Salient®

Epsilon Theory

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"Two Growth Announcements and One Not So Much"

I'm with you in Rockland
where we are great writers on the same dreadful typewriter.
– Allen Ginsberg, "Howl" (1956)

Give me a long enough lever and a fulcrum on which to place it, and I will move the world.
– Archimedes (287 – 212 BC)

Play-offs?!? Don't talk about … Play-offs?!? You kidding me? Play-offs?!?
– Indianapolis Colts coach Jim Mora press conference, November 21, 2001

A brief note today about Fed "lift-off" following last Friday's jobs report. As with so many announcements that are trumpeted with great fanfare in the Golden Age of the Central Banker, I think there's less here than meets the eye. But before we get into that, I have two growth announcements that I think are, in fact, authentic indications of something interesting afoot.

First, Salient announced today that we closed our acquisition of Forward Management. With more than $6 billion under management, Forward is a big bite for Salient, and anyone who has been involved with a major transaction or integration knows that nothing about this stuff is easy. But it's a risk worth taking. Why? Because there is a desperate investor need for smart, new twists on smart, old ideas … ideas like diversification, de-risking, and risk balancing. The combination of Salient and Forward engages the people and the ideas and the scale to set traditional asset management on its ear. And not a moment too soon!

Second, last Tuesday was Epsilon Theory's second birthday. I launched this project in June 2013 with a manifesto emailed to 200 colleagues and friends. Today I am emailing this note to more than 24,000 colleagues and friends, and some multiple of that number will read the note through forwarding and the various websites that republish Epsilon Theory. My best guess is that on average a dozen people around the world are reading Epsilon Theory every second of every hour of every day.

I'm certainly no stranger to the deadly sin of pride, and any writer who tells you otherwise about his or her work is a liar. But in my more self-aware moments I try to step back and figure out what this audience growth *means*. It strikes me that Google made a pretty good business out of the realization that engagement, i.e. time + attention, is the most important metric in the content world, and that's the lesson I've tried to take to heart. What's most distinctive about Epsilon Theory is not the size of the audience, but the *engagement* of the audience, the willingness of tens of thousands of smart, successful people to invest their most valuable resource – their time – to wrestle with the ideas I'm writing about.

Because here's the thing. **The ideas I'm writing about in Epsilon Theory are not novel or new.** They are good, old ideas that have been submerged by the status quo institutions that dominate our investment world. Those institutions aren't just the mega-banks and the mega-asset managers and the mega-rich (yes, Piketty has a point, and if you don't see this you're just not paying attention), but are also the mega-political parties, the mega-media conglomerates, and the mega-academic complex (that last category includes all modern central banks, of course). **It's a mega-world we live in today, where virtually every signal bombarding us has been intentionally constructed to further the interests of the mega-institutions, even those signals – no, scratch that – *especially those signals* which purport to communicate accurate information about our social world and our role within that world.**

If you're reading Epsilon Theory, you already know this.

Maybe you haven't said it out loud. Maybe you work for one of the mega-institutions and can only mumble the knowledge in careless moments. Maybe it's something you've been feeling in your gut for a long time and haven't had the words to express. But you know it all the same.

Or to put it another way, Epsilon Theory was there waaaaay before I started writing it. **What's most meaningful here is the self-identification of a critical mass of smart, successful people who are committed to finding their way in a world that they *know* is playing them false.** They go along with the mega-institutions because they are, in fact, smart, successful people, but they haven't taken the Party line into their hearts. When I started writing Epsilon Theory I thought that the mega-institutions had won. Now I know that they're not even close. And that's the most powerfully uplifting statement I could ever write.

This is why I make such a big deal about giving updates on Salient and Epsilon Theory growth. It's not (only) to indulge my ego. It's to spread the word that the mega-institutions are NOT winning, that we are NOT alone or isolated in our knowing, subterranean resistance to The Powers That Be.

Okay, Ben, enough mirror-gazing. Back to planet Earth for a brief comment on last Friday's job report and what it means (or doesn't mean) for investors.

First, I want to call attention to every Fed watcher's favorite word these days: "lift-off". As if the Fed's first rate increase, whenever that comes to pass, is the ignition of some giant Saturn V rocket that will inexorably carry interest rates up, up, and away. Please. This is Narrative creation … really, Narrative abuse … of the first order. The next time you read or hear someone use the word "lift-off", I'm begging you to remember Jim Mora's classic press conference when he was asked about the Colts' chances of making the play-offs, because it's a dead ringer for what Janet Yellen is saying in her heart of hearts.

You think Yellen is thinking ahead to a rates lift-off? Really? **The reputational risk and future payday risk associated with this *first* rate increase is astronomical for Yellen, much less a *series* of rate increases.** Yes, wage inflation is slowly staggering up off the floor after being knocked unconscious for the past five years. Yes, it would be nice if the Fed were not scared to death of spooking the bond market (thank you, Captain Obvious … err, I mean former Fed governor and current BlueMountain millionaire Jeremy Stein). But the notion that we're either off to the races in the real economy or that Yellen woke up on Monday with a political and personal deathwish to tell off the bond market is just ludicrous.

The Fed wants to raise short rates to put some bullets back in the exhausted gun of ordinary monetary policy, and that gives a totally different *meaning* to the notion of a rate increase today than in, say, 1994. Since when was the Fed concerned about getting in front of – gasp! – 2.3% wage inflation? No, the Fed wants to reload with conventional ammo before the next external shock or the next inventory-led slowdown, which is all smart and good and thoughtful, but they're being forced to reload while the battle is still raging. That creates a very different decision-making and implementation *path* for rate increases than any historical corollary of the past 60 years, which means that any investment conclusion based on those historical corollaries is almost certainly a category error, the worst possible methodological mistake you can make. Sorry, but my crystal ball is still broken, and I think yours is, too.

Second, I want to call attention to the crucial distinction in logic (and gambling) between probabilities and odds. Will the Fed raise interest rates one day? Sure. There is a 99.999% probability that this event will occur over a long enough time period, in exactly the same way there is a 99.999% probability that a Triple Crown winner will materialize over a long enough time period. Is it profitable to attempt to predict when that day will materialize? No. The payoff odds associated with any specific meeting being THE meeting of the Fed rate increase will inevitably be poor, in exactly the same way the Belmont Stakes betting odds on American Pharoah (it kills me to misspell this word) and every other Triple Crown candidate over the past 35 years were poor. Why? **Because when human beings pay great attention to any probabilistic event, they ALWAYS over-estimate the likelihood of that event occurring.** This is one of the strongest findings in all of behavioral economics, and it runs rampant at both the track and the stock market. Over-estimated probabilities mean bad odds. To wit: just because American Pharoah won the Belmont stakes, and if you bet on him to win you were absolutely right, that doesn't mean it was smart to make a bet at 3:5 odds.

I've got a lot more to say on the issue of investor attention, as it's one of the most interesting areas of modern academic research on markets, but for now I'll leave you with this. We will never know the approximately "true" probability of American Pharoah winning the Belmont stakes, because we can't repeat the experiment a dozen or so times. What we know with near certainty, however, is that the expressed odds of 3:5 for the single experiment were worse than whatever the true probability might have been. What we also know with near certainty is that pundits LOVE infrequent probabilistic exercises like Fed meetings or Triple Crown races, and their attention magnifies investor attention in a profoundly unhealthy way. Why do pundits swarm like flies around these events? Because they are tautological exercises – without a repeated experiment, you can NEVER be proven wrong in your pre-race or pre-meeting assessment of probabilities – and that's a great business model for them. Of course, that means it's a terribly weak signaling model for you. **My view: once you hear more than a handful of Missionaries arguing about any sort of well-publicized probabilistic event, whether it's a horse race or an election or a Fed meeting or a jobs report or whatever, it's un-investable. Run away.** Far better to *adapt* to whatever the outcome turns out to be as part of a prepared *strategy* than to fling yourself from pillar to post in an attempt to anticipate an overly-examined, poorly-estimated, totally-gamed event. That's not the sexy way to invest. It's not the heroic way to invest. But if there's one Epsilon Theory lesson that I never get tired of repeating, the Golden Age of the Central Banker is a time for investment survivors, not investment heroes.

All the best,
Ben

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