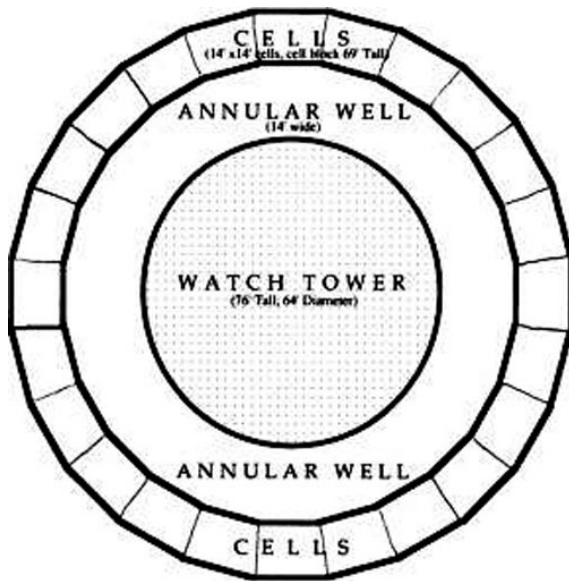


Panopticon



Panopticon schematic, 1791



Michel Foucault, 1975 © Camera Press

The Panopticon: a new mode of obtaining power of mind over mind, in a quantity hitherto without example.

– Jeremy Bentham, founder of modern utilitarianism (1748 – 1832)

But the guilty person is only one of the targets of punishment. For punishment is directed above all at others, at all the potentially guilty.

– Michel Foucault, *"Discipline and Punish: The Birth of the Prison"*

Visibility is a trap.

– Michel Foucault, *"Discipline and Punish: The Birth of the Prison"*

There is little doubt that hedge funds have entered a new era of transparency and public openness – a transformation that I believe will benefit investors, the public, and regulators... One immediate benefit of this requirement to your industry should be that transparency will enable you to shed the secretive, "shadowy" reputation that some would say has unfairly surrounded you.

– Mary Jo White, SEC Chair, speech to Managed Funds Association, October 18, 2013

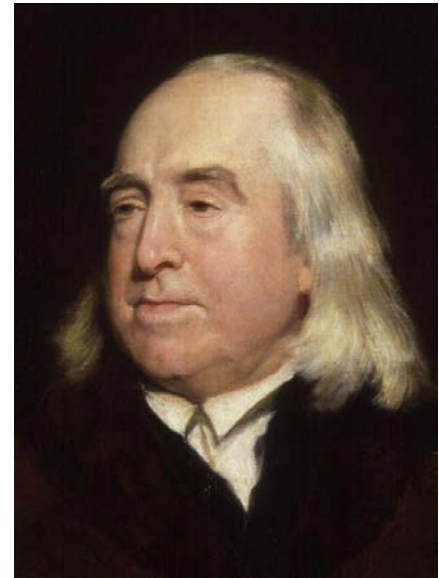
The advance of civilization is nothing but an exercise in the limiting of privacy.

– Isaac Asimov, *"Foundation's Edge"*

Whatever games are played with us, we must play no games with ourselves, but deal in our privacy with the last honesty and truth.

– Ralph Waldo Emerson (1803-1882)

In 1791, Jeremy Bentham published a book describing what was clearly a revolutionary design for prisons, factories, schools, hospitals – any institutional building where a few administer instruction, discipline, or care to the many. This design, what Bentham called a *Panopticon*, was trumpeted as “Morals reformed — health preserved — industry invigorated — instruction diffused — public burdens lightened — Economy seated, as it were, upon a rock — the Gordian knot of the poor-law not cut, but untied — all by a simple idea in Architecture!” No shrinking violet here, but the booming, confident voice of the father of utilitarianism, a man who wrote 30,000,000 words in a lifetime of social activism.



Jeremy Bentham, by Henry William Pickersgill

A Panopticon has a large circular watchtower in the middle of a larger circle of cells or offices or classrooms or whatever functional task space is appropriate for the building at hand. The outer circle of cells has inner walls and doors made of transparent windows, and the reverse is true of the central watchtower, which is completely opaque as seen from the outside. From the watchtower you can see perfectly into every cell, but from a cell you can see nothing in the watchtower. Importantly, any occupant of a cell can see pretty much every other occupant of every other cell.

The beauty of the Panopticon, per Bentham, was that the occupants of each cell would soon come to police themselves. That is, the only thing necessary to create the perception of being watched and monitored and punished for bad behavior was the constant possibility of being watched and monitored and punished for bad behavior, together with the communal witnessing of your fellow prisoners behaving as if they were watched and monitored and punished for bad behavior. It's not necessary for a guard or overseer to watch each prisoner at all times; what's necessary is for each prisoner to live in a perfectly transparent cell, so that each prisoner *thinks* that he is being watched at all times. As Bentham wrote, **the Panopticon design was a means of controlling the minds of prisoners or workers through mental force, as opposed to the traditional goal in 18th century prisons and workhouses of controlling bodies through brute force.** Just like [the warden in Cool](#)

[Hand Luke](#), just like [Dick Clark with American Bandstand](#), Bentham understood the enormous power of the crowd seeing the crowd. What he added to the calculus of social control was the important catalyst of *transparency*.

Thinking of transparency and openness as an instrument of social mind control is a hard pill to swallow in an era of social media and reality TV. So many of us *embrace* personal openness and the sharing of our thoughts...so many of us, as Christopher Hitchens ruefully noted about himself, run towards a camera instead of run away...that it seems almost un-American, rather impolite, and certainly anti-modern to maintain privacy and secrecy in our social relationships. We live in an age where transparency is lauded as a personal virtue and touted as a hallmark of liberty, where public confession is a celebrated ritual and a trusty engine of popular entertainment, where our employers expect as a matter of course that our private lives will merge with our business lives to allow constant access and attention. We live in an age where government requires disclosure of private investment strategies and holdings under the guise of “risk management”, where [failure to disclose a private opinion on public securities can be a crime](#), where – as Dave Egger’s chillingly writes in *The Circle* – “Secrets are Lies”, “Sharing is Caring”, and “Privacy is Theft”.

Transparency has nothing to do with freedom and everything to do with control, and the more “radical” the transparency the more effective the control...the more willingly and completely we police ourselves in our own corporate or social Panopticons. This was Michel Foucault’s argument in his classic post-modern critique *Discipline and Punish: The Birth of the Prison*, which – just because it was written in an intentionally impenetrable post-modernist style, and just because Foucault himself was a self-righteous, preening academic bully as only a French public intellectual can be – doesn’t make it wrong. The human animal conforms when it observes and is observed by a crowd, at first for fear of discipline but ultimately because that discipline is internalized as belief and expectation.

To be clear, I’m not saying that transparency is a bad thing for the society or institutions that enforce it. I simply want to call it by its proper name...an extremely powerful instrument of social control, not a “benefit” for the watched. Firms like Bridgewater that famously require a culture of transparency are, I believe, far more efficient and robust than their competitors that don’t. To take a trivial example apropos in mid-March, do you think that a lot of time is wasted at Bridgewater during work hours by employees sending around NCAA tournament brackets? Yeah, right. Not because there’s some “rule” against researching your NCAA bracket while at work, but because it

would be *unthinkable* (and I mean that in a purely literal sense of the word) to do so within the glass walls of an effective Panopticon. **A Panopticon crushes any sense of complacency in its residents, and that's a really big plus for a modern institution.** For the residents themselves, of course, that lack of complacency may manifest itself as a wee bit of constant stress. Or to take an example from the investment industry as a whole, SEC Chair Mary Jo White is absolutely right when she says that transparency is good for regulators. Heck, it's *great* for regulators. But she's entirely disingenuous when she touts the removal of secrecy as a good thing for private investment funds.

What's my investment point in this little diatribe? As investors in highly regulated public markets we are all operating within a Panopticon of sorts. Some of us more obviously than others, but we're all similarly situated to a rough degree. It's critical to understand the dynamics of the crowd watching the crowd within a regulatory environment of forced transparency so that we can have a realistic notion of what's possible and what's not as we try to achieve our personal or institutional investment goals.

Capturing alpha in an investment strategy requires private information. **To the degree that forced regulatory transparency and Big Data technology reduce private information by turning it into common knowledge, there is less alpha in markets.** That's a cold, hard fact. Finding alpha has never been easy. It's always been the rarest thing in the investing world, but now it's truly an endangered species, particularly in the stock-picking world of fundamental analysis of public companies. We have moved from a regulatory environment where illegal private information was pretty much defined as stealing the orange growers' crop report from the USDA a la *Trading Places* (Mortimer Duke: "Turn those machines back on!"), to an environment where the mere existence of market-beating investment returns is treated as prima facie evidence that you must have been doing *something* illegal to generate those returns. Professional investors today are scared to death of private information on public companies. It's never been more expensive or difficult to acquire, and the regulatory assumption is that – if it works – then it must have been illegally obtained. No wonder, then, that so many hedge fund giants accustomed to investing on the basis of private information are sailing as fast as they can for the safe harbor of advocacy and activism, where a large position and a board seat or two may cost you dearly in terms of liquidity but allows you to legally obtain and act on private information as a company insider. And even if you don't reach the promised land of board membership and true insider status, at least you can talk up your own book with incessant public statements about your "investment thesis" without drawing regulatory

scrutiny. All of the big boys play the Common Knowledge game today, because that's how they adapt to a Panopticon. They make themselves *more* visible to the crowd and make *more* public statements because they can create, for a while at least, their own investing reality. They know that if they speak loudly enough and long enough, enough of us little guys will follow their lead on the stock. It's what little guys DO.

Wow, that's a pretty bleak assessment, Ben. Isn't there some hope for alpha still out there in the world, even for the little guys? Sure. It's in your neighborhood. It's in your family business. It's in whatever you know really well, some endeavor that by dint of education or experience you happen to have private information about. That's where you'll find alpha. Remember Peter Lynch and "buy what you know"? There's a lot of wisdom in that, so long as you keep in mind that in Lynch's day you could know an Apple or a Microsoft in a way that is impossible and/or illegal today. In today's public markets I think it's still possible to find managers with private information, but you have to look in the cracks and crevices of the market, in relatively small niches where the traders and investors that I refer to as [beautiful parasites](#) still live. These managers tend to be relatively small, and they are almost always [superb game-players](#), able to generate alpha by, as Keynes put it, "guessing better than the crowd how the crowd will behave."

And remember, too, that finding alpha isn't the only reason to invest in public markets. Liquidity is important. Tagging along with broad-based economic growth through a broad-based capital market is important. **But most of all diversification is important.** Harry Markowitz, the father of Modern Portfolio Theory, always bristles at that label, saying that there's nothing modern about it at all. He's exactly right. Portfolio theory is an old, wonderful idea. You can dress it up in scientific finery as MPT does, and there's definitely a role for that, but there's also a very real danger that the arcane language and [self-appointed priesthood of modern economic science](#) gets in the way of a personal appreciation of the very real benefits of a diversified portfolio. I've written recently about [applying the Adaptive Investing lens to questions of diversification](#), and I'm going to continue focusing on that in the future. Because while alpha in public markets may be rare and getting rarer as private information vanishes before the onslaught of forced transparency, diversification is still there for the taking. And that's an opportunity I'm happy to use my media microphone to encourage.

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