"The Name of the Rose"

If names be not correct, language is not in accordance with the truth of things.

— *Confucius, "The Analects of Confucius" (551 - 479 BC)*

Give me a lever long enough and a fulcrum on which to place it, and I shall move the world.

— *Archimedes (287 - 212 BC)*

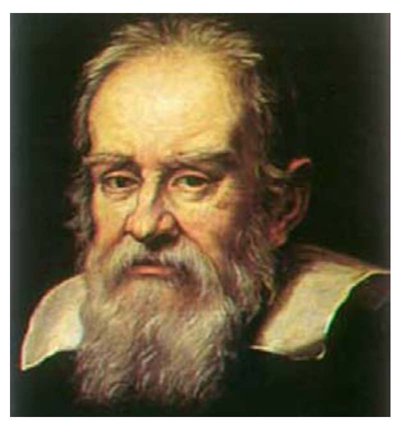
Call him Voldemort, Harry. Always use the proper name for things. Fear of a name increases fear of the thing itself.

— *J.K. Rowling, "Harry Potter and the Sorcerer's Stone" (1997)*

Do you know why hurricanes have names instead of numbers? To keep the killing personal. No one cares about a bunch of people killed by a number. '200 Dead as Number Three Slams Ashore' is not nearly as interesting a headline as 'Charlie kills 200.' Death is much more satisfying and entertaining if you personalize it.

Me, I'm still waitin' for Hurricane Ed. Old Ed wouldn't hurt ya, would he? Sounds kinda friendly. 'Hell no, we ain't evacuatin'. Ed's comin'!

— *George Carlin, "Brain Droppings" (1998)*

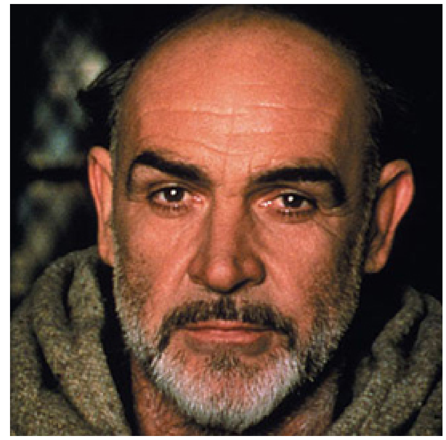


I have been pronounced by the Holy Office to be vehemently suspected of heresy, that is to say, of having held and believed that the Sun is the center of the world and immovable, and that the earth is not the center and moves.

Therefore, desiring to remove from the minds of your Eminences, and of all faithful Christians, this vehement suspicion, justly conceived against me, with sincere heart and unfeigned faith I abjure, curse, and detest the aforesaid errors and heresies, … and I swear that in the future I will never again say or assert, verbally or in writing, anything that might furnish occasion for a similar suspicion regarding me.

— *Galileo Galilei (1564 – 1642)*

William of Baskerville: I, too, was an Inquisitor, but in the early days, when the Inquisition strove to guide, not to punish. And once I had to preside at a trial of a man whose only crime was to have translated a Greek book that conflicted with the Holy Scriptures. Bernardo Gui wanted him condemned as a heretic; I … acquitted the man. Then Bernardo Gui accused *me* of heresy, for having defended him. I appealed to the Pope. I … I was put in prison, tortured, and ... and I recanted.



Adso of Melk: What happened then?

William of Baskerville: The man was burned at the stake and I am still alive.

— *"The Name of the Rose" (1986)*

Adso of Melk: And what was the word you both kept mentioning?

William of Baskerville: ***Penitenziagite*.**

Adso of Melk: What does it mean?

William of Baskerville: It means that the hunchback undoubtedly was once a heretic. ***Penitenziagite*** was a rallying cry of the Dolcinites.

Adso of Melk: Dolcinites? Who were they, master?

William of Baskerville: Those who believed in the poverty of Christ.

Adso of Melk: So do we Franciscans.

William of Baskerville: But they also declared that everyone must be poor, so they slaughtered the rich. Ha! You see, Adso, the step between ecstatic vision and sinful frenzy is all too brief.

— *"The Name of the Rose" (1986)*

Every battle against heresy wants only this: to keep the leper as he is.

— *Umberto Eco, "The Name of the Rose" (1980)*

"The Name of the Rose" was an under-rated movie in the mid-1980's with an in-his-prime Sean Connery and a young Christian Slater (not to mention some great scene-stealing by Ron Perlman), based on an under-rated novel by one of my favorite authors, Umberto Eco. To be sure, Eco is prone to the occasional bout of overwrought ego-stoking prose (but aren't we all!), and my take on "The Name of the Rose" is that while Eco intended it as a work of great literature masquerading as a murder mystery, it's really a great murder mystery masquerading as literature. But as a highly entertaining yet wise examination of the power of ideas, the implacable opposition of status quo institutions to "heresy", and the role of language in that struggle, "The Name of the Rose" has no equal in my library.

I thought of Eco's book last week when I read the WSJ's breathless article about the San Diego County pension fund (SDCERA), Salient Partners, and the use of … gasp! … "leverage" and "derivatives" as part of Salient's recommended allocation strategy. In terms of public Narrative, the words "leverage" and "derivative" have become so mushy and ill-used that they have lost almost all meaning except as a weapon, as a tool to cast doubt on someone's motives, competency, and ethics. It's the modern equivalent of accusing someone of witchcraft or heresy, and it's what status quo institutions and their apologists have done for centuries with insurgent ideas. They use language – or rather, *they intentionally misuse language* – to paint the insurgent idea as heretical. It's like Dana Carvey's Church Lady interviewing someone on *Saturday Night Live*, only with the tagline shifted from "Could it be … Satan?" to "Could it be … Leverage?".

Anyone with public accountability or transparency bears the brunt of this linguistic warfare, particularly the investment board or staff of any public pension plan. In my experience these are almost always very smart people who are "there for the right reasons" to use the catch-phrase of "The Bachelorette". But like William of Baskerville, they find themselves in an untenable position, where even considering an unorthodox idea, much less defending it, is cause for public attack, ridicule, and excommunication. At least being raked over the coals today is a figurative rather than literal punishment, but frankly I think I might prefer the latter.

Modern torture-by-comment may be more psychological than physical, but it's no less vicious, and it's growing exponentially in power and scope. How many of you, like me, go straight to the comment area of an ESPN article? It's not that I care at all what any single commenter says about Johnny Manziel or Tim Tebow, but I am *fascinated* by the outpouring of effort, the tens of thousands of voices who apparently believe that others really do care about their opinion. It's entertainment for me. But imagine that you're the target of this outpouring of know-nothing vitriol, that you're a pension board member who hears a virtual mob saying that you're obviously either an idiot or a criminal to use "leverage" – *whatever that means* – in your investment strategy. **It is very difficult to maintain the courage of your convictions or even an open mind to consider new ideas under the onslaught of this modern day Inquisition, and that's the real damage that's done here**. William of Baskerville recanted. Galileo recanted. And we expect anything more from public pension officials than CYA?

The unfortunate truth in all this is that, as Eco wrote, "every battle against heresy wants only this: to keep the leper as he is." **There are many status quo institutions – particularly political institutions like parties and media institutions like newspapers, but also more than a few large market institutions – who are *delighted* to keep public pension funds in this perpetual state of retributive fear and defensive under-performance.** It has nothing to do with "keeping them honest" or whatever other bromide is trotted out for public consumption. It has everything to do with maintaining a mute whipping boy for political or economic gain.

This is why newspaper hacks and political wannabes all over the country lick their chops whenever some new idea is proposed by a public agency, whether it's a local zoning board in a small town or a multi-billion dollar pension investment board. There is zero downside to making these attacks, no matter how simple-minded or misleading. The target is usually defenseless. The political upside is usually significant. And the economic beneficiaries, of course, other than the stalwart media defenders of orthodoxy, are the entrenched financial service providers.

We're all familiar with the *Indiana Jones* knife fight, where a fierce turbaned warrior dressed all in black challenges Harrison Ford with his sword, only for Ford to pull out his gun and shoot the guy cold. **Our current political and media system forces public pension funds into the turbaned warrior role.** They are competing directly with the most advanced institutional investment firms in the world, firms that have an arsenal of weapons at their disposal. But God forbid that a public pension fund use "leverage" – again, *whatever that means* – in its investment strategy. Oh no, can't have that. Better to fail conventionally than to succeed unconventionally. Better to arm yourself with that simple sword and be gunned down before the fight even starts.

Enough. Leverage and derivatives are not inherently demonic and aren't exclusively the purview of dark wizards. If you say the words out loud I promise you won't call forth a horde of Deatheaters.

Can leverage, however defined, be used in Voldemort-ian fashion for evil rather than good? Of course. As Eco writes in one of my favorite quotes, "the step between ecstatic vision and sinful frenzy is all too brief", and as a risk manager that's certainly something I watch for in any strategy or any investment manager. Can derivatives, however defined, be used as "financial weapons of mass destruction", to quote Warren Buffett? You bet, although I find this quote mighty odd for a guy who wrote close to $15 *billion* of equity index puts and credit default swaps in 2006 to help fund Berkshire Hathaway. It all depends on what actual activity is being described by the words "leverage" and "derivatives". **It all depends on calling things by their proper names**. To use the same word – "derivative" – for both exchange-traded futures in gigantically deep markets *and* a bespoke swap on some highly structured mortgage securitization is ludicrous, but that's exactly what the modern Inquisition does intentionally for its own political and economic interests.

Properly understood – which means properly named – many common uses of leverage and derivatives aren't that scary. They're also not inherently instruments of risk creation. On the contrary – and this is the entire point of the risk-balancing "heresy" within the public pension world – **using leverage and derivatives wisely can reduce the risk of an unlevered portfolio without reducing its long-term potential return or conversely may increase the long-term potential return of the portfolio without increasing its risk.**

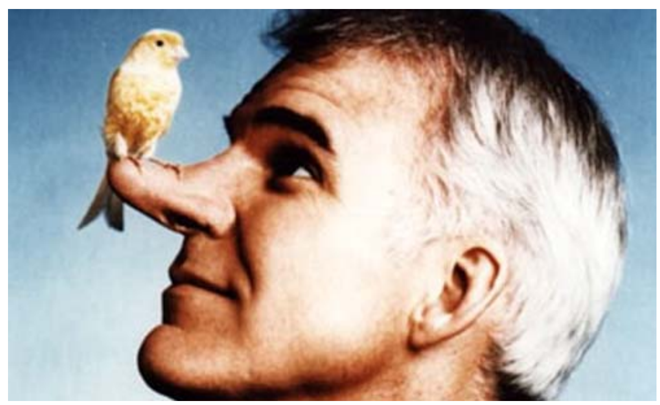
How? By using the age-old investment idea of **balance**, of not putting all of your eggs in one basket like the stock market. A risk-balancing strategy argues that you should put your money into multiple baskets – stocks, corporate bonds, commodities, and government bonds – and that you should balance between those baskets on the basis of historical risk, not simple dollar amounts. Also, most risk-balancing strategies have some mechanism to *adapt* to changing market conditions by letting the market tell you when something is working or not working. There, that's it. Pretty scary, huh?

But you can't execute a risk-balancing strategy without using leverage (properly defined) and derivatives (properly defined). Three reasons. First, to be adaptive you need to be quick on your feet. Not millisecond fast, but one or two days fast. With the massive amounts of money that pension funds invest today, it's impossible to be sufficiently nimble if you're locked into individual stocks and bonds. Second, if you want to put some of your investment eggs into the commodity basket, you have to use leverage and derivatives because that's the only way to control them directly. Third, to balance out the risk between the baskets, as opposed to simply the dollars, you're going to need to control a lot more dollars in your bond baskets than in the stock basket. Why? Because the historical risk to bonds, particularly government bonds, is so much less than the historical risk to stocks. To get an equivalent amount of risk you either have to get rid of almost all of your stocks, which would be a mathematically correct but financially ill-advised solution, or you have to control a lot more bonds. I think it's wise to choose the latter … with limits, within reason, and constantly adapting to changing market conditions.

What a risk-balancing strategy means by "leverage" is the same as Archimedes meant the word 2,500 years ago, or that generals on the battlefield mean the word today: it's controlling a lot with a little by using a force multiplier. It's not borrowed money. It's not "doubling down" or "turbo-charging" or whatever other misleading phrase your local genius columnist or comment troll throws out there as Gospel. It's buying an exchange-traded, liquid contract that controls a lot of stocks or bonds or commodities for a little bit of money for a defined amount of time. These contracts are necessary because they are by far the most effective way of implementing what I think is an important new twist on an important old idea – balance your investments across several different asset baskets, but balance by risk (not dollars) and adapt to a changing market.

Does the use of leverage (properly defined) and derivatives (properly defined) create trading risks that wouldn't be there if you just bought the Vanguard 60/40 fund and called it a day? Sure. **But I believe risk-balancing strategies mitigate far more dangerous risks to a public pension portfolio – particularly an over-reliance on equity markets.** Public pensions are complex entities whose liability structures are often many times greater than the size of their investment portfolios. The common practice to resolve this dilemma has been to pursue an equity-dominated asset structure that has greater chances of achieving the required return to make the entire structure work. **The problem is that equities are themselves leveraged, but it's hidden leverage and thus hidden risk.**

What does this mean, to say that equities embody hidden leverage? It means that the assets of S&P 500 operating companies are nearly five times as large as the equity that finances them. It means that, by definition, the gulf between assets and equity can only be bridged by various forms of leverage. This is the alchemy that transformed a paltry 3.27% return-on-assets for S&P 500 operating companies in 2013 to an impressive 15.01% return-on-equity.[1] For all the equity enthusiasts out there who shake their heads and tut-tut the idea of a few turns of leverage on a liquid portfolio of government bonds, I'd ask why you're so confident in a 5x equity leverage on the 3.27% unlevered ROA of the S&P 500, but so fearful of, say, a 2x leverage on the 3.44% average interest paid on 30-year government bonds. That's not a slam on equities. I love equities. Nor is it to say that there's no risk in government bonds. My point is simply that as an investor you *must* take risk to achieve a return that is higher than the risk-free rate. There is no way around this, no free lunch, no way to get something for nothing. The question, at least for an investor like most public pensions, is not how to eliminate risk. **The relevant questions are: do you know what risks exist in your portfolio, and which of these risks do you want to embrace?**



Maybe you just don't like a risk-balancing allocation strategy, for whatever reason. That's fine. Or maybe you have a concern or an objection to the strategy or its implementation. That's fine, too, and believe me, there are plenty of reasonable concerns you could raise or I could raise about ANY investment strategy. But don't just shout out "Leverage!" as if it were a self-evident condemnation of the strategy or its adopters. It's like the scene in Steve Martin's wonderful movie *Roxanne*, where a heckler in a crowded bar shouts out "Big nose!". Martin's response? He's insulted by the triviality of the insult, and proceeds to whip out 20 superior insults that the heckler could have made (my personal fave – "Obscure: whoa! I'd hate to see the grindstone."). In this case, I would suggest "Looming: if you thought your leverage and derivative exposures were big, just wait till you see your liabilities." or "Clairvoyant: if you're so smart, why use diversification at all?".

[1] Sources: Bloomberg, Standard & Poors, August 2014.

I'll close with two quotes from Will Rogers, who not only never met a man he didn't like but also had an amazing knack for communicating advanced investment insights without resorting to three syllable words or mathematical equations.

You've got to go out on a limb sometimes because that's where the fruit is.

Don't gamble; take all your savings and buy some good stock and hold it till it goes up, then sell it. If it don't go up, don't buy it.

— *Will Rogers (1879 – 1935)*

I love these quotes because they encapsulate **why** Salient recommends a risk-balancing core allocation strategy. We want to embrace risk as an ally rather than treat it as the Great Satan. We do it for the same reason, as Will Rogers said, that you go out on a limb. Because that's where the fruit is. Risk and reward are entirely inseparable. They are two sides of an unsplittable coin, and you can't have one without the other. But you need to think about that relationship between risk and reward smartly. More importantly, you need to think about that relationship *wisely*. What's the difference? Smart thinks that he can model the future. Wise knows that she doesn't know what the future holds. Smart is intellectually sharp. Wise is intellectually honest.

Being wise about risk and reward means you don't claim to own a magical crystal ball that predicts where risk will be low and reward will be high in the future. It means being intellectually honest enough to say that you don't know. That's the hardest thing in the investment world to admit, because there is no shortage of smart people who will tell you that they have just such a crystal ball. And maybe they're right. If you have that crystal ball or you know someone who does … if you are able, as Will Rogers advised, to avoid buying stocks that don't go up in the future … then you don't need a risk balancing strategy. Otherwise, let's have a conversation, or at least listen in by reading Epsilon Theory.

I'm not suggesting that we have a monopoly on new ideas for investing – we don't – or that our ideas are right for everyone – they're not. But we believe we are part of an insurgent movement to change the way investors think about asset allocation, and we are buoyed by a consistent lesson from history. The struggle between status quo and insurgent ideas can take a long time and it's never an easy road for the truth-seekers caught in the middle, but eventually **… the Inquisition always loses.**

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