Those fee savings sure didn't go very far, and the direct costs of all this tinkering may not even be the biggest effect!

**Every piece of data on this topic tells the same story: when we try to time our cash positions to have "ammo to take advantage of opportunities," when we decide a market is overbought, when we rotate to this sector because of this "environment" that is about to kick off, when we move out**

**of markets that "look like they've gotten riskier," when we get back in because there's "support" at a price, we are burning down our houses to live by watchfires.**

There are two ways in which we as investors do this, one familiar and one less so.

## Of Clients and Crooked Card Games

First, the familiar. We stay in the crooked game because it's what's expected of us. It's tempting to think of the desire, this inclination toward constant "tactical" trading as an internal impulse. A response to boredom or, perhaps, an addiction to certain of the chemical responses associated with winning, with risking capital, even with losing. I think that's probably true for some investors. I know that when I sat in an allocator's seat, when I heard a portfolio manager tell me he had "fallen in love with the market" when he was six years old and started trading options with his dad when he was 10, I didn't see that as a particularly *good* thing. One can get too familiar with vegetables, you know.

But just as often, the impulse to stay in the game is external, and that pressure usually comes from the client. I'm empathetic to it, and it's not unique to our industry.

Have you ever sent a document to a lawyer and gotten no comments back? Have you ever visited a doctor and gotten a 100% clean bill of health with no recommendations? Have you ever taken your car to a mechanic and had them tell you about just the thing you brought it in for? Have you ever consulted with a therapist or psychiatrist who didn't find something *wrong with you*, even if they had the bedside manner to avoid using those exact words? It isn't just that those folks are being paid for the additional services they're proposing. **There is a natural feeling among professional providers of advice that they must justify their cost to their clients even if the best possible advice is to do nothing.**

The result is that the crooked card game usually takes three different forms, which, in addition to all the fees and tax impact discussed above, may add risk and harm returns for portfolios in other ways as well:

- **The Cash Game**: When investors feel concerned about the timing of their entry into markets, the direction of markets, upcoming events, or some other factor and temporarily sell investments and go to cash, they're playing the Cash Game. I recently had a meeting with an intermediary who had recently launched a system to integrate all client holdings (including accounts held away). Their initial run identified average aggregate cash positions of more than 15%!
- **The Performance-Chasing Game**: I've talked about this ad nauseam in prior notes. We investors find all sorts of vaguely dishonest ways to pretend that we aren't just performance-chasing. It doesn't work, and a goodly portion of the damage done by tinkering and "tactical" moves is just performance-chasing in guise, even if we are high-minded enough to pretend that we're making the decision because "the fund manager changed his process" or euphemistically inclined enough to say the investment "just wasn't working," whatever that means.
- **The In-Over-Our-Heads Game:** Still other games are essentially designed to "fleece the odd sucker," causing investors to seek out hedges and interesting trades to take

> advantage of events and "low cost" insurance for portfolios. As a case study, please take a gander at the size and volume of instruments and funds tracking the VIX. Please look at the return experience of holders of those various instruments. It's not the vehicles themselves that are flawed, but the way in which these markets prey on misplaced expectations of investors that they know when insurance is cheap or expensive. As a quick test: if you can't define *gamma* without looking it up on Investopedia, you probably shouldn't own any of these instruments, much less be flopping in and out of them. This concept is broadly transferable to a variety of things investors do to "hedge" — buying S&P puts, buying short ETFs, etc.

I know I'm not treading new ground here. Borrowing from the work done in a thorough survey on the literature that itself concludes a 1.0% impact from the ways in which investors trade in and out of funds, the figures are pretty consistent. The folks over at Dalbar concluded in 2016 that investors in equity mutual funds underperformed equity indices by 3.5% over the last 20 years, 1.5% of which they attribute to "panic selling, exuberant buying and attempts at market timing." Frazzini and Lamont previously estimated 0.85%. In 2007, Friesen and Sapp said 1.56%. We've got something for hedge fund investors, too.

You've heard this story before. So why am I telling you this?

Because when I meet or speak with investors, I often worry that when they think about dominant narratives and observations about human behaviors, they are focused on identifying tradable trends and signals. In rare cases, that is a worthwhile endeavor. And we've made no secret that we're spending a lot of time thinking about the Narrative Machine — after all, if we believe that investors systematically make mistakes that cost them returns and money, it should be possible to identify ways to capitalize on the actions taken by others.

But far more often, the message from the analysis of prevailing narratives is to *back away from the table.* Investors I've spoken to in the past few years have heard a voice of caution against rotating away chunks of portfolios that by all rights ought to be invested in bonds based on flimsy rationale like, "rates couldn't possibly get lower!" I've likewise cautioned against haphazardly fleeing equity markets into cash on the basis of historically high valuations, perceived political turmoil and the like. There will come times where it may be right to make strong positive observations on opportunities for tactical allocations, but as in all decisions we make when investing, it is imperative that we be aware that the hurdle for staying at the table to play *the only game in town* is very high. Our skepticism about opportunities to play it should be extreme.

## Of Bambi and Battle Tanks

Since I'm advising you to be skeptical, I'll forgo the apocryphal (it's real to me, dammit!) story I was going to tell at this point in my little piece. I *was* going to tell you a story my brother told me once about a high school classmate, an M1A1 Abrams tank and a whitetail deer. It is apparently not normal in polite company to discuss the disintegration of adorable animals, and so I won't unless you buy me a drink (Lagavulin and water, please). What I *will* do is highlight that the often-overlooked pitfall of the tinkering mentality is the tendency to use very big tools to accomplish very small things, for which the intended aim is almost always overwhelmed by the unintended consequence. Pointing a 120mm smoothbore cannon at a tiny animal isn't going to shrink the explosion it causes. Likewise, pointing a major change in risk posture or asset allocation at an event we're a bit nervous about isn't going to change the fact that we've made a change to some very fundamental characteristics of the portfolio.

This happens all the time.

In the last year, I've met with advisors, allocators and investors convinced of the inexorable, unstoppable, indomitable rise of interest rates who exited their government and investment-grade bond portfolios — in many cases, the only remnant of their portfolio standing against them and a downturn in risk assets — in favor of higher yielding equity portfolios that wouldn't be as exposed to the environment they expect. I've seen investors leaving passive equity allocations in favor of concentrated private deals because they are concerned about the broader economy's impact on stocks. I've seen investors switch *asset classes* because they didn't like the manager they were invested with.

There may be reasons for some of those views, and in some cases even for acting on them. But I am always concerned when I see changes like that unaccompanied by consideration of the magnitude of the unintended consequences: are we still taking the right amount of risk? Are we achieving adequate diversification? As we close out the list of Things that Don't Matter, I look forward to publishing our list of things that actually DO, because these questions play prominently. There is hope. There are things we can do, and most of them will run contrary to our instincts to take rapid, "nimble" action in our portolios.

Within that thread of hope, a plea first to readers who prefer poetry: that we feel disillusioned or confused about the outcomes for markets does not mean we ought to be more active, more nimble in modifying our asset allocation, however good and wise those things sound when we say them to ourselves and our clients. All the data tell us that we are likely to find ourselves warming our hands at a watchfire before long. To those who prefer poker: you don't have to play the game. It is OK to step away from the table, walk back to the elevator bank and call it a night, to take what the market gives us.

Make no mistake: the alternative is worse. It's an expensive alternative. It's often a risk-additive alternative. It's a tax-producing alternative. It's an alternative that frankly most of us just aren't in a position to successfully execute. There is a reason that most global macro and GTAA hedge funds hire traders who have success in individual markets, even individual types of trading strategies within individual markets. It's because being able to effectively determine when to switch among managers, among asset classes and among drivers of risk and return is very, very hard. The data bear this out, and no matter how hard we feel like we have to do *something*, it won't change the fact that lighting our house on fire isn't going to make the sun come back.

Understanding the dominant impact of narratives in markets today doesn't mean abandoning our well-designed processes and our work determining asset allocation, risk targets and portfolio construction in favor of a haphazard chasing of the narrative-driven theme for the day. It means that human behavior and unstructured forms of information should — must — increasingly play a role in the structure of each of those processes in the first place.

After all, all investing is behavioral investing. Anyone who tells you different is either incompetent, selling something or both. One of the most pointless such behaviors — our unquenchable desire to act — nearly completes our list of the *Things that Don't Matter.*