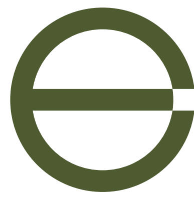

Epsilon Theory

THE FIVE THINGS THAT MATTER #3 | BY RUSTY GUINN

The Myth of Market In-Itself

Part 2

Nothing at all. No figures. Only a blank.

"What's it mean?" Reinhart muttered, dazed.

"It's fantastic. We didn't think this could—"

"What's happened?"

"The machines aren't able to handle the item. No reading can come. It's data they can't integrate. They can't use it for prediction material, and it throws off all their other figures."

"Why?"

"It's—it's a variable." Kaplan was shaking, white-lipped and pale. "Something from which no inference can be made. The man from the past. The machines can't deal with him. The variable man!"

- *The Variable Man (1953), by Philip K. Dick*

This science fiction classic imagines a future world where specialization and technology have made versatility, adaptability and ingenuity obsolete. The unwitting introduction of a man from

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the past - Thomas Cole - capable of solving practical (and mundane) problems of this world throws off the models they use to predict the outcomes of government and military action.

Thomas Cole breaks the models because his foreignness allows him to see problems outside the confines of specialized taxonomy. He isn't too dumb to see the tribes and archetypes of the future. He transcends them, and can't be controlled by them. The successful navigator of policy-controlled, narrative-driven markets must be Thomas Cole. He must be The Variable Man.

> When someone shows you who they are, believe them the first time.
>
> - *Maya Angelou, as told by Oprah Winfrey*

> I have given them Your word; and the world has hated them because they are not of the world, just as I am not of the world. I do not pray that You should take them out of the world, but that You should keep them from the evil one. They are not of the world, just as I am not of the world. Sanctify them by Your truth. Your word is truth. As You sent Me into the world, I also have sent them into the world.
>
> - *The Gospel of John, Chapter 17, Verses 14-18*

One of the most powerful consistent themes of many religious texts is the battle between the adherent's role in the spiritual world and in the physical one. The approach Jesus describes here in the Gospel of John is to be *in the world,* but not *of it*. It's a consistent message for the man who dined with gamblers and prostitutes.

We're presented with the same challenge. Behavior exists. Tribes exist. Taxonomies exist. "Communications Policy" exists. Rejecting them doesn't mean rejecting their existence, and it absolutely doesn't mean that we ought not to invest and trade with awareness of how they impact markets. Being as shrewd as snakes and as innocent as doves means a willingness to know about tribal thinking even when we reject it in ourselves.

The Most Interesting Man in the World: "I have no idea what this is."

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Although, truth be told, there are some things it's worth being content knowing nothing about.

> We will live in this world, which for us has all the disquieting strangeness of the desert and of the simulacrum, with all the veracity of living phantoms, of wandering and simulating animals that capital, that the death of capital has made of us—because the desert of cities is equal to the desert of sand—the jungle of signs is equal to that of the forests—the vertigo of simulacra is equal to that of nature—only the vertiginous seduction of a dying system remains, in which work buries work, in which value buries value—leaving a virgin, sacred space without pathways.
>
> - *Simulacra and Simulations, by Jean Baudrillard (1981)*

If anything describes the feeling I get about the market, it is *disquieting strangeness.* Sound familiar to you? As Baudrillard pointed out, this is the vertigo we get from a world of things that are not things in-themselves, but socially constructed amalgams of symbols and proxies for those things. With every Narrative, every bit of fiat news, the vertigo for those who seek after the truth of something increases. There is no cure, but the only treatment is to try to really, truly understand the simulacra of reality for what *they* are.

We live in a world awash with archetypes.

A personality test once told me that I'm an INTJ. When I play(ed) Dungeons and Dragons my alignment was Chaotic Good, and I usually roleplayed a Half-Elf Bard. I'm a #NeverTrumper on the libertarian wing of the Republican Party. I attend a Presbyterian Church, but I've always identified as Non-Denominational, which is, of course, a denomination that takes its denominational identity from not belonging to a denomination. I've been a WASP all my life, and a non-POC cishet who was coercively assigned the male gender at birth for about 2 ½ years since society decided that the sentence I just wrote is not at all horrifying and makes any kind of sense. I am of Scots-Irish extraction, a Libra or a Virgo depending on the calendar, and Buzzfeed tells me I would be Faramir[1] in the Lord of the Rings Universe, Jon Snow in Game of Thrones and Miranda in Sex and the City. Apparently, if I were admitted to Hogwarts the sorting hat would put me in Ravenclaw.

[1] Hopefully it's book Faramir, and not the movie Faramir that Peter Jackson made into a spineless clone of Boromir because Jackson lacks any understanding of plot or character.

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Over the last few months Ben and I have written a lot about archetypes like this, along with tribes and symbols, and the way that they are used. In Gandalf, GZA and Granovetter I argued that when symbols are used as allegories – as tools to divide and dominate - they have the effect of either (1) causing people to *shift* their beliefs and actions to match up with the symbol or tribe they identify with or (2) causing people to treat others as if their beliefs and values align with the symbol. Or, in Ben's terminology, the (1) obedience collar and the (2) dog whistle. In that note, I took particular issue with the latter, with the idea that anyone gets to determine our intent as citizens or investors.

Here, as we continue the exploration of why investor behavior is one of the Things that Matter in our Code, I want to expand on the first: the tendency for the temperament and behaviors of investors to coalesce around archetypes. Because while we believe we ought to fight to ensure that we are all treated like principals, we also believe that **when someone shows us who they are, we ought to believe them**. And investors show us an awful lot about who they are. Archetypes are everywhere in markets, and if you have the patience to understand and observe them, you will understand what we think is one of the Things That Matter for all investors.

Notes from a Much More Boring Field

I grew up running through corn fields in Minooka, Illinois, but I don't have it in me to be a gentleman farmer like Ben.

No, my notes from the field are much more dull - as regular readers will know, my prior field was an institutional allocator. And people who were and are in my position bear a lot of responsibility for the archetypes in markets. You see, picking fund managers is hard, usually a waste of time, and **basically everybody sucks at it**. Fund evaluators have very little visibility into what causes a manager to generate returns that produce outperformance or a higher-than-expected risk-adjusted return. And so, instead of focusing on a few "things that matter" to identifying strategies and approaches that could even conceivably have an edge, the emphasis of nearly every fund allocator is exclusively on *process*.

Here's the problem with that: process is a necessary but insufficient condition for consistently beating the market.

The fund allocator's toolkit is full of ways to tell if a manager is following *his process*. He looks at tracking error. Rolling correlations to all sorts of indices. Cash positions over time. Factor exposures over time. Risk contributions from factor exposures, country bets, all sorts of things. These are the things that fund managers are expected to discuss, and they are often the right things to discuss. But if you have no justifiable idea whether the process itself should or will lead to outperformance, what the hell are you actually measuring? We have built an entire industry on accurately measuring whether someone followed the recipe, without knowing if the recipe tastes like hot garbage.

As a consequence, the conventions of our industry are exactly the same as the conventions of our political reality: we evaluate participants' consistency with an archetype that is vapor, a construct, a simulacrum. In so doing, we create strong forces to drive them toward consistently behaving in that very particular way, toward incentives and responses to stimuli that are repeatable mostly because we reward them for being repeatable! It's not really even a Pavlovian response, because the reward is usually crappy performance.

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Managers of institutional pools of capital are one of the largest influences on markets, and so it is critical to understand the languages that coalesce around these archetypes. Others form around the conventions of retail gatekeepers (Howdy, Morningstar… or Lipper for the mutual fund managers who didn't like their Morningstar rating), around sell-side research providers, around the styles of well-respected investors (e.g. Buffett) or around insufferable gasbaskets (e.g. Cramer). Others form around the self-reinforcing conventions of esoteric worlds like FinTwitter, which end up driving far more of something like USD/BTC than anything fundamental about cryptocurrency.

Returns are anywhere and everywhere a behavioral phenomenon. Dick Thaler likes to quote Herb Simon's characterization of "behavioral economics" as a pleonasm, but talking about a behavioral approach to markets is just as redundant. It is impossible for a non-behavioral analysis of market returns to be useful. If we are ever to understand why prices move and why our investments generate returns for the portfolios we build for ourselves and our clients, we must at least develop some understanding of how and why blocs of investors form, how they buy and sell securities, how and when they change their stripes, and how that results in changes in the prices of the investments we own. We're going to do a lot of generalizing, so caveat the below however you deem appropriate. This isn't a precise science – or **at least it isn't yet**.

The Value Archetype

It's easy enough to introduce what it is we're talking about with a "style" that most investors are familiar with. Well, sort of, anyway.

The language of value is familiar—buy cheap things. The investor who has adopted it is rarely a news-responder. In many cases he fancies himself a bettor on things that are out-of-favor or forgotten. In the market voting machine, he casts his ballots and crosses the [actual and proverbial] spread for things with bad tape, with bad narratives, with problems. Don't mistake the language for the style. Graham and Dodd, Buffett and their "intrinsic value" ilk are value investors in the way that *everyone* is a value investor – in that they want to buy something they think will be worth more in the future than it is today. They aren't who we're talking about here.

We are talking about the investor who believes that investors pay too much for quality, for growth, for sex appeal, and that it will harm their returns. These days, most of these value investors are quants. Some of them are financial advisors selling a package of contrarian ideas, of differentiated thinking. Many more of them are fundamental shops, folks that focus on multiples-based analysis and build fancy models after the fact to justify the things they buy on the basis of multiples, *not that there's anything wrong with that.*

So how do these value investors impact prices and returns?

Visualize the order book from **Part 1**, and again, think about it in long-horizon terms. Members of the Value Archetype form a big part of the willingness of the market to buy things that most think are unattractive. They form the corpus of the out-of-the-money bid for any security or market, and like their counterparts in the Mean-Reversion Archetype we'll read about shortly, that's when they tend to participate in the marginal price-setting process. That, and on the ask side, where they tend to be the sellers of gains. When a lot of people are rallying at this banner, it can be a pretty meaningful force to constrain upward movement in prices.

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When there aren't as many, the Value Archetype plays a much smaller part in the price-setting process. Consider: who is selling a stock that goes from trading at 45x earnings to 50x earnings? It ain't the Value guy. He sold it a long time ago, and the next guy couldn't care less.

The Growth Archetype

We tend to think of "growth" as being the opposite of "value," but that isn't strictly true. For most of the indexes that track these styles, it is kinda true, although in their vernacular, "growth" is really just "anti-value." In other words, when you see a growth index, in most cases it isn't sorting companies by how quickly they grew or are expected to grow, but by how expensive they are. That's not what we're talking about.

There may be a few investors out there who are actively looking to buy things *because* they are expensive, I suppose, but there are plenty who don't care all that much if it has what they are looking for. What many of them are looking for is growth, or at a minimum the *narrative* of growth. That narrative may be favoring one stock over a peer. It may be in favoring technology securities over the retail sector. It may be in favoring emerging markets investments over developed markets. There are some investors – at certain times and under certain conditions – who see valuations as temporary phenomena and growth narratives as the only relevant focus.

Some of these individuals actively choose this posture. They believe the narratives, they buy, and they cross the spread to do it. Prices rise.

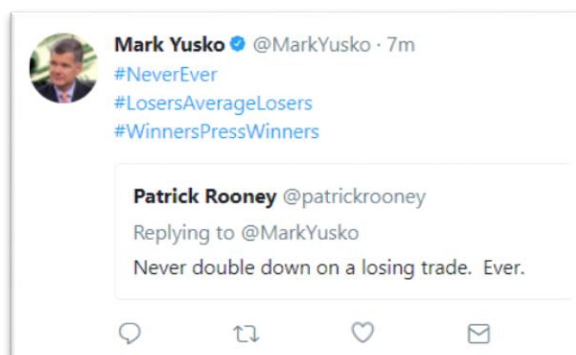
Some under this banner have no choice. They have asset-liability issues that require them to seek out growth. They are pushed by falling yields in alternative asset classes precipitated by central bank action. They, too, must buy and cross the figurative spread to do it. Prices rise.

We'll come back to this, because it's important.

The Momentum Archetype

Some investors don't care so much about fundamental growth or the narrative of growth as much as they do about whether the thing has generally been rising in price.

Quantitative investors do this. Traders do this. In a way, of course, these are people responding to the Epsilon that represents a portion of market returns. In most cases, they do it because it generally works. Winners *tend to* keep winning and losers *tend to* keep losing. Many investors who coalesce around this archetype do so very willingly (pictured right), while others would be mortified to think that they would be tarred with a "technical" investor brush. And so they are focused on consistent improvement in earnings, or in guidance from management, or in an *improving story.* Narrative momentum rather than price momentum, but momentum all the same.



In the end, what matters is that these individuals 'cross the spread' to support continued

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movement in the price of securities. Some can be long/short, and so this can happen in both directions. But it's generally long, and getting longer.

The Mean-Reversion Archetype

I'm abstracting a lot from time horizons here, and I'm doing so intentionally. Part of my story is that in a non-**ergodic world**, the idea that the long-term can be considered fully independently from the path that begins in shorter horizons is madness. And so, while I fully recognize that there are many, many funds that pursue strategies that happily encompass each of value, momentum and mean-reversion strategies, I'm not talking about strategies. I'm talking about frameworks of thinking and talking about investments that color the decisions that investors make across the board.

And on this dimension, while mean-reversion has a specific meaning within the context of, say, CTA and statistical arbitrage strategies, what I'm really talking about is *the consciously contrarian* asset allocator. Only instead of looking for unloved companies, this is the falling-knife catcher. The one looking for the turn, the top, the bottom, the inflection point.

Some demonstrate this trait consciously, but far more do so passively through policies called "rebalancing," most of which have a negative expected return. After all, momentum works. But these people are volatility reducers. They step in to provide the bid when the longs are screaming bloody murder and the ask when the shorts are getting crushed.

The Others

Look, there are all sorts of taxonomies people rally around. We could talk about some nebulous definition of "quality" guys or the nothing-land that is most "GARP" investing. We could talk about investors who are students of more arcane technical trading approaches, or about those who invest based on macroeconomic data or news. But it's the four things above that matter.

Except that there is a rapidly growing fifth category, a sort of Nihilistic Archetype. It's the passive investor. Except inasmuch as he adheres to another archetype in his cross-asset allocation decisions **(which he frequently does)**, the passive investor expresses no opinion whatsoever with respect to the pricing of individual securities. He doesn't participate in relative price-setting.

He is out of the game.

Where Does This Put Us?

Can you tell that I'm going somewhere with this? To better understand why I think it's important for all investors to think about the behaviors of their fellow-travelers in markets, let's walk through what I *think* is happening right now:

- The Value Archetype is dead: No one is rallying around this banner. Read the sell-side language. No one is pitching value-oriented research, because they'd have no one to sell it to. Even the old stalwarts, the quants, have evolved toward either risk premia-based or Value+Momentum+Quality mandates that dampen the emphasis on value alone. Sure, you'll get the occasional bank strategist calling for a rotation into financials (they've got to be early calling the new thing), but of the people setting prices, very few of them are

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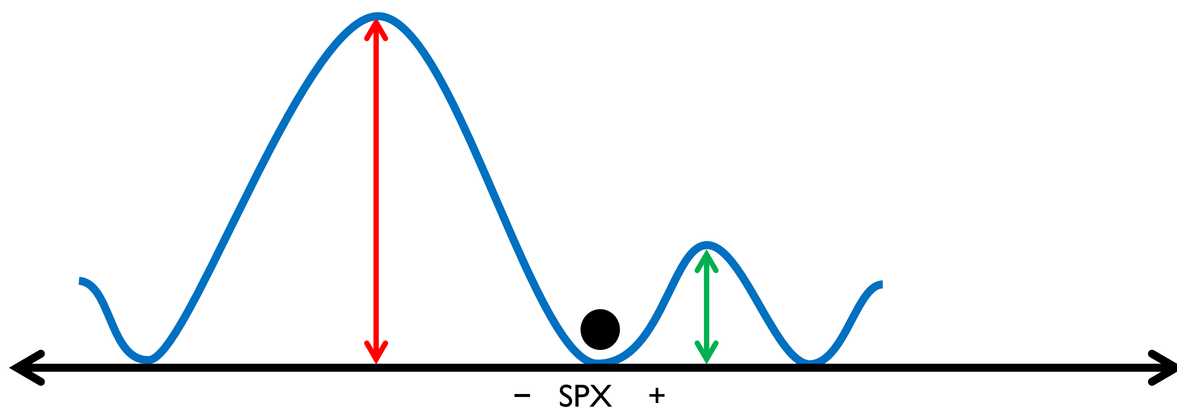
speaking this language. I'm not saying I don't believe in value. I do! But the market's belief in it is nothing more than lip service right now.

- The Mean-Reversion Archetype guys in CTA and Global Macro Land are bleeding out: Selling winners and buying losers has rarely been a more painful trade. I've talked to a few FAs who are sticking with long vol trades or defensive positions because, well, at this point, you might as well stick to your guns. But other than that, this is a dead language, folks. If you expect someone to bail you out of a short squeeze, you're barking up the wrong tree.

- Passive Investing is levitating broad markets but allowing intra-market volatility: Investors, allocators and fund managers alike have piled into the Growth train, in part because they want to, and in part because retirees and pension plans with unfunded future liabilities have no other choice. Since they are doing so through broad market instruments and are not about to sell into weaker growth prospects, there is continued upward pressure on prices. Within markets, the decline in participants who are actively participating on individual securities is allowing continued spread potential between sectors, styles, etc.

The combined effect? Everything is levitating. With value and mean-reversion as *lingua non grata*, the people setting prices are (1) Growth investors, (2) Momentum investors and (3) Passive investors adhering to those archetypes. There is no one left to sell, because there is no one left who cares nearly enough about valuation or is confident enough in their ability to time a top in markets to sell into strength. The result is – in Information Surface terms – a market that has tremendous difficulty generating any price volatility to the negative.



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What Does This Mean for Investors?

We can be in the market and be long. We can be not of this market and be ready for the move to the downside. Or we can be *in* the market, but not *of* it, by incorporating the behaviors of others into our thinking about markets AND retaining our ability to think independently about possible outcomes. How?

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1. With the core of your portfolio, you don't fight it. This is most of what being aware of investor behaviors and the complete hegemony they have over market movements means.

2. You think more specifically about how other investors are thinking about this market. Why they're buying. Why they're buying what they're buying. You think about their motivations. And you think about how a change in their motivations would change in response to various market influences. Is a shooting war in the Middle East going to materially change investors' view of and preference for growth? (Probably not) Is a material change in language coming from all Central Banks going to shift it? (Maybe, as Ben has written)

3. You prepare your portfolio – or at least your framework - for what happens when that informational bowling ball climbs the wall to the downside, because when it does, volatility can return in a big damned hurry.

Thomas Cole wasn't a genius. He succeeded because he was capable of acknowledging the existence and influence of archetypes without succumbing to them in his own behavior and actions. If you would navigate this market, your Code should allow you to do the same.

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