"It's Not About the Nail"

Do, or do not. There is no try.
— Yoda, "Star Wars: Episode V – The Empire Strikes Back" (1980)

I see it all perfectly; there are two possible situations — one can either do this or that. My honest opinion and my friendly advice is this: do it or do not do it — you will regret both.
— Søren Kierkegaard, "Either/Or: A Fragment of Life" (1843)

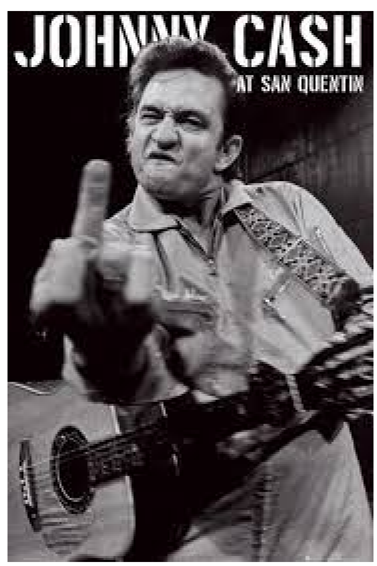
The only victories which leave no regret are those which are gained over ignorance.
— Napoléon Bonaparte (1769 – 1821)

Maybe all one can do is hope to end up with the right regrets.
— Arthur Miller, "The Ride Down Mt. Morgan" (1991)

Of all the words of mice and men, the saddest are, "It might have been."
— Kurt Vonnegut, "Cat's Cradle" (1963)

One can't reason away regret – it's a bit like falling in love, fall into regret.
— Graham Greene, "The Human Factor" (1978)

I bet there's rich folks eatin'
In a fancy dining car.
They're probably drinkin' coffee
And smokin' big cigars.
Well I know I had it comin'.
I know I can't be free.
But those people keep a-movin'
And that's what tortures me.
– Johnny Cash, "Folsom Prison Blues"(1955)



Regrets … I've had a few.
But then again, too few to mention.
– Paul Anka, Frank Sinatra, "My Way" (1969)

The Moving Finger writes; and, having writ,
Moves on: nor all thy Piety nor Wit
Shall lure it back to cancel half a Line,
Nor all thy Tears wash out a Word of it.
— Omar Khayyam, "Rubaiyat" (1048 – 1141)

You can tell it any way you want but that's the way it is. I should of done it and I didn't. And some part of me has never quit wishin' I could go back. And I can't. I didn't know you could steal your own life. And I didn't know that it would bring you no more benefit than about anything else you might steal. I think I done the best with it I knew how but it still wasn't mine. It never has been. "
— Cormac McCarthy, "No Country for Old Men" (2005)

Jesse: Yeah, right, well, great. So listen, so here's the deal. This is what we should do. You should get off the train with me here in Vienna, and come check out the capital.

Celine: What?

Jesse: Come on. It'll be fun. Come on.

Celine: What would we do?

Jesse: Umm, I don't know. All I know is I have to catch an Austrian Airlines flight tomorrow morning at 9:30 and I don't really have enough money for a hotel, so I was just going to walk around, and it would be a lot more fun if you came with me. And if I turn out to be some kind of psycho, you know, you just get on the next train.

Alright, alright. Think of it like this: jump ahead, ten, twenty years, okay, and you're married. Only your marriage doesn't have that same energy that it used to have, y'know. You start to blame your husband. You start to think about all those guys you've met in your life and what might have happened if you'd picked up with one of them, right? Well, I'm one of those guys. That's me, y'know, so think of this as time travel, from then, to now, to find out what you're missing out on. See, what this really could be is a gigantic favor to both you and your future husband to find out that you're not missing out on anything. I'm just as big a loser as he is, totally unmotivated, totally boring, and, uh, you made the right choice, and you're really happy.

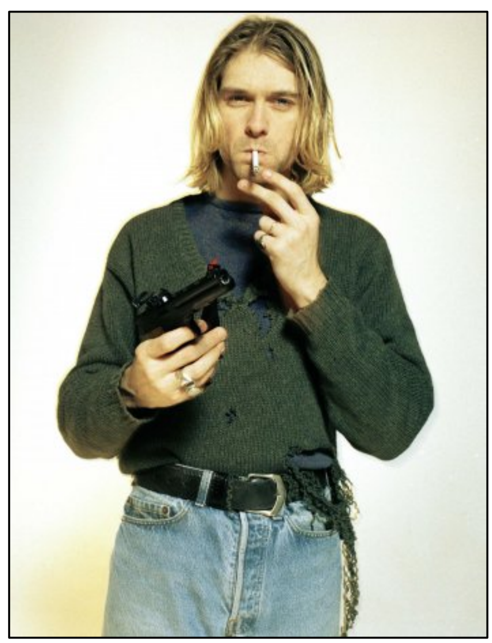
Celine: Let me get my bag.

– Richard Linklater, "Before Sunrise" (1995)

For it falls out
That what we have we prize not to the worth
Whiles we enjoy it, but being lacked and lost,
Why, then we rack the value, then we find
The virtue that possession would not show us
While it was ours.
— William Shakespeare, "Much Ado About Nothing" (1612)

When to the sessions of sweet silent thought
I summon up remembrance of things past,
I sigh the lack of many a thing I sought,
And with old woes new wail my dear time's waste:
– William Shakespeare, "Sonnet 30" (1609)

No, I don't have a gun.
– Nirvana, "Come As You Are" (1992)



I spend a lot of my time speaking with investors and financial advisors of all stripes and sizes, and here's what I'm hearing, loud and clear. **There's a massive disconnect between advisors and investors today, and it's reflected in both declining investment activity as well as a general fatigue with the advisor-investor conversation.** I mean "advisor-investor conversation" in the broadest possible context, a context that should be recognizable to everyone reading this note. It's the conversation of a financial advisor with an individual investor client. It's the conversation of a consultant with an institutional investor client. It's the conversation of a CIO with a Board of Directors. **It's the conversation of many of us with ourselves.** The wariness and weariness associated with this conversation runs in both directions, by the way.

Advisors continue to preach the faith of diversification, and investors continue to genuflect in its general direction. But the sermon isn't connecting. Investors continue to express their nervousness with the market and dissatisfaction with their portfolio performance, and advisors continue to nod their heads and say they understand. It reminds me of Jason Headley's brilliant short film, "[It's Not About the Nail]", with the advisor reprising Headley's role. Yes, the advisor is listening. But most find it impossible to get past what they believe is the obvious answer to the obvious problem. Got a headache? Take the nail out of your head. Nervous about the market? Diversify your portfolio. But there are headaches and then there are headaches. There is nervousness and then there is nervousness. It's not about the nail, and the sooner advisors realize this, the sooner they will find a way to reconnect with their clients. Even if it's just a conversation with yourself.

Investors aren't asking for diversification, which isn't that surprising after 6 years of a bull market. Investors never ask for diversification after 6 years of a bull market. They only ask for it after the Fall, as a door-closing exercise when the horse has already left the burning barn. **What's surprising is that investors are asking for de-risking, similar in some respects to diversification but different in crucial ways.** What's surprising is that investors are asking for de-risking rather than re-risking, which is what you'd typically expect at this stage of such a powerful bull market.

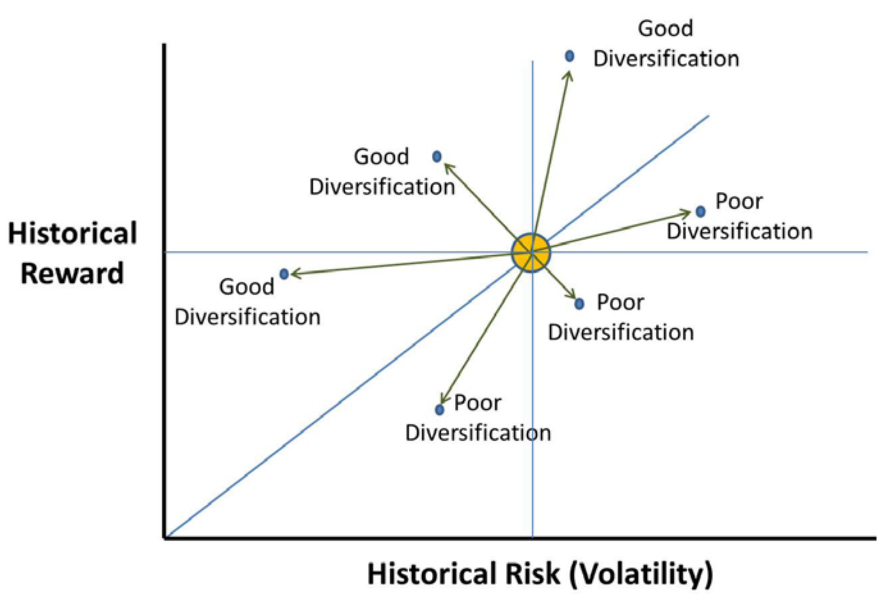
Investors are asking for de-risking because this is the most mistrusted bull market in recorded history, a market that seemingly everyone wants to fade rather than press. Why? [Because no one thinks this market is real.] Everyone believes that it's a by-product of outrageously extraordinary monetary policy actions rather than the by-product of fundamental economic growth and productivity, and what the Fed giveth … the Fed can taketh away.

This is a big problem for the Fed, as their efforts to force greater risk-taking in markets through LSAP and QE (and thus more productive risk-taking, or at least inflation, in the real economy) have failed to take hold in investor hearts and minds. Yes, we're fully invested, but only because we have to be. To paraphrase the old saying about beauty, risk-taking is only skin deep for today's investor, but risk-aversion goes clear to the bone.

It's also the root of our current advisor-investor malaise. De-risking a bull market is a very different animal than de-risking a bear market. And neither is the same as diversification.

Let's take that second point first.

Here's a simple representation of what diversification looks like, *from a risk/reward perspective.*



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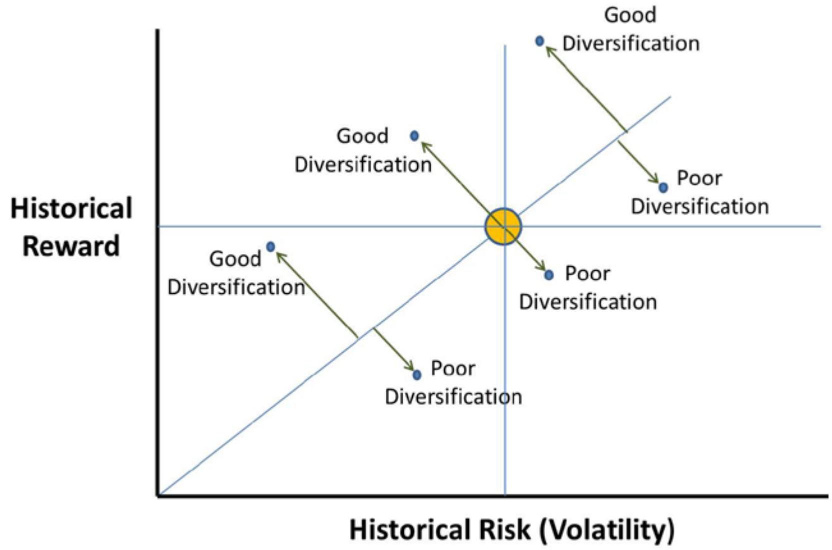
The gold ball is whatever your portfolio looks like today from a historical risk/reward perspective, and the goal of diversification is to move your portfolio up and to the left of the risk/reward trade-off line that runs diagonally through the current portfolio position. Diversification is all about increasing the risk/reward balance, about getting more reward per unit of risk in your portfolio, and the goodness or poorness of your diversification effort is defined by how far you move your portfolio away from that diagonal line. In fact, as the graph below shows, each of the Good Diversification outcomes are equally good from a risk/reward balance perspective because they are equally distant from the original risk/reward balance line, and vice versa for the Poor Diversification outcomes.



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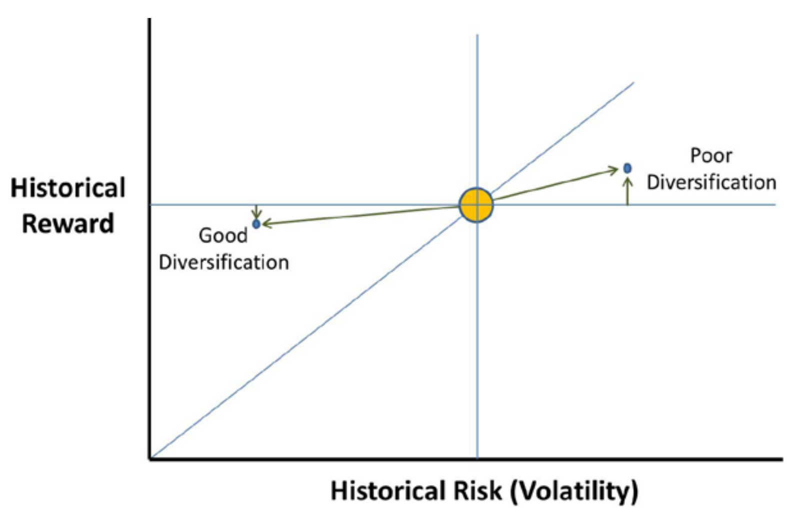
Diversification does NOT mean getting more reward out of your portfolio *per se*, which means that some Poor Diversification changes to your portfolio will outperform some Good Diversification changes to your portfolio over time (albeit with a much bumpier ride).



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It's an absolute myth to say that any well-diversified portfolio will outperform all poorly diversified portfolios over time. But it's an absolute truth to say that any well-diversified portfolio will outperform all poorly diversified portfolios over time *on a risk-adjusted basis*. If an investor is thinking predominantly in terms of risk and reward, then greater diversification is the slam-dunk portfolio recommendation. This is the central insight of Harry Markowitz and his modern portfolio theory contemporaries, and I'm sure I don't need to belabor that for anyone reading this note.

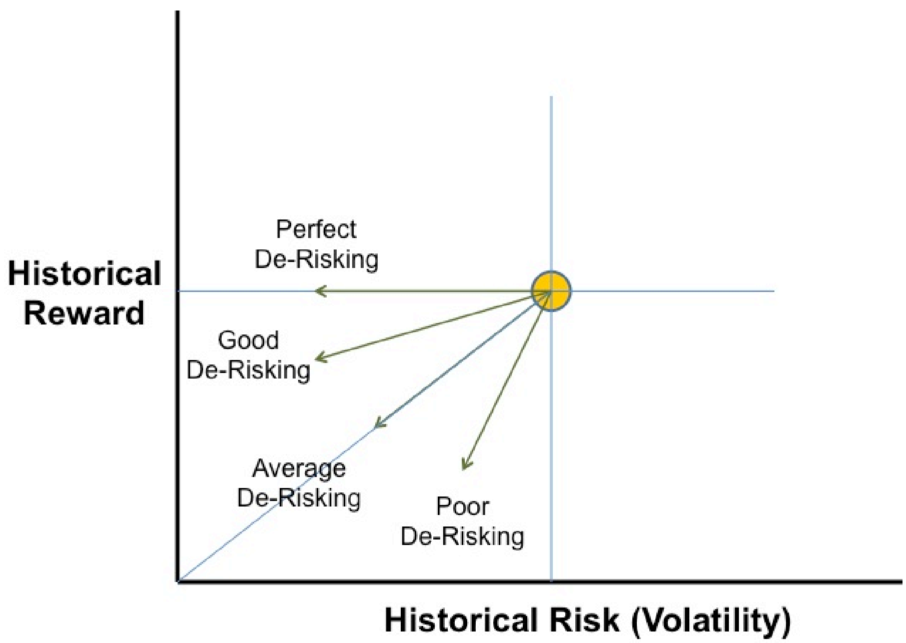
The problem is that investors are not only risk/reward maximizers, they are also regret minimizers (see Epsilon Theory notes "Why Take a Chance" and "The Koan of Donald Rumsfeld" for more, or read anything by Daniel Kahneman). The *meaning* of "risk" must be understood as not only as the other side of the reward coin, but also as the co-pilot of behavioral regret. That's a mixed metaphor, and it's intentional. The human animal holds two very different meanings for risk in its brain simultaneously. One notion of risk, as part and parcel of expected investment returns and the path those returns are likely to take, is captured well by the concept of volatility and the toolkit of modern economic theory. The other, as part and parcel of the psychological utility associated with both realized and foregone investment returns, is captured well by the concepts of evolutionary biology and the toolkit of modern game theory.

The problem is that diversification can *only* be understood as an exercise in risk/reward maximization, has next to nothing to say about regret minimization, and thus fails to connect with investors who are consumed by concerns of regret minimization. This fundamental miscommunication is almost always present in any advisor-investor conversation, but it is particularly pernicious during periods of global debt deleveraging as we saw in the 1870's, the 1930's, and today. Why? Because the political consequences of that deleveraging create investment uncertainty in the technical, game theoretic sense, an uncertainty which is reflected in reduced investor confidence in the efficacy of fundamental market and macroeconomic factors to drive market outcomes. In other words, the rules of the investment game change when politicians attempt to maintain the status quo – i.e., their power – when caught in the hurricane of a global debt crisis. That's what happened in the 1870's. That's what happened in the 1930's. And it's darn sure happening today. We all feel it. We all feel like we've entered some Brave New World where the old market moorings make little sense, and that's what's driving the acute anxiety expressed today by investors both large and small. Recommending old-school diversification techniques as a cure-all for this psychological pain isn't necessarily wrong. It probably won't do any harm. But it's not doing anyone much good, either. It's not about the nail.

On the other hand, the concept of de-risking has a lot of meaning within the context of regret minimization, which makes it a good framework for exploring a more psychologically satisfactory set of portfolio allocation recommendations. But to develop that framework, we need to ask what drives investment regret. And just as we talk about different notions of volatility-based portfolio constructions under different market regimes, so do we need to talk about different notions of regret-based portfolio constructions under different market regimes.

Okay, that last paragraph was a bit of a mouthful. Let me skip the academic-ese and get straight to the point. **In a bear market, regret minimization is driven by existential concerns. In a bull market, regret minimization is driven by peer comparisons.**

In a bear market your primary regret – the thing you must avoid at all costs – is ruin, and that provokes a very direct, very physical reaction. You can't sleep. And that's why Rule #1 of de-risking in a bear market is so simple: sell until you can sleep at night. Go to cash. Here's what de-risking in a bear market looks like, *as drawn in risk/reward space*.



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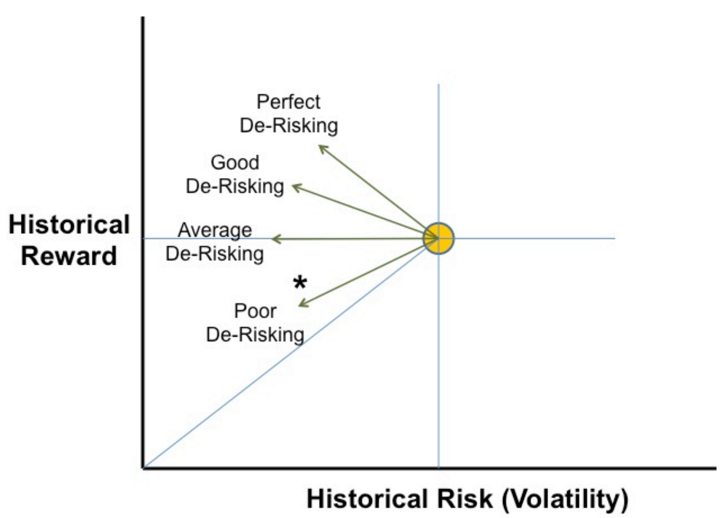
Again, the gold ball is whatever your portfolio looks like today from a historical risk/reward perspective. De-risking means moving your portfolio to the left, i.e. a lower degree of risk. The question is how much reward you are forced to sacrifice for that move to the left. Perfect De-Risking sacrifices zero performance. Good luck with that if you are reducing your gross exposure. Average De-Risking is typically accomplished by selling down your portfolio in a pro rata fashion across all of your holdings, and that's a simple, effective strategy. Good De-Risking and Poor De-Risking are the result of active choices in selling down some portion of your portfolio more than another portion of your portfolio, or – if you don't want to go to cash – replacing something in your portfolio that's relatively volatile with something that's relatively less volatile.

In a bull market, on the other hand, your primary regret is looking or feeling stupid, and that provokes a very conflicted, very psychological reaction. You want to de-risk because you don't understand this market, and you're scared of what will happen when the policy ground shifts. But you're equally scared of being tagged with the worst possible insults you can suffer in our business: "you're a panicker" … "you missed the greatest bull market of this or any other generation". Again, maybe this is a conversation you're having with yourself (frankly, that's the most difficult and conflicted conversation most of us will ever have). And so you do nothing. You avoid making a decision, which means you also avoid the advisor-investor conversation. Ultimately everyone, advisor and investor alike, looks to blame someone else for their own feelings of unease. No one's happy, even as the good times roll.

So what's to be done? Is it possible to both de-risk a portfolio and satisfy the regret minimization calculus of a bull market?

Through the lens of regret minimization, here's what de-risking in a bull market looks like, again *as depicted in risk/reward space*:



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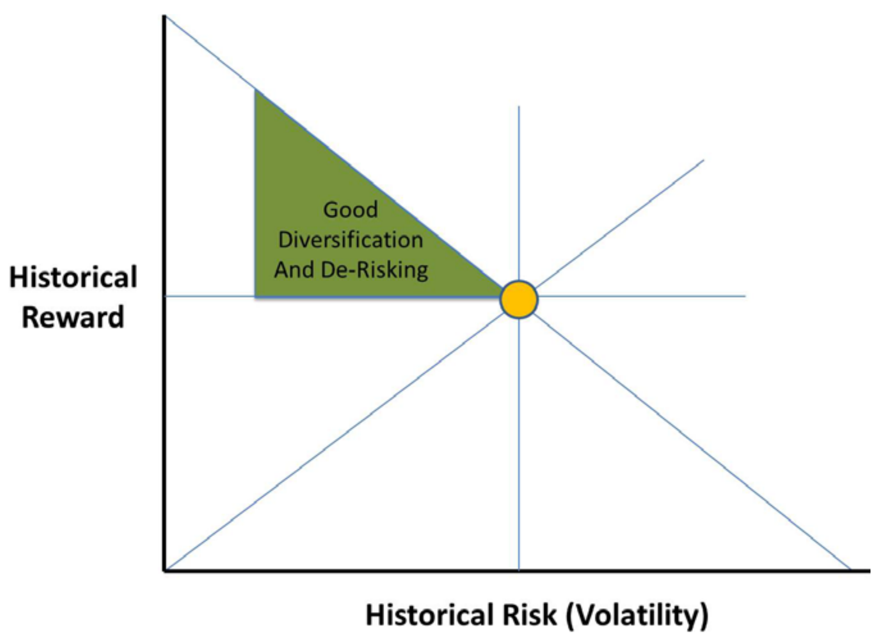
Essentially you've taken all of the bear market de-risking arrows and moved them 45 degrees clockwise. What would be Perfect De-Risking in a bear market is only perceived as average in a bull market, and many outcomes that would be considered Good Diversification in pure risk/reward terms are seen as Poor De-Risking. I submit that this latter condition, what I've marked with an asterisk in the graph above, is exactly what poisons so many advisor-investor conversations today. It's a portfolio adjustment that's up and to the left from the diagonal risk/reward balance line, so you're getting better risk-adjusted returns and Good Diversification – but it's utterly disappointing in a bull market as peer comparison regret minimization takes hold. It doesn't even serve as a Good De-Risking outcome as it would in a bear market.

Now here's the good news. There are diversification outcomes that overlap with the bull market Good De-Risking outcomes, as shown in the graph below. In fact, it's ONLY diversification strategies that can get you into the bull market Good De-Risking area. That is, typical de-risking strategies look to cut exposure, not replace it with equivalent but uncorrelated exposure as diversification strategies do, and you're highly unlikely to improve the reward profile of your portfolio (moving up vertically from the horizontal line going through the gold ball) by reducing gross exposure. The trick to satisfying investors in a bull market is to increase reward AND reduce volatility. I never said this was easy.



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The question is … what diversification strategies can move your portfolio into this promised land? Also (as if this weren't a challenging enough task already), what diversification strategies can work quickly enough to satisfy a de-risking calculus? Diversification can take a long time to prove itself, and that's rarely acceptable to investors who are seeking the immediate portfolio impact of de-risking, whether it's the bear market or bull market variety.

What we need are diversification strategies that can act quickly. More to the point, we need strategies that can *react* quickly, all while maintaining a full head of steam with their gross exposure to non-correlated or negatively-correlated return streams. This is at the heart of what I've been calling Adaptive Investing.

Epsilon Theory isn't the right venue to make specific investment recommendations. But I'll make three general points.

First, I'd suggest looking at strategies that can go short. If you're de-risking a bull market, you need to make money when you're right, not just lose less money. Losing less money pays off over the long haul, but the long haul is problematic from a regret-based perspective, which tends to be quite path-sensitive. Short positions are, by definition, negatively correlated to the thing that they're short. They have a lot more oomph than the non-correlated or weakly-correlated exposures that are at the heart of most old-school diversification strategies, and that's really powerful in this framework. Of course, you've got to be right about your shorts for this to work, which is why I'm suggesting a look at strategies that CAN go short as an adaptation to changing circumstances, not necessarily strategies that ARE short as a matter of habit or requirement.

Second, and relatedly, I'd suggest looking at trend-following strategies, which keep you in assets that are working and get you out of assets that aren't (or better yet, allow you to go short the assets that aren't working). Trend-following strategies are inherently behaviorally-based, which is near and dear to the Epsilon Theory heart, and more importantly they embody the profound agnosticism that I think is absolutely critical to maintain when uncertainty rules the day and fundamental "rules" change on political whim. **Trend-following strategies are driven by the maxim that the market is always right, and that's never been more true – or more difficult to remember – than here in the Golden Age of the Central Banker**.

Third, these graphs of portfolio adjustments in risk/reward space are not hypothetical exercises. Take the historical risk/reward of your current portfolio, or some portion of that portfolio such as the real assets allocation, and just see what the impact of including one or more liquid alternative strategies would be over the past few years. **Check out what the impact on your portfolio would be since the Fed and the ECB embarked on divergent monetary policy courses late last summer, [creating an entirely different macroeconomic regime](.).** Seriously, it's not a difficult exercise, and I think you'll be surprised at what, for example, a relatively small trend-following allocation can do to de-risk a portfolio while still preserving the regret-based logic of managing a portfolio in a bull market. For both advisors and investors, this is the time to engage in a conversation about de-risking and diversification, properly understood as creatures of regret minimization as well as risk/reward maximization, rather than to avoid the conversation. **As the old saying goes, risk happens fast. Well … so does regret.**

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