"Rounders"

Mike McDermott: In "Confessions of a Winning Poker Player," Jack King said, "Few players recall big pots they have won, strange as it seems, but every player can remember with remarkable accuracy the outstanding tough beats of his career." It seems true to me, cause walking in here, I can hardly remember how I built my bankroll, but I can't stop thinking of how I lost it.
– "Rounders" (1998)

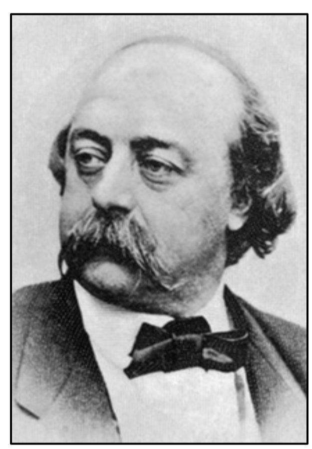
I know it's crooked, but it's the only game in town.
— Canada Bill Jones (c. 1840 – 1880), described as "the greatest three-card monte sharp to ever work the boats", on being told by his partner George Devol that a Faro game in Cairo, Illinois was rigged.

David Howard: We're up!
Linda Howard: We're still down.
David Howard: How down?
Linda Howard: Down.
David Howard: How down is she?
Desert Inn Casino Manager: Down.
…
Desert Inn Casino Manager: You're a nice guy. You make me laugh. But our policy is: we can't give you your money back.
– "Lost In America" (1985)

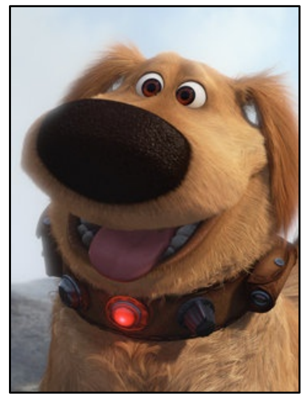
Boredom is the conviction that you can't change ... the shriek of unused capacities.
— Saul Bellow, "The Adventures of Augie March" (1953)

Anything becomes interesting if you look at it long enough.
— Gustave Flaubert (1821 – 1880)

She wanted to die, but she also wanted to live in Paris.
— Gustave Flaubert, "Madame Bovary" (1856)



To me, at least in retrospect, the really interesting question is why dullness proves to be such a powerful impediment to attention. Why we recoil from the dull. … surely something must lie behind not just Muzak in dull or tedious places but now also actual TV in waiting rooms, supermarkets' checkouts, airport gates, SUVs' backseats. Walkman, iPods, BlackBerries, cell phones that attach to your head. This terror of silence with nothing diverting to do. I can't think anyone really believes that today's so-called 'information society' is just about information. Everyone knows it's about something else, way down.
— David Foster Wallace, "The Pale King" (2011)



Carl: This is crazy. I finally meet my childhood hero and he's trying to kill us. What a joke.
Dug: Hey, I know a joke! A squirrel walks up to a tree and says, "I forgot to store acorns for the winter and now I am dead." Ha! It is funny because the squirrel gets dead.
– "Up" (2009)

I'm a good poker player. I know that everyone says that about themselves, so you'll just have to take my word for it. I'm also a good stock picker, which again is something that everyone says about themselves. At least on this point I've got a track record from a prior life to make the case. But I don't consider myself to be a great poker player or a great stock picker. Why not? Because I get *bored* with the interminable and rigorous discipline that being a great poker player or a great stock picker requires. And I bet you do, too.

To be clear, it's not the actual work of poker playing or stock picking that I find boring. I could happily spend every waking moment turning over a new set of cards or researching a new company. And it's certainly not boring to make a bet, either on a hand or a stock. What's boring is NOT making a bet on a hand or a stock. What's boring is folding hand after hand or passing on stock after stock because you know it's the right thing to do. The investment process that makes a great poker player or a great stock picker isn't the research or the analysis, even though that's what gets a lot of the attention. Nor is it the willingness to make a big bet when you believe the table or the market or the world has given you a rare combination of edge and odds, even though that's what gets even more of the attention. No, what makes for greatness as a stock picker is the discipline to act appropriately on whatever the market is giving you, *particularly when you're being dealt one low conviction hand after another.* **The hardest thing in the world for talented people is to ignore our mental "shriek of unused capacities", to use Saul Bellow's phrase, and to avoid turning a low edge and odds opportunity into an unreasonably high conviction bet simply because we want it so badly and have analyzed the situation so smartly.** In both poker and investing, we brutally overestimate the edge and odds associated with merely ordinary opportunities once we've been forced by circumstances to sit on our hands for a while.

As David Foster Wallace puts it so well, "the really interesting question is why dullness proves to be such a powerful impediment to attention." Why do we increasingly suffer from a "terror of silence" where we use electronic information devices to fill the void? Why are most of you reading this note with at least one TV screen showing CNBC or Bloomberg within easy viewing distance? **How many of us are bored to tears with the Fed's Hamlet act on raising rates, and yet have been staring at this debate for so long that we have convinced ourselves that we have a meaningful view on what will transpire, even though it's a decision where we have zero investing edge and unknowable risk/reward odds.** I'm raising my hand as I re-read this sentence.

The biggest challenge of our investing lives is not finding ways to process more information, or even finding ways to process information more effectively. Our biggest challenge is finding the courage to focus on what matters, to admit that more or quicker information will not help our investment decisions, to recognize that our investment discipline suffers mightily at the hands of the impediment of dullness. **Because let's be honest … the Golden Age of the Central Banker is a really, really dull time for a stock-picking investor.** I'm not saying that the markets themselves are dull or that market price action is boring. On the contrary, this joint is jumping. **I'm saying that stock pickers are being dealt one dull, low conviction hand after another by global Central Banks, even though they're forced to sit inside a glitzy casino with lots of lights and sounds and exciting gambling action happening all around them.** We have little edge in a Reg-FD public market. We have at best unknowable odds and at worst a negatively skewed risk/reward asymmetry in a market where policy shocks abound. And yet we find ways to convince ourselves that we have both edge and odds, making the same concentrated equity bets we made back in happier times when idiosyncratic company fundamentals and catalysts were actually attached to a company's stock price. Builders build. Drillers drill. Stock pickers pick stocks. We can't help ourselves, even if the deck is stacked against us here in the only game in town.

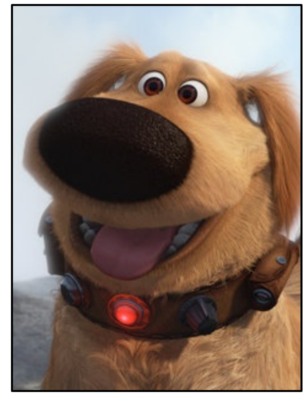
Investment discipline suffers under the weight of dullness and low conviction in at least four distinct ways here in the Golden Age of the Central Banker.

First, just as there's a winner on every poker hand that you sit out, there's a winner every day in the markets regardless of whether or not you are participating. **The *business risk* of sitting out too many hands weighs heavily on most of us in the asset management or financial advisory worlds.** We can talk about maintaining our investment discipline all we like, but the truth is that all of us, in the immortal words of Bob Dylan, gotta serve somebody. If we're not telling our investors or our board or our CIO that we have high conviction investment ideas … well, they're going to find someone else who WILL tell them what they want to hear. And for those lucky few of you reading this note blessed with access to more or less permanent capital, I'll just say that **the conversations we have with ourselves tend to be even more pressuring than the conversations we have with others.** No one forces me to "make a play" when I have a middle pair and a so-so kicker, but I've somehow convinced myself that I can take down a pot just because I've been playing tight for the past hour. No one forced Stanley Druckenmiller – one of the truly great investors of our era – to top-tick the NASDAQ bubble when he bought $6 billion worth of Internet stocks in March 2000. Why did he do it?

> So, I'll never forget it. January of 2000 I go into Soros's office and I say I'm selling all the tech stocks, selling everything. This is crazy at 104 times earnings. This is nuts. Just kind of as I explained earlier, we're going to step aside, wait for the next fat pitch. I didn't fire the two gun slingers. They didn't have enough money to really hurt the fund, but they started making 3 percent a day and I'm out. It is driving me nuts. I mean their little account is like up 50 percent on the year. I think Quantum was up seven. It's just sitting there.
>
> So like around March I could feel it coming. I just … I had to play. I couldn't help myself. And three times during the same week I pick up a phone but don't do it. Don't do it. Anyway, I pick up the phone finally. I think I missed the top by an hour. I bought $6 billion worth of tech stocks, and in six weeks I had left Soros and I had lost $3 billion in that one play. You asked me what I learned. I didn't learn anything. I already knew I wasn't supposed to do that. I was just an emotional basket case and couldn't help myself. So maybe I learned not to do it again, but I already knew that.

If living in the NASDAQ bubble can make Stan Druckenmiller convince himself that stocks trading at >100x earnings were a high conviction play only a few months after selling out of them entirely, what chance do we mere mortals have in not succumbing to 6-plus years of the most accommodative monetary policy in the history of man?

Second, every facet of the financial services industry is trying to convince you to play more hands, and we are biologically hard-wired to respond. I don't have a good answer to Wallace's question about why we all fear the silence and all feel compelled to fill the void with electronically delivered "information", **but I am certain that the business models of the Big Boy information providers all depend on Flow.** So you can count on the "information" that we constantly and willingly beam into our brains being geared to convince us to join the casino fun. My favorite character in the wonderful movie "Up" is Dug the dog, who despite his advanced technological tools is a prisoner of his own biology whenever he hears the signal "Squirrel!". We are all Dug the dog.



Third, Central Bankers have intentionally sown confusion in our ranks. Like the barkers on CNBC and the sell-side, the Fed and the ECB and the BOJ and the PBOC are determined to force us into riskier investment decisions than we would otherwise choose to make. This is the entire point of extraordinary monetary policy over the past 6 years! All of it. All of the LSAPs, all of the TLTROs, all of the exercises in "Communication Policy" … all of it has been designed with one single purpose in mind: to punish investors who choose to sit on their hands and reward investors who make a bet, all for the laudable goal of preventing a deflationary equilibrium. And as a result we have the most mistrusted bull market in history, a bull market where traditional investment discipline was punished rather than rewarded, and where any investor who hasn't been totally hornswoggled by Fed communication policy is now rightly worried about having the policy rug pulled out from underneath his feet.

Or to make this point from a slightly different perspective, while there is confusion between the concepts of investing and allocation in the best of times, there is an intentional conflation of the two notions here in the Golden Age of the Central Banker. **The Fed wants to turn investors into allocators, and they've largely succeeded.** That is, the Fed doesn't care about your picking one stock over another stock or one sector over another sector or one company over another company. They just want to push you out on the risk curve, which for the vast majority of investors just means buying stocks. Any stock. All stocks. This is why the quality bias that most investors have – preferring solid management, strong balance sheets, and good cash flow generation to their opposites – has been largely immaterial as an investment factor (if not an outright drag on investment returns) over the past 6 years. If the King is flooding the town with easy credit, the deadbeat tailor will do relatively better than the thrifty mason every time. But try telling a true-believer that quality is just an investment factor, no more (and no less) privileged than any other investment factor. Honestly, I'll get 50 unsubscribe emails just for writing this down.

Fourth, our small-number brains are good local data relativists, not effective cross-temporal or global data evaluators. Okay, that's a mouthful. Translation: the human brain has evolved over millions of years and human society has been trained for tens of thousands of years to make sense of highly localized data patterns. Humans are excellent at prioritizing the risks and opportunities that they are paying attention to at any moment in time, and excellent at allocating their behavioral budget accordingly. It's why we're really good at driving cars or, in primate days of yore, surviving on the Serengeti plains. But if asked to compare the risks and rewards of a current decision opportunity with the risks and rewards of a decision opportunity last year (much less 10 years ago), or if asked to compare the opportunity we've been evaluating for months with something less familiar, we are utterly flummoxed. It's not that we can't remember or think on our feet, but there is an overwhelming attention and recency bias in human decision-making. That's fine so long as we share the market with other humans, much less fine when we share the market with machine intelligences that *excel* at the information processing tasks we consistently flub. **Whether it's trading or investing, humans are no longer the apex predator in capital markets, but we act as if we are.**

So what's an investor to do?

I can sum it up in one deceptively simple sentence: You take what the market gives you.

It's deceptively simple because it implies a totally different perspective on markets than most investors (or allocators, frankly) bring to bear. It means approaching markets from a position of humility, i.e. risk tolerance, rather than from a position of hubris, i.e. return expectations. It's all well and good to tell your financial advisor or your board or yourself that you're "targeting an 8% return." That's great. I understand that's your desire. But the market couldn't care less what your desire might be. **I think it's so important to stop focusing on our "expectations" of the market, as if it were some unruly teenager that needs to get its act together and start doing what it's told.** It's madness to anthropomorphize the market and believe that we can control it or predict its behavior. Instead, we need to focus on what we CAN control and what we CAN predict, which is our own reaction to what a stochastically-dominated social system like the market is going to throw at us over time. Tell me what your risk tolerance is. Tell me what *path* you're comfortable walking. *Then* we can talk about the uncorrelated stepping stone strategies that will make up that path to get you where you want to go. *Then* we can talk about sticking to the path, which far more often means keeping risk in the portfolio than taking it out. *Then* we can talk about adaptively allocating between the stepping stone strategies as the risk they generate today differs from the risk they generated in the past. Maybe you'll get lucky and one of the strategies will crush it, like US equities did in 2013. Excellent! But aren't we wise enough to distinguish allocation luck from investment skill? I keep asking myself that rhetorical question, but I'm never quite happy with the answer.

You know, there's this mythology around poker tournaments that the path to success is a succession of all-in bets where you "read" your opponent and make some seemingly brilliant bluff or call. I'm sure this mythology is driven by the way in which poker tournaments are televised, where viewers see a succession of exactly this sort of dramatic moment, complete with commentary attributing deep strategic thoughts to every action. What nonsense. The goal of great poker players is NEVER to go all-in. Going all-in is a failure of risk management, not a success. I'm exaggerating when it comes to poker, because the nice thing about poker tournaments is that there's always another one. But I'm not exaggerating when it comes to investing. There's only one Nest Egg ("Lost In America" is by far my favorite Albert Brooks movie), and thinking about investing and allocation through the lens of risk tolerance rather than return expectations is the best way I know to grow and keep that Nest Egg.

Taking What The Market Gives You has specific implications for each of the four ways in which the Golden Age of the Central Banker weakens investor discipline.

1) For the business risk associated with maintaining a stock-picking discipline and sitting out an equity market that you just don't trust … it means taking complementary non-correlated strategies into your portfolio, as well as strategies that have positive expected returns but can make money when equities go down (like trend-following strategies or government bonds). It rarely means going to cash. (For more, see "It's Not About the Nail")
2) For the constant exhortations from the financial media and the sell-side to try a new game at the market casino … it means taking what you know. It means taking what you know the market is giving you because you have direct experience with it, not taking what other people are telling you that the market is giving you. Here's my test: if I hear a pitch for a stock or a strategy and I find myself looking around the room (either literally or metaphorically) to see how other people are reacting to the pitch, then I know that I'm being sucked into the Common Knowledge Game. I know that I'm at risk of playing a hand I shouldn't. (For more, see "Wherefore Art Thou, Marcus Welby?")

3) For the communication policy of the Fed and the soul-crushing power of a risk-free rate that pays absolutely nothing … it means taking stocks that get as close as possible to real-world economic growth and real-world cash flows in order to minimize the confounding influence of Central Bankers and the game-playing that surrounds them. There's nowhere to hide completely, as the volatility virus that started with the end of global monetary policy coordination in the summer of 2014 will eventually spread everywhere, but there's no better place to ride out the storm than getting close to actual cash flows of companies that are determined to return those cash flows to investors. (For more, see "Suddenly Last Summer")
4) For the transformation of the market jungle into a machine-dominated ecosystem … it means either adopting the same market perspective as a machine intelligence through systematic asset allocation strategies, or it means focusing on niche areas of the market where useful fundamental information is not yet aggregated for the machines. In either case, it means leaving behind the quaint notion that you can do fundamental analysis on large cap public companies and somehow gain an edge or identify attractive odds. (For more, see "One MILLION Dollars")

One final point, and it's one that seems particularly apropos after watching some bloodbaths in certain stocks and sectors over the past week or two. Investor discipline isn't only the virtue of great investors when it comes to buying stocks. **It's also the virtue of great investors when it comes to selling stocks.** I started Epsilon Theory a little more than two years ago in the midst of a grand bull market that I saw as driven by Narrative and policy rather than a self-sustaining recovery in the real economy. For about a year, I got widespread pushback on that notion. Today, it seems that everyone is a believer in the Narrative of Central Bank Omnipotence. What I find most interesting, though, is that not only is belief in this specific Narrative widespread, but so is belief in the Epsilon Theory meta-Narrative … the Narrative that it is, in fact, Narratives that drive market outcomes of all sorts. My hope, and at this point it's only a hope, is that this understanding of the power of Narratives will inoculate a critical mass of investors and allocators from this scourge. Because the same stories and Narratives and low conviction hands that shook us out of our investment discipline on the way up will attack us even more ferociously on the way down.

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