Salient

Epsilon Theory

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"You Had One Job"

Lots more where this came from on [you-had-one-job.com](you-had-one-job.com). Of course I think these pix and this meme are hilarious. But then I start to think about whether or not alternative investment strategies have done their job. I start to think about what that job is. And I go hmmm …

Whenever you are about to find fault with someone, ask yourself the following question: What fault of mine most nearly resembles the one I am about to criticize?
— Marcus Aurelius, "Meditations" (180 AD)

Cesar Millan, dog whisperer. The show can be silly, but I'm a fan. If you want to boil his advice down into one phrase, it's this: *every dog needs a job.*

It's true for the pack, and it's true for the portfolio.

I know he doesn't look like much, but Karnak is the most powerful superhero of them all. His ability? To see the flaw in all things. That includes death and philosophies. That includes himself. When he's not begrudgingly saving the world, Karnak spends most of his time staring at blocks of stone.

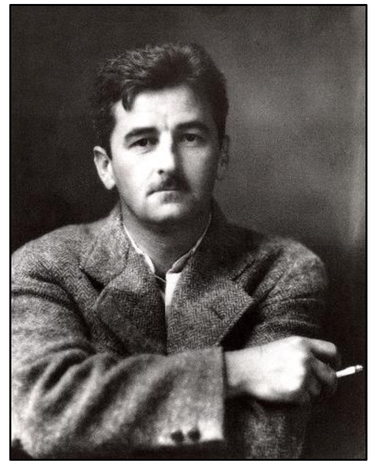
One of Karnak's flaws is that he can't lead. No one follows a man who sees exactly what's wrong with you. But he'd make a great short-seller.

Again. Sadder than was. Again. Saddest of all. Again.
— William Faulkner, "The Sound and the Fury" (1929)

How often have I lain beneath rain on a strange roof, thinking of home.
— William Faulkner, "As I Lay Dying" (1930)

Memory believes before knowing remembers.
— William Faulkner, "Light in August" (1932)

The past is never dead. It's not even past.
— William Faulkner, "Requiem for a Nun" (1951)



A Great Rabbi stands, teaching in the marketplace. It happens that a husband finds proof that morning of his wife's adultery, and a mob carries her to the marketplace to stone her to death.

There is a familiar version of this story, but a friend of mine — a Speaker for the Dead — has told me of two other Rabbis that faced the same situation. Those are the ones I'm going to tell you.

The Rabbi walks forward and stands beside the woman. Out of respect for him the mob forbears and waits with the stones heavy in their hands. 'Is there any man here,' he says to them, 'who has not desired another man's wife, another woman's husband?'

They murmur and say, 'We all know the desire, but Rabbi none of us has acted on it.'

The Rabbi says, 'Then kneel down and give thanks that God has made you strong.' He takes the woman by the hand and leads her out of the market. Just before he lets her go, he whispers to her, 'Tell the Lord Magistrate who saved his mistress, then he'll know I am his loyal servant.'

So the woman lives because the community is too corrupt to protect itself from disorder.

Another Rabbi. Another city. He goes to her and stops the mob as in the other story and says, 'Which of you is without sin? Let him cast the first stone.'

The people are abashed, and they forget their unity of purpose in the memory of their own individual sins. 'Someday,' they think, 'I may be like this woman. And I'll hope for forgiveness and another chance. I should treat her as I wish to be treated.'

As they opened their hands and let their stones fall to the ground, the Rabbi picks up one of the fallen stones, lifts it high over the woman's head and throws it straight down with all his might. It crushes her skull and dashes her brain among the cobblestones. 'Nor am I without sins,' he says to the people, 'but if we allow only perfect people to enforce the law, the law will soon be dead — and our city with it.'

So the woman died because her community was too rigid to endure her deviance.

The famous version of this story is noteworthy because it is so startlingly rare in our experience. Most communities lurch between decay and rigor mortis and when they veer too far they die. Only one Rabbi dared to expect of us such a perfect balance that we could preserve the law and still forgive the deviation.

So of course, we killed him.

- San Angelo, "Letters to an Incipient Heretic"
— Orson Scott Card, "Speaker for the Dead" (1986)

It takes a village to manage a portfolio. Or a country. Discipline to maintain process. Flexibility to tolerate deviance … err, I mean tracking error. We need better Rabbis. Who we don't kill.

In *all* cases, not only in the two which we have analyzed, recovery came of itself. But this is not all: our analysis leads us to believe that recovery is sound only if it does come of itself. For any revival which is merely due to artificial stimulus leaves part of the work of depressions undone and adds, to an undigested remnant of maladjustment, new maladjustment of its own which has to be liquidated in turn, thus threatening business with another crisis ahead. *Particularly, our story provides a presumption against remedial measures which work through money and credit.* For the trouble is fundamentally not with money and credit, and policies of this class are particularly apt to keep up, and add to, maladjustment, and to produce additional trouble in the future.

— Joseph Schumpeter, "Depressions: Can we learn from past experience" (1934)

Schumpeter famously wrote that his personal goals were to be the smartest economist in Europe, the finest horseman in Austria, and the most accomplished lover in Vienna. He judged these to be equally difficult and equally praiseworthy achievements. I think he overrated the whole economist thing.

Marsellus: The thing is, Butch, right now you got ability. But painful as it may be, ability don't last. And your days are just about over. Now that's a hard motherfn' fact of life, but that's a fact of life you're gonna have to get realistic about. See, this business is filled to the brim with unrealistic motherf'rs. Motherf'rs who thought their ass would age like wine. If you mean it turns to vinegar, it does. If you mean it gets better with age, it don't. Besides, Butch, how many fights do you think you got in you anyhow? Two? Boxers don't have an Old Timers Place. You came close but you never made it. And if you were gonna make it, you would have made it before now. [*holds out the envelope of cash just out of Butch's reach*] You're mine, dig?

Butch: It certainly appears so.

— "Pulp Fiction" (1994)

Like boxing and organized crime, our business is filled to the brim with unrealistic motherf'rs.
This is the line that haunts me: if you were gonna make it, you would have made it before now.

The Hunt family has three dogs, each with a distinct job. The German Shephard's job is to protect. The Sheltie's job is to herd. The Golden's job is to love. Each dog is very good at its job, sometimes in an annoying way (particularly the Sheltie), but they're oh-so happy with what they do well, and it fits our entire family dynamic. There are sacrifices we make for having this particular pack, like we can't have any other dogs drop in for a visit or else the German Shephard might eat them, but the positives far outweigh the negatives. We're a solid pack, and there's nothing quite like that feeling of knowing that the dogs are there for you and you for them, and that the entire Hunt family — human and dog alike — is stronger not just in fact but in spirit for giving ourselves over to the pack.

It's the same with investment portfolios. Every dog needs a job, and every investment does, too. No single dog can be all things to all people, and neither can a single investment. Nor can any pack of dogs accomplish anything and everything you like. **The biggest mistake people make when they get a dog is trying to make the dog fit into the life they *wish* they led, rather than the life they *actually* lead.** You better know thyself before you get a dog, much less a couple of dogs, and it's exactly the same thing with making an investment. But if you get it right … man, there's nothing better. Like a confident pack, a confident portfolio provides both strength in fact, as well as — and this is the part I bet you're missing right now and the focus of this note — strength in spirit.

In my experience, most people don't particularly like their portfolios, much less get a lift from them. They tolerate their portfolios. They may be pleased enough with the performance, but they don't get a psychic boost from their portfolios. They don't enjoy the confidence and strength of spirit that a solid pack or a solid portfolio can provide. And before you say that this really doesn't matter to you, that so long as your portfolio performs up to a certain standard you couldn't really care less whether it provides any "psychic strength" or any such mumbo-jumbo hogwash, let me stop you to say that you're not just wrong, you're completely wrong. In truth, the *only* thing that matters to you about your portfolio is its psychic reward, the positive way it makes you *feel*.

Now don't misunderstand me. Performance is part of that psychic reward, usually the biggest part. But in the same way that the Economic Machine is part of a larger social phenomenon that I call the Narrative Machine, in the same way that Newtonian physics is part of a larger set of natural laws called Einsteinian physics, in the same way that Game Theory is part of a larger intellectual construct called Information Theory, so is "performance enjoyment" part of a larger behavioral attitude toward our portfolios. I first wrote about all this in *Epsilon Theory* with "It's Not About the Nail" and "It's (Still) Not About the Nail", and it's high time I picked up on this thread as part of the current "Anthem!" series.

The place where I see the greatest dissatisfaction or lack of spirit in most portfolios is in the allocation to alternative strategies. Most model portfolios that come down from on high at the big wealth management firms suggest that alternative strategies should be anywhere from 10-20% of a portfolio. But in fact most actual portfolios for actual clients have a small fraction of the recommended allocation, say 3-4% at most. Why the disconnect?

To answer that question, let me start by telling you what the answer is not. The answer is NOT that financial advisors or professional investors need more "education" about the virtues of an alternatives-heavy portfolio. I think that this focus on "education" is the single most tone-deaf and semi-condescending aspect of the business of modern investment management, which I suppose is a pretty bold statement given the sheer number of tone-deaf and semi-condescending things in our line of work. But there you go. I see it every day. Another email, another webinar, another white paper, another earnest effort to "educate" financial advisors about alternatives, with, let's be honest, the unspoken implication that you are kinda stupid if you don't have a heaping plate of alternatives in your portfolio.

It's not that any of these "educational" efforts are wrong. They speak the truth, albeit a bloodless, overly scientificized truth. But the truth is *also* that financial advisors have had a poor experience with alternative investment strategies, and once burned twice shy. Why burned? Because A) they've been *pushed* onto financial advisors as some sort of wonder dog that can be all things to all portfolios, and B) they've been *pulled* into portfolios by financial advisors who were thinking more about the portfolio and clients that they *wish* they had rather than the portfolio and clients that they *actually* have.

I'm not going to spend a lot of time on point A because it's obviously egregious and I see this changing for the better in my conversations with financial advisors. They are still inundated with semi-condescending "educational" materials from every possible source, but at least the content of those materials today is a lot more even-handed about the specific job that alternative strategies can perform in a portfolio, as opposed to promising the investment equivalent of Scrappy Doo, Scooby's far more competent crime-fighting nephew. Pro tip: if you're offered a walking, talking dog to fill out your pack, you should hold onto your wallet.

It's point B that I think is a bit less obvious and one that needs more explication. Basically I think what's happened is that a lot of financial advisors and serious investors believe they know the job that alternatives can help provide for a portfolio — diversification — and they really want that for their portfolio. But they set themselves up for failure, *where the alternative strategies in their portfolio don't FEEL satisfying even if the performance is okay*, in two important ways.

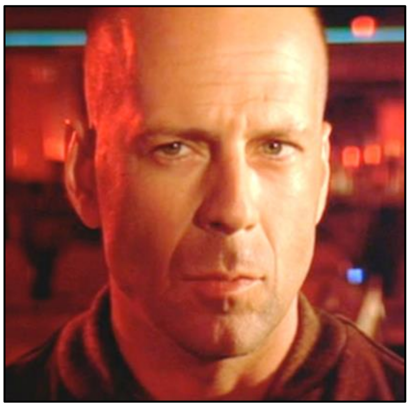
First, they're mistaking a quality of the portfolio — diversification — for a job of an individual investment. Asking an investment to provide diversification is like asking a dog to provide pack stability. It's just not within their power to do this. Portfolio diversification and pack stability *emerge* from the proper organization and job assignment of the individual members of the portfolio or pack, not the other way around. If someone tells you that their alternative strategy is "a diversifier", your question should be "Relative to what?" if you're in a generous mood, something a little more snippy if you're not. The question you need answered is what job does the strategy perform in your portfolio. How should I expect it to behave under what conditions? Then you can decide for yourself how that job fits with the other jobs your other investments are doing. Then you can evaluate this potential new member of your pack in a *non-alienated* fashion, focusing on its fit within the whole rather than its standalone attributes.

Second, they're judging this alternative strategy versus that alternative strategy on the basis of standalone historical performance, *alienated* from the psychological meaning that the overall portfolio composition — the pack — plays in their client's or their own life. Alternative strategies in this conception are a line item in the portfolio, a tasty-looking dish that one orders from a 10-page diner menu, a beautiful exotic dog breed that one reads about in *The New York Times Style Magazine*.

Odds are that you'll be disappointed with that exotic dog, through no fault of the dog and actually, through no fault of yours. Odds are that you'll be disappointed with that fancy alternative strategy, similarly through no fault of the strategy or you. Why? Because human rationality is based on *Bayesian decision-making*, a $10 phrase that means we make up our minds as we go along and new information comes our way. Maybe that dog is, in truth, perfect for you and your life. But maybe it's not. I mean, you got all excited about the breed from an article you read in the *NYT Style Magazine*. Are you crazy? Maybe that alternative strategy is a perfect diversifying complement for your portfolio. But maybe it's not. I mean, you got all excited about the fund because the manager sounded really smart. Really? Did you really make THAT mistake again?

My point is that we start any standalone investment from a position of self-doubt, and from a Bayesian perspective it takes a lot of evidence before we come to any conclusion as to whether we made a good original decision or not. Even then our conclusions are never final or definitive in a Bayesian approach, because there's always a chance that new information will come to light that shifts our opinion. **Moreover,**

the qualities of portfolio diversification and pack stability take quite a bit of time to emerge. If you think you see these qualities right off the bat, or conversely you think you see something that shows this is a disaster, you're usually mistaken. In fact, with both dogs and alternative investment strategies, by the time you've received enough information to judge for sure whether or not you've actually got a "good one" or a "bad one", it's almost always too late to make a switch or do anything differently about it. Put it all together, and we stay in this position of self-doubt on an effectively permanent basis.



It's what I call The Curse of (Some) Talent, and it's one of the most pernicious aspects not only of investing, but of the human condition. It's embodied in Butch, the Bruce Willis character in *Pulp Fiction*, a boxer who's a pretty good fighter but is now getting a little long in the tooth. As Marsellus Wallace, the crime boss who bribes Butch to take a dive, says, "if you were gonna make it, you would have made it before now." Butch has (some) talent, enough to become a professional fighter. But he doesn't have enough talent to really succeed, to really make it big. I recognize Butch in myself, which is what makes this scene so haunting. Here I am, 52 years old, sitting in a hotel room far away from home on another business trip, writing this note. If I was gonna make it, wouldn't I have made it before now? I recognize Butch in all the really smart portfolio managers I know, each of whom runs what seems like a really interesting strategy that for whatever reason hasn't made them a Master of the Universe. If they were gonna make it, wouldn't they have made it before now? Clearly they have (some) talent. Do they have enough to be an individual star? And if that's what I need from them or if that's how I'm evaluating them, then how in the world do I muster up the confidence to take the chance that they do? How in the world do I maintain the confidence to keep them in my portfolio when the winds of chance blow against me or them, something that will *always* happen at some point?

I think that most financial advisors or serious investors know exactly what I'm talking about here, and this is why most of them are waaaay under-allocated to what investment "science" and their model portfolios and their own voices inside their heads tell them should be their "proper" allocation to alternative strategies. **If we're evaluating these strategies on a standalone, line-item basis, plagued by the self-doubt inherent in Bayesian decision-making and the other-doubt inherent in the Curse of (Some) Talent, then the mystery isn't why current allocations to alternatives are so low at 3-4%, but why they're so high!**

So here's what I think is a better way to think about portfolio construction, one that puts not only alternative strategies but ALL strategies in their proper place, which is in service to the pack. That's your responsibility, too, by the way. The pack always comes first.

Step One. Every investment in the portfolio must have a job, meaning that we expect each investment to do certain things under certain circumstances. *This means that we have to imagine what those future circumstances might be.* Here are two scenarios that I think we should wrestle with.

1) The Long Gray Slog: a continuation of the current investment status quo, where central banks continue to squelch the volatility out of markets in their continuing efforts to turn markets and the entire macro-economy into political utilities. Business cycles and bear markets are effectively outlawed, but the imposition of a floor also imposes a ceiling. It's 1% GDP growth and zero on your savings and flat to slightly up markets just as far as the eye can see.
2) Fire & Ice: a political event that sets the global economy on a new deflationary leg down, which in turn creates a global credit freeze and liquidity concerns at systemically important European banks. This is Ice. But central banks of the modern ilk refuse to back down, unleashing a wave of bank nationalizations, negative interest rates, and helicopter money drops of various sorts, all designed to force asset prices higher by sheer dint of printing and distributing vast quantities of fiat currencies. This is Fire. You don't get the Fire without the Ice, and I need strategies that can survive both.

Step Two: Now that we've identified the scenarios we think we might face, we need to figure out what sort of portfolio can survive or thrive under these circumstances. How do we do that? By immersing ourselves in the *stories* of investors who survived and thrived during Long Gray Slogs or Fire & Ice scenarios of the past. By developing a sense of *empathy* for what it felt like to invest during, say, the 1930s or the 1970s or (for the younger crowd) the 2000s. This is how we figure out what sort of pack supports the life we want to live when confronted by these circumstances. This is how we figure out what strategies — in complement with each other — can create that pack with strength of spirit as well as strength of performance.

We gain this sense of empathy in two ways. We talk to old-timers (for much of my audience, that's anyone older than 40), and we read. We read a lot. We read biographies. We read memoirs. We read old newspapers and old magazines, as much primary material as we can. We read and we talk, not in the modern cynical way of gotcha and tsk-tsk and eye-roll, but in older ways of trying to understand the WHY and the FEEL, not just the WHAT and the FACT. It's a Faulknerian effort of trying to understand the past on a visceral level, such that it's part of the living us and not "the past" at all. Empathy means putting yourself in someone else's shoes, and it's one of the hardest, least taught skills in the modern age of narcissism and self-absorption. But it's also one of the most important. I hire history majors.

What strategies have I found that perform specific, useful jobs in these scenarios? Keep in mind that this is for a portfolio that works for me and my family and the life we've chosen. We're not like everyone. We live out in the woods in Fairfield County, CT. We homeschool our kids. We have sheep and goats and horses. Your kids will have a blast when they visit, but if you bring over your dog, it might be killed by our dogs. Just kidding on that last one. Kind of.

On the Long Gray Slog side, for me it's basically what's worked for the last several years, strategies that either harvest global betas in a cheap, efficient, preferably volatility-controlled way, or strategies that "play the player" in a trend-following or discretionary way. Especially the discretionary stuff, but then again I'm a discretionary global macro kind of guy. That's who I am. Also, in a more or less permanently low growth world, any sort of secular growth and real cash flows from real economic activity is something to be treasured. See my "Hobson's Choice" and "Cat's Cradle" notes for more.

The Fire & Ice scenario is perhaps a little more contentious, but only because we've been living so completely in the Long Gray Slog for the past few years. My take on Fire & Ice is pretty simple. I want as close to direct ownership as possible of real assets with real cash flows. My definition of real assets is pretty broad, including not just the obvious choices like infrastructure and real estate, but also intellectual property and gold. Yes, I know that gold doesn't have intrinsic cash flows. Neither does an insurance policy (which is what gold is against central bank error), and I like insurance. A lot of people are fans of Bitcoin and other cryptocurrencies for a Fire & Ice scenario. I'm not (you can read my views here). Basically I'm looking for maximum resiliency, what Nassim Taleb would call antifragile, in the jobs I want my portfolio holdings to perform in a Fire & Ice scenario. And remember, in my scenario, Fire comes last and it can go on and on. Bond holders beware. This is where the right discretionary calls on global macro, particularly on the short side where you get the timing right on long-volatility bets, can make a career. This is when you want Karnak on your team.

As an aside … well, not so much of an aside, because it's central to the *Epsilon Theory* effort … this embrace of empathy and the true lessons of the past is exactly what our central bankers are NOT doing. I put a long quote by Joseph Schumpeter at the start of the note just to show that there have been some other really smart people in the past who suffered through really similar macro-economic situations and looked carefully at empirical evidence and came to diametrically opposed conclusions on what monetary policy should and shouldn't do as a response. What we are told today is the Truth with a capital T in regards to monetary policy is nothing of the sort. It's a particular sort of truth, an *ex cathedra* pronouncement by cultists like Ben Bernanke and his academic acolytes, cherrypicking historical data about the U.S. in the '30s or Japan in the '90s that fits their tautological world view and rejecting the rest, brooking no dissent.

It's a mongrel pack of policies that provides neither strength in fact nor strength in spirit to the citizens it's supposed to support and protect. That's a lot of mixed metaphors, but you get my point. And my disgust. Just remember that Greenspan used to be lauded as a hero, too. Today not so much. Today he's the man who knew, as in the man who knew better. Okay, rant concluded for today.

Step Three: So I know what sort of portfolio I want for the sort of future scenarios I might encounter. I know what jobs I need filled in that portfolio and I've got a sense of the strategies that can best do those jobs. Now how do I choose between specific strategies or managers or what have you? How do I avoid that whole Curse of (Some) Talent thing? Here's what I'm not doing. I'm not evaluating historical track records, projecting those into the future in some sort of crystal ball, capital markets return prediction effort, and then rolling those individual calculations up into some aggregate portfolio projection. I think that's nuts. Instead, I'm asking whether the manager has a clear idea of what makes the strategy work (or not). What is the job that the manager performs and under what conditions does he or she perform it? Then I evaluate those claims in a Bayesian way. The most important evidence: did the manager do this job before? As advertised and for realz, not in a backtest. What was the investor experience within that prior job performance? How did it *feel*? Almost as important from a Bayesian perspective, does the manager have a stable, visible process? Does the process impose a discipline of sticking to the principles of the strategy come hell or high water, while also handling uncertainty and deviation in a calm and intellectually rigorous way? That's how I judge real talent, the talent that ultimately matters most, in others and in myself. Fortune is fickle, even for the most talented. Experience and process never is.

The hardest part about Step Three is saying no to a talented manager, a good Rabbi for the strategy he administers, because the strategy doesn't do the required job for the portfolio you actually have, as opposed to the portfolio you wish you had. In truth, that's the hardest part about this entire process, the monomaniacal focus on what's best for the portfolio as a whole, given the challenges it might face in the future. But in the same way that we require (or should require) discipline in our managers, we should absolutely require that discipline in ourselves as financial advisors or serious investors. It's what creates a confident client/advisor relationship, it's what creates a confident investor/manager relationship, it's what turns any collection of individuals, man or beast, into a well-functioning pack.

Ultimately, that's what we're after here. **The protection of the pack.** It's been the human animal's source of strength, in both fact and spirit, for a couple of hundred thousand years now. I think we're going to need it over the next few years, too.

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