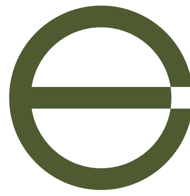

Epsilon Theory

THE NARRATIVE

THEORY IN ACTION | BY RUSTY GUINN

What a Good-Looking Question!

The Five Things that Don't Matter: Part II

March 31, 2017

Peter Griffin: What can you tell me about this one?

Car Salesman: Oh, that's just an old tank I use for those commercials where I declare war on high prices. Now about that sedan…

Peter Griffin: Hang on there, slick. Now I see your game. We come in here wanting a practical car, but then you dangle this tank in front of me and expect me to walk away. Now, I may be an idiot, but there is one thing I am not, sir, and that, sir, is an idiot. Now, I *demand* you tell me more about this tank!

Car Salesman: Well, if you're looking for quality, then look no further.

Peter: That's more like it! Tell me, what are the tank's safety features?

Car Salesman: What a good-looking question. Three inches of reinforced steel protects your daughter from short-range missile attacks.

Peter: I see. And does the sedan protect against missiles?

Car Salesman: It does not.

— *Family Guy*, Season 5, Episode 3, "Hell Comes to Quahog"

©2017 Salient Partners, L.P.
All rights reserved.

There was an unclouded fountain, with silver-bright water, which neither shepherds nor goats grazing the hills, nor other flocks, touched, that no animal or bird disturbed not even a branch falling from a tree. Grass was around it, fed by the moisture nearby, and a grove of trees that prevented the sun from warming the place. Here, the boy, tired by the heat and his enthusiasm for the chase, lies down, drawn to it by its look and by the fountain. While he desires to quench his thirst, a different thirst is created. While he drinks he is seized by the vision of his reflected form. He loves a bodiless dream. He thinks that a body, that is only a shadow. He is astonished by himself, and hangs there motionless, with a fixed expression, like a statue carved from Parian marble.

Flat on the ground, he contemplates two stars, his eyes, and his hair, fit for Bacchus, fit for Apollo, his youthful cheeks and ivory neck, the beauty of his face, the rose-flush mingled in the whiteness of snow, admiring everything for which he is himself admired. Unknowingly he desires himself, and the one who praises is himself praised, and, while he courts, is courted, so that, equally, he inflames and burns. How often he gave his lips in vain to the deceptive pool, how often, trying to embrace the neck he could see, he plunged his arms into the water, but could not catch himself within them! What he has seen he does not understand, but what he sees he is on fire for, and the same error both seduces and deceives his eyes.

— Ovid, *Metamorphoses*, Book III

Brian: Look, you've got it all wrong! You don't need to follow me. You've got to think for yourselves! You're all individuals!

Crowd: Yes! We're all individuals!

Brian: You're all different!

Crowd: Yes! We're all different!

Man: I'm not.

Crowd: Shhh!

— *Life of Brian* (1979)

There may be members of the committee who might fail to distinguish between asbestos and galvanized iron, but every man there knows about coffee — what it is, how it should be made, where it should be bought — and whether indeed it should be bought at all. This item on the agenda will occupy the members for an hour and a quarter, and they will end by asking the Secretary to procure further information, leaving the matter to be decided at the next meeting.

— C. Northcote Parkinson, *Parkinson's Law: Or the Pursuit of Progress*

©2017 Salient Partners, L.P.
All rights reserved.

One of our portfolio managers at Salient started his career working the desk at a retail branch of a large financial services firm in Braintree, Massachusetts. He likes to tell the story of "Danny from Quincy" (pronounced Qwin'-zee). Danny is a rabid Boston sports fan who frequently called in to a local sports talk radio show. Your mind may have already conjured an image of our protagonist, but for the uninitiated, American sports talk radio is community theatre at its most bizarre (and entertaining), its callers a parade of exaggerated regional accents shouting really awful things at no one in particular. Local sports talk radio is even more of an oddity, since on the clear fundamental question, that is, which team everyone supports, practically all parties involved agree.

Lest Bostonians feel singled out, this phenomenon is infinitely transferable. In Buffalo, Pittsburgh, Chicago, Kansas City and Oakland, it is much the same. In each, the listener can expect the same level of anger, whether it is shouting about things everyone listening agrees on, like the 'fact' that the NFL has always preferred Peyton Manning to Tom Brady and that Deflategate just boiled down to jealousy, or relatively petty items of disagreement, like the 'fact' that Belichick reached on a player in the draft who would have been available in the 4th or 5th rounds when what they really needed was help at defensive back.

When Danny from Quincy wandered into our colleague's Braintree branch, Danny's voice was distinctive enough that he was immediately recognized. From their conversation, it was clear that this happened to Danny all the time. Here was a local celebrity minted by nothing other than the fact that he could shout agreed-upon concepts at the loudest possible volume and with proper non-rhotic diction.

It is hardly a novel observation that disputes among those who agree on the most critical questions and disagree on details are often among the most violent. After all, more died in the disputes between French Catholics and Huguenots alone than in all three of the Crusades. And it took twice as long for John Lennon and Paul McCartney to get in a recording studio together after the Yoko Ono Experience than it took for King George III to receive John Adams as ambassador after the Treaty of Paris. As investors, however, we have turned this seemingly normal human behavior into an art form.

There are all sorts of social and psychological reasons why we so enjoy wallowing in issues of lesser import with those with whom we otherwise largely agree. One of the main reasons is that big, important issues — the ones that divide us into broad groups — tend to be either issues outside of our control, or complex and more difficult to understand. By contrast, the smaller, less important issues are more likely to be understood by a wider range of people. Or at least they are more familiar.

In 1957, C. Northcote Parkinson's eponymously titled book *Parkinson's Law: Or the Pursuit of Progress* dubbed this phenomenon the Law of Triviality. In referencing the work of a finance committee, it concluded that "…the time spent on any item of the agenda will be in inverse proportion to the sum involved." In other words, the more trivial something is, the more time we are likely to spend discussing it.

In his book, Parkinson dramatically reenacts the three agenda items before a finance committee: a $10 million nuclear reactor, a $2,350 bicycle shed and a $57 annual committee meeting refreshment budget. As you might expect, the details of a plan to build a nuclear reactor would fall well outside the abilities of even sophisticated committees, and even for those members with some sophistication, the task of bringing legitimate concerns or questions before an otherwise

©2017 Salient Partners, L.P.
All rights reserved.

unknowledgeable group is daunting. In Parkinson's example, the knowledgeable Mr. Brickworth considers commenting on the item but "…does not know where to begin. The other members could not read the blueprint if he referred to it. He would have to begin by explaining what a reactor is and no one there would admit that he did not already know." He concludes that it is "better to say nothing."

The item passes after two and a half minutes of discussion.

The next item before the committee is the discussion of a committee to build a bicycle shed for clerical staff. The discussion includes a range of topics, from cost to necessity to the choice of construction materials. As Parkinson puts it, "A sum of $2,350 is well within everybody's comprehension. Everyone can visualize a bicycle shed. Discussion goes on, therefore, for 45 minutes, with the possible result of saving some $300. Members at length sit back with a feeling of achievement." It is not difficult to guess where the meeting goes from there. It becomes a multi-hour marathon discussion of the $57 coffee budget, which leads to a demand for additional research and a subsequent meeting.

This dynamic should be familiar to almost anyone in the investment industry. Whether you are a financial advisor, institutional allocator, professional investor or just an individual trying to navigate the waters of an industry seemingly designed with the purpose of confusing investors, you're at risk of more than a few Bike Shed discussions.

The code-driven investor doesn't waste his time on the Things that Don't Matter.

The Biggest Bike Shed of Them All

Problematically, the biggest, most egregious Bike Shed probably dominates more discussions between asset owners (individuals, institutional investors) and asset managers than anything else: **talking stocks**.

Stop for a moment and take an inventory. If you're an individual investor, think about your last meeting with your financial advisor. Financial advisors, pension fund execs, endowment managers, think about your last meeting with your fund managers. How much of the meeting did you spend talking about or listening to them talk about stocks and companies? A third of the meeting? Half? More? Maybe you were well-behaved and focused on things that matter, but let's be honest with each other. We all talk about stocks way too much and we know it.

It makes me think a bit about doctors in the post-WebMD era. Once upon a time, an experienced and well-trained physician could practice medicine with deference — almost a sort of detached awe — from the patient. That is, until the internet convinced every one of us who ran in sheer terror from the syllabus for organic chemistry that we have every bit as much skill as a doctor in diagnosing ourselves with every kind of malady. For the professional investor — especially the professional investor in common stocks — this has been the case for centuries. There is no profession for which the lay person considers himself so prepared to succeed as in the management of stock portfolios.

©2017 Salient Partners, L.P.
All rights reserved.

Lest you feel any empathy for the professional in this case, our layperson isn't entirely wrong. Not because he has some latent talent but because the average stock portfolio manager probably doesn't. This shouldn't be provocative. It also isn't an opinion, as Nobel Prize winner Eugene Fama famously said, and as I rather less famously agreed in **I Am Spartacus**. It's math. To pick winners and losers in the stock market is a zero-sum game, which means that for every winner who is overweight a good stock, there is a loser who is underweight. And both of them are paying fees.

As I wrote previously, it is true that this notion is driven by a narrow capitalization-weighted view of the world. It also doesn't take into account that investors with different utility functions may differ in what they consider a win. Yet the point remains: so long as math is still a thing, on average, active managers won't outperform because they can't. This is a big reason why over long periods only 3% of mutual fund managers demonstrate the skill to do so after fees (Fama & French, 2010).

But the question of whether we ought to hire active stock managers isn't even the Bike Shed discussion — after all, the phony active vs. passive debate took the top spot on this ignominious list. Instead, the mistake is the obscene amount of time we as investors spend thinking about, discussing and debating our views on individual stocks.

So why do we spend so much time doing this?

Well, for one, it's a hell of a lot of fun. Whether we are investors on our own behalf or professionals in the industry, dealing with financial lives and investments can be drudgery. As individuals, it's taxes and household budgets and 401(k) deferral percentages and paying people fees. As professionals, it's due diligence and sales meetings and prospectuses and post-Christmas-party trips to HR training. Daydreaming about a stock where you really feel like you have a unique view that you haven't heard from someone else is a blast by comparison.

Fun aside, familiarity plays an even more significant role. Each investor encounters companies with public stocks as a consumer and citizen on a daily basis. We are familiar with Apple because we buy their phones and tablet devices. We know Exxon because we have a friend or family member who works there. We work at another pharmaceuticals company and we think that gives us an edge in understanding Merck.

It is so important to recognize that these things give you an edge in *talking* about a stock, but absolutely zero advantage in *investing* in one. Lest we think that something is better than nothing, in this case, that is decidedly not so. When we know nothing, and know that we know nothing (h/t Socrates) about a company that will matter to its stock, we are far more likely to make sensible decisions concerning it, which typically means making *no* decision at all. When we know nothing and think we know something valuable, we are more likely to take actions for which we have no realistic expectation of a positive payoff. But it's worse than taking a random uncompensated risk, because this kind of false-knowledge-driven investing also engenders all sorts of emotional and behavioral biases. These biases will drive you to hold positions longer than you should, ignore negative information and all other sorts of things that emotionally compromised humans do.

We also spend time doing this because talking about companies and stocks gives us a sort of feeling of parity that we usually don't feel when we're talking to our fund managers and financial advisors. These guys are often some of the smartest people we get to talk to. It can be intimidating. We look

©2017 Salient Partners, L.P.
All rights reserved.

for any common ground we can find. We love being told we asked a very good or smart question. Strangely, my questions were much smarter when I worked at a $120 billion fund than since that time. I must have gotten stupider.

In case this is hitting a bit too close to home, let me assure you that you are not alone.

Before I was an asset manager — when I represented an asset owner — I was occasionally invited to speak at conferences. One such conference was in Monaco. Now, our fund had an investment with a hedge fund based there and given the travel expenses associated with conducting diligence meetings in Europe, combining the two made good fiscal sense. It also meant that our usual practice of conducting diligence in pairs wasn't really feasible. So, I was running solo.

On Tuesday, I attended the conference, giving speeches to other asset owners about what effective diversification in a hedge fund portfolio looks like, and then speaking later on a panel to an audience of hedge funds on how to present effectively to pension fund prospects. I could barely leave the room without a mob of people looking for a minute of my time or a business card, and friends, I'm not a particularly interesting public speaker. I felt like a big shot.

On Wednesday, I met our fund manager for lunch. I don't remember the name of the venue, but it was attached to some Belle Époque hotel with a patio overlooking the Mediterranean. From the front of the hotel, we were ushered through a sort of secret passageway by a tuxedoed man who, when we arrived at the patio, was joined by three similarly attired partners who proceeded to lift and move a 400-some-odd-pound concrete planter that isolated the table we would be sitting at from the rest of the patrons. When we had passed by and sat down — not without a Monsieur-so-and-so greeting and obsequious bow of the head to my host — they then lifted and returned the planter to its place and disappeared.

The gentleman welcomed me to his city graciously in Oxbridge English, but I knew from my notes that he spoke Italian, German and French as a native as well. I think he was conversant in Dutch and several other languages besides. He was an activist investor, and had such a penetrating understanding of the companies in which he invested (usually no more than 5 or 6 at any time) that I could tell immediately I was several leagues out of my depth. He was so intimately familiar with the tax loss carryforward implications of eight potential cross-border merger partners for a portfolio financial services holding that I deemed it impossible he didn't sport an eidetic memory.

By the time I had finished a cup of bisque and he had finished (food untouched) passionately discussing solutions to flawed regulator-driven capital adequacy measures, I was so thoroughly terrified of this brilliant and just disgustingly knowledgeable man that I couldn't help but grasp at the thing I knew I could hang with him on. I wasn't going to be the sucker at this table!

"So, what about your position in this British consumer electronics retailer?"

And down we go into the rabbit hole, Alice. Ugh.

Look, we've all been there. Or maybe it's just me and none of you have ever felt intimidated and stupid and reached out for something, anything. Either way, it's so critical that you know that your fund manager, even your financial advisor, **loves** it when you want to talk stocks. Loves. It. He loves it because he knows his client will have some knowledge of them, which gives him a chance to establish common ground and develop rapport with you. It keeps the meeting going without forcing

©2017 Salient Partners, L.P.
All rights reserved.

him to talk about the things he doesn't want to talk about, namely his performance, his fees and how he actually makes money for his clients.

It's a great use of time for him — he's selling! — and an absolutely terrible use of time and attention for you, the investor. If they drive the conversation in that direction, stop them. If you commit an unforced error and try to get them to sell you the tank instead of the sedan, stop yourself.

Why It Doesn't Matter

But is thinking about your individual stock investments and those made on your behalf *really* always such a terrible use of time? Even though I asked the question I just answered in a rhetorical way that might have indicated I was going to change my mind and go a different direction here, yeah, no, seriously, it's a ridiculously bad use of time. Let me be specific:

If you are spending more than a miniscule fraction of your day (say, 5% of whatever time you spend working on or talking to people about investments) trying to pick or talk about individual stocks, and you are not (1) an equity portfolio manager or (2) managing a portfolio with multiple individual stock positions that are more than 5% of total capital *each*, this is absolutely one of the Five Things that Don't Matter.

Why? The answer has more to do with the nature of stock picking than anything else, but in short:

1. You probably don't have an edge.
2. Even if you do, being right about it won't necessarily make the stock go up.
3. And even if it sometimes did, it wouldn't matter to your portfolio.

There are empirical ways to tell you how hard it is to have an edge. Academics and asset managers alike have published innumerable studies highlighting the poor performance of active equity managers against broad benchmarks and pointing out the statistical inevitability of outliers like Buffett or Miller. But you've probably already read those, and if you're like me you want to know why. So here's why it's so damned hard.

There are only two possible ways to outperform as a stock-picker:

> **Method 1:** Having a different view about a company's fundamental characteristics than the market expects, being right, and the market recognizing that you are right.
>
> **Method 2:** Having a view that market perception about a company will change or is changing, estimating how that will impact buying and selling behaviors, and being right.

That's it. Any investment strategy that works must by definition do one of these things, whether consciously or subconsciously. Deep value investors, quality investors, Holt and CFROI and CROCE aficionados, DDM wonks, intrinsic value guys, "intuitive" guys, day traders, the San Diego Momentum Mafia, quants — whatever. It's all packaging for different ways of systematically or intuitively cracking one of these two components in a repeatable way.

The problem for almost all of us — individuals, FAs, fund managers, asset owners — is that we want to think that doing truly excellent fundamental analysis guided by a rigorous process and well-constructed models is enough. Friends, this is the fundamental message of *Epsilon Theory*, so I hope this doesn't offend, but **fundamental analysis alone is never enough to generate alpha.**

©2017 Salient Partners, L.P.
All rights reserved.

This is what leads us to focus our efforts vainly on trying to find the most blindingly intelligent people we can find to build the best models and find that one-off balance sheet detail in the 10-K notes that no one else has found. We're then disappointed after three straight years of underperformance, and then we fire them and hire the next rising star. It is what leads us to spending time researching companies ourselves, evaluating their new products, comparing their profitability ratios to those of other companies, and the like.

This isn't to say that fundamental analysis doesn't have value to a valid equity investment strategy. It certainly can and may, but as a **necessary but insufficient** component of Method 1 described above. The missing and absolutely indispensable piece is an accurate picture of what the market actually knows and is expecting for the stock, and how participants will react to your fundamental thesis being correct.

This is where (probably) you, I and the overwhelming majority of fund managers and financial professionals sit. We may have the capacity to understand what makes a company tick, how it works. We may even be able to identify the key variables that will determine its success. But when it comes to really assessing what the next $500 million of marginal buyers and sellers — you know, the people who determine what the price of the thing actually is — really think about this stock and how they would respond to our thesis being right, I believe we are typically lost. We've built a Ferrari with no tires to grip the road. A beautiful, perfectly engineered, useless masterpiece of an engine.

This is one of the reasons I think that platforms that canvass the views of the people that mostly closely influence the decision-making framework of buy-side investors (i.e., sell-side research) are one of the rare forms of true and defensible edge in our industry. It's also why I think highly of quantitative investors who systematically exploit behavioral biases that continuously creep into both Methods above over time. It's why statistical arbitrage and high-speed trading methods work by focusing on nothing other than how the marginal buyer or seller will implement a change in their views. It's why I think you can make an argument for activist investing on the basis that it takes direct control of both a key fundamental factor and how it is being messaged to market participants. It's also why we're so excited about the Narrative Machine.

But it's also why — despite my biases toward all things technological — I also retain respect for the rare instances of accumulated knowledge and intuition about the drivers of investor behavior. I can add no thoughts or added value concerning the most recent allegations against him, but Lee Cooperman is the best case study I can think of for an investor who gets Method 1. This is a man who defines old school in terms of fundamental analysis. He sits at a marble desk, shelves behind him bedecked with binders of his team's research and Value Line books flanking a recording studio-style window looking out on his trading floor. His process leverages a large team of hungry young analysts in a classic you-propose-I-dispose model. So yes, the fundamental analysis is the centerpiece. But in my opinion what set him and his returns apart was his ability from 50 years in this city, training or working with half of his competitors, to understand how his peers — the marginal buyer and seller — would be thinking about and would respond to what he discovered in his team's fundamental analysis.

Ladies and gents, if you think the savvy kid from the Bronx who gets people in an intuitive sense doesn't occupy a prominent seat at this table, you simply don't know what you're talking about.

©2017 Salient Partners, L.P.
All rights reserved.

But even so, let's daydream. Let's imagine that you are, in fact, Leon-effing-Cooperman in the flesh, with all his skills and experience. But instead of holding his relatively concentrated book, you're holding what you and I probably own or advise for our clients or constituents (or at least should): some form of a balanced and diversified portfolio. Even if you knew that you were good at this one part of the game, would it even matter?

Sadly, not really.

You see, in a typical diversified investor's portfolio, the idiosyncratic characteristics of individual securities — the ones driven by the factors truly unique to that company — are unlikely to represent even a fraction of a fraction of the risk an investor takes.

Consider for example a generalized case where an investor built a portfolio from an index portfolio — say US stocks — and a separate "tracking error" portfolio. This is kind of what we're doing when we select an active manager. Even with relatively robust expectations for tracking error and the unrealistic assumption that all of the tracking error came from idiosyncratic (those unique to that security) sources with no correlation to our equity portfolio, the bets made on individual stocks account for less than 10% of total risk.

Percent of Portfolio Risk from Active Risk

	Portfolio Volatility					
Tracking Error	15%	16%	17%	18%	19%	20%
1%	0.44%	0.39%	0.34%	0.31%	0.28%	0.25%
2%	1.75%	1.54%	1.37%	1.22%	1.10%	0.99%
3%	3.85%	3.40%	3.02%	2.70%	2.43%	2.20%
4%	6.64%	5.88%	5.25%	4.71%	4.24%	3.85%
5%	10.00%	8.90%	7.96%	7.16%	6.48%	5.88%

Source: Salient Partners, L.P., as of 03/31/17

Now think about this in context of our larger portfolio! In practice, most stock discussions take place in context of multi-manager structures or portfolios, in which case the number of stocks will rise and the level of tracking error will fall even further than the above. To take that even further, the majority of the sources of that tracking error will often not be related so much to the individual securities selected by the underlying managers, but a small number of systematic factors that end up looking like equity risk, namely (1) a bias to small cap stocks and (2) a bias toward or away from market volatility.

In the context of any adequately diversified portfolio, stock picks are a Bike Shed. If it is your job in the context of a very large organization to evaluate the impact of active management, you may bristle a bit at this. I remember how I justified it to myself by saying, "Well, I'm only talking about stocks this much because I want to get a picture of how she thinks about investing, and what her process is." That's all well and good, if true. Even so, consider whether the discussion is really allowing you to fully determine whether the advisor or fund manager has an edge under the Methods described above.

For the rest of us, spending time thinking about, discussing and debating your stock picks or those of your advisors is almost certainly a bad use of time, no matter how enjoyable. That's why it sits at #2 on our Code's list of Things that Don't Matter. And if you still think we've given fund managers too much of a pass here, you'll find more to like at #3.

©2017 Salient Partners, L.P.
All rights reserved.

DISCLOSURES

This commentary is being provided to you by individual personnel of Salient Partners, L.P. and affiliates ("Salient") and is provided as general information only and should not be taken as investment advice. The opinions expressed in these materials represent the personal views of the author(s) and do not necessarily represent the opinions of Salient. It is not investment research or a research recommendation, as it does not constitute substantive research or analysis. Any action that you take as a result of information contained in this document is ultimately your responsibility. Salient will not accept liability for any loss or damage, including without limitation to any loss of profit, which may arise directly or indirectly from use of or reliance on such information. Consult your investment advisor before making any investment decisions. It must be noted, that no one can accurately predict the future of the market with certainty or guarantee future investment performance. Past performance is not a guarantee of future results.

Statements in this communication are forward-looking statements.

The forward-looking statements and other views expressed herein are as of the date of this publication. Actual future results or occurrences may differ significantly from those anticipated in any forward-looking statements, and there is no guarantee that any predictions will come to pass. The views expressed herein are subject to change at any time, due to numerous market and other factors. Salient disclaims any obligation to update publicly or revise any forward-looking statements or views expressed herein.

This information is neither an offer to sell nor a solicitation of any offer to buy any securities. Any offering or solicitation will be made only to eligible investors and pursuant to any applicable Private Placement Memorandum and other governing documents, all of which must be read in their entirety.

Salient commentary has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. Salient recommends that investors independently evaluate particular investments and strategies, and encourage investors to seek the advice of a financial advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

Epsilon Theory commentary is a copyright of Salient Partners, L.P., all rights reserved. *Epsilon Theory* commentary is provided by individual personnel of Salient Partners, L.P., and is not a service of, and does not reflect the opinions of, any of Salient Partners, L.P.'s subsidiaries or affiliates.