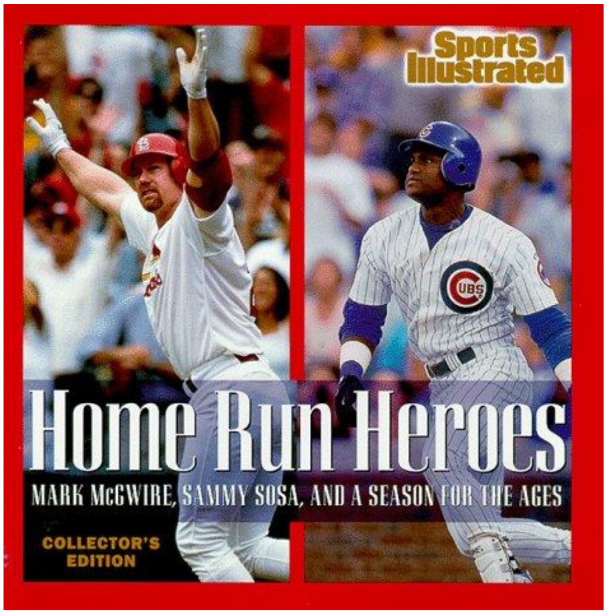
The Levelers

Mr. Incredible: You mean you killed off real heroes so that you could *pretend* to be one?

Syndrome: Oh, I'm real. Real enough to defeat you! And I did it without your precious gifts, your oh-so-special powers. I'll give them heroics. I'll give them the most spectacular heroics the world has ever seen! And when I'm old and I've had my fun, I'll sell my inventions so that *everyone* can have powers. *Everyone* can be super! ***And when everyone's super ... [chuckles evilly] … no one will be.***

Captain, although your abilities intrigue me, you are quite honestly inferior. Mentally, physically.

– Khan Noonien Singh, "Star Trek: Space Seed" (1967)



The whole country has been involved in this, I think, since after the All-Star break. If people say it's bringing the country together, I'm happy to bring the country together.

– Mark McGwire (1998)

I'm not here to talk about the past.

– Mark McGwire (2005)

In some respects, insider trading is a form of financial steroid. It is unfair; it is offensive; it is unlawful; and it puts a black mark on the entire enterprise.

– Preet Bharara, U.S. Attorney, Southern District of New York

When I played pro football, I never set out to hurt anyone deliberately - unless it was, you know, important, like a league game or something.
– Dick Butkus, Chicago Bears (1965 – 1973)

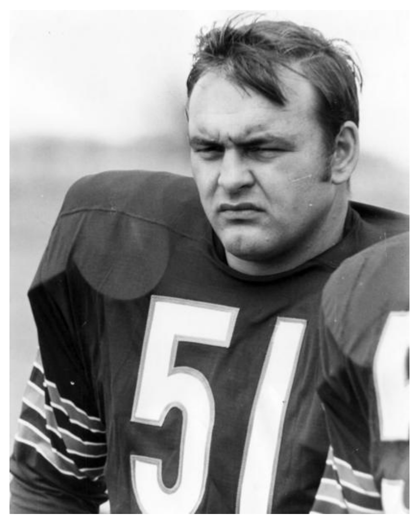
Fortunately for a quarterback, you can play for a long time because you don't get hit very often.
– Tom Brady, New England Patriots (2000 – ???)

Earlier this month, Massachusetts State Secretary William Galvin imposed a $30 million fine on Citigroup because an equity analyst shared his research on an Apple iPhone supplier with analysts at a couple of investment funds before he published the research publicly. To be clear, this was not a case of the analyst telling the hedge funds his true views and writing fraudulent pieces for public consumption, à la Merrill Lynch analyst Henry Blodgett and many others, which resulted in the 2003 Global Research Analyst Settlement between the SEC and most Wall Street sell-side firms, as well as the launching of Eliot Spitzer's political career. Nor was this a case of the analyst leaking inside information from the company he covered to the hedge funds, à la some of the protagonists in the Galleon Group prosecutions that began in 2009. *This was the analyst's own work and research, perfectly aligned with what he would publish publicly.* But because Citigroup is a party to the 2003 Global Research Analyst Settlement, whereby "CIR [Citigroup Research] equity research analysts cannot preview in writing unpublished, or disavow in writing published research views to personnel outside of CIR", the analyst was a dead man walking as soon as he emailed his "New Forecast" numbers to external analysts.

This is the same issue that tripped up prominent equity analyst Mark Mahaney (also of Citigroup) in October last year, when he emailed a reporter in a way that indicated his unpublished projections of YouTube's revenue growth and profitability. Again, no disconnect between public and private communications and no revelation of inside information, but a clear violation of both the 2003 consent decree and bank policy, for which Mahaney was summarily fired. *As he should have been*. It's not like Mahaney was unaware of the prohibition against this sort of communication (as he wrote in an email later cited by the bank, "This could get me in trouble. Shoot."), and it's pretty clear that the analyst in this week's case was similarly aware of the rules, seeing as he rushed the published report out the door immediately after emailing the hedge funds.

My point is not that these guys were treated unfairly or that sell-side equity research rules should be changed back to their pre-2003 form. These are the rules of the game today, everyone knows that these are the rules, and if you don't want to play within these rules you should find another game.

Let me put it this way … Do you enjoy seeing a defensive back level a wide receiver with a big hit? Are you annoyed by your team's defensive lineman being flagged for roughing the passer if he lays a fingernail on pretty boy Tom Brady? Me, too.

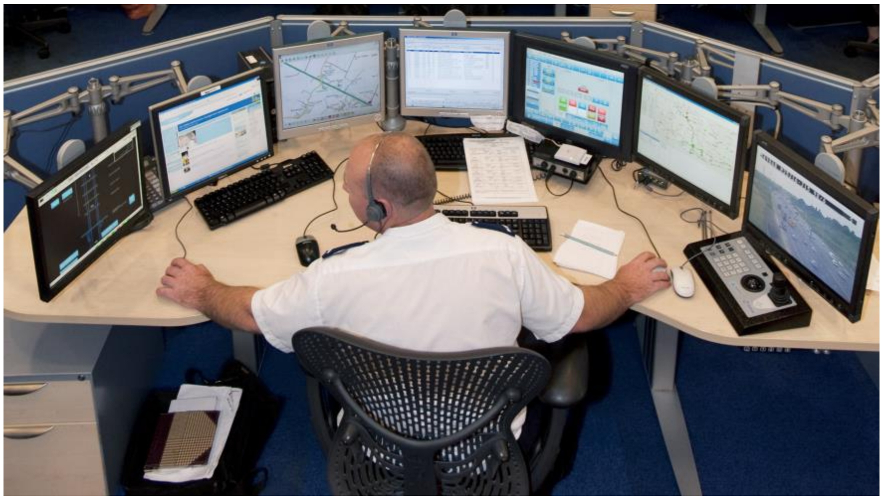


But the game of football as played by Dick Butkus is gone. It's not coming back. Get over it. Certainly the NFL players and coaches have gotten over it, because they have to deal with the game as it is – not as it was or how they wish it were – in order to succeed. Ditto for baseball. Is it completely arbitrary to make a distinction between "illegal" performance-enhancing regimens like a course of anabolic steroids and "legal" performance-enhancing regimens like Lasix surgery or tendon replacement? Of course it is. But there's nothing "natural" about any choices a rule-making organization might impose. Any game is defined by the rules in force, explicitly and tacitly, at a given point in time. If you want to play in that game, you play by that set of unnatural rules and not some other set of unnatural rules. Period. Nostalgia is a luxury for observers, not participants, whether you're talking about the game of sports or the game of thrones or the game of markets.

My point (other than to say "For the love of God, don't use email when the law specifically enjoins only *written* communications") is that the rules governing the flow of private information within capital markets – and the way those rules are enforced – create structural changes in markets. Those structural changes, in turn, shape not only investor behavior but also investment returns. **Alpha generation in public equity markets has been crippled by the current regulatory regime, which is engaged in an intentional effort to criminalize private information regarding public companies.** This is an institutionalized effort to "level the playing field" as every U.S. Attorney and Senator and President and Attorney General and Governor likes to say. This is not a Democratic or Republican effort. It is an entirely natural and rational effort by *any* politician in the aftermath of a nationwide economic crisis. It is an effort that will not go away and will in all likelihood get more pronounced. The rules of the game are changing, and if you don't change the way you play the game to match these new rules, you will be bounced out of the game as fast as Butkus would be if he played football today.

I'm not concerned with the public theatre of all this. There are show trials in the aftermath of every lost war, and the aggregate cost of the Great Recession to the US economy was the rough equivalent of losing a decent-sized war. No one is going to shed a tear over Raj Rajaratnam or Stevie Cohen or their ilk, so let the perp walks and the ritual executions begin. Certainly it's a little comical at times. How many shots did the photographer have to take of US Attorney Preet Bharara before his media handlers decided that he evinced just the right degree of steely determination as he gazes out the window with the DOJ seal in the background?

On the other hand, here's a photograph of the seven monitors that Stevie Cohen keeps on his desk at



SAC. In their response to the SEC "failure to supervise" charge against SAC, Cohen's lawyers actually make the argument that having so many monitors proves that Cohen could not possibly have been paying attention to the incriminating emails sent to him, that in fact this is prima facie evidence that Cohen is a trader extraordinaire, a wizard who made his billions by keeping his finger on the beating pulse of the market. Maybe the only thing funnier than the lawyers' argument was the way in which the news was picked up by *The Wall Street Job Report*, with an article titled "Steve Cohen has seven monitors at his desk. Should you, too?" Conclusion: seven is probably "excessive", although "multiple studies suggest that having a second or third screen makes workers more productive." I mean, you just can't make this stuff up.

But the real issue here is not the show trials. **The real issue is the regulatory evisceration of the day-to-day process by which investment managers and analysts acquire information about public companies.**

Galvin is not stopping with the $30 million fine of Citigroup. He is "looking at whether there are other enforcement actions possible" against SAC, Citadel, GLG, and T. Rowe Price for *asking the question* about the Citigroup analyst's views on the iPhone supply chain. In particular, Galvin called SAC's efforts "extremely aggressive" and is considering whether to hand over his evidence to federal prosecutors and the SEC. Well, this certainly sounds interesting, so I went through the Massachusetts complaint to see just what sort of hardball tactics SAC employed. Here you go:

44. On the morning of Dec. 13, 2012, an employee of SAC Capital, a CGMI client holding Apple stock, began emailing Kevin Chang, asking “Hey Kevin, are you picking up any order cuts to iPhone?”

45. Also on the morning of Dec. 13, 2012, an employee of SAC Capital’s CR Intrinsic division emailed Kevin Chang, asking “Hi Kevin, Macquarie just downgraded Hon Hai and cited very weak demand for the iPhone (down 35-40%) into the March qtr. Have you picked up any checks that would suggest this is the case? I think when we exchanged emails a bit earlier you were still pretty bullish about March estimates? Thanks!”

46. Also on the morning of Dec.13, 2012, an employee of SAC Capital’s LP division emailed Kevin Chang, asking “Hello Kevin, do you have some time to speak? Not sure if you are in Taiwan?”

47. Also on the morning of Dec. 13, 2012, an employee of SAC Capital’s Sigma Capital division emailed Kevin Chang, asking “A competitor had a negi note on HH today. I was wondering if you had a few minutes tonight (ET), am for you, to catch up on your general thoughts.”

48. On Dec. 13, 2012, prior to the publication of Kevin Chang’s Dec. 14 Hon Hai Report, another employee of the hedge fund emailed Kevin Chang, copying a Citi Equities employee, with the subject of the email as “[Employee Name] at SAC request for conference call today URGENT.”

49. In this email chain, the SAC employee asked, “Kevin are you available?” The Citi Equities employee replied to this chain, asking, “Kevin, have been told this morning that you are in Japan. Is there a possibility of calling [the hedge fund employee] on his mobile number at [U.S. phone number] or in his office at [U.S. phone number]. Any help is greatly appreciated.” Lastly the employee of the hedge fund replied to both Kevin Chang and the Citi Equities employee, stating, “Thanks very much – mobile is best at [U.S. phone number].”

That’s it. Pretty ferocious, huh? Only two of the five emails said thank you, which struck me as terribly impolite and just the sort of aggressive, take-no-prisoners behavior that SAC is so well-known for. And I think we’re all aware that when a SAC analyst says “I was wondering if you had a few minutes to catch up on your general thoughts?” that’s code for “we are holding your wife and kids hostage.”

Are there rules for what sell-side analysts can say and when they can say it? Yes, if your firm is in the business of selling or marketing securities and particularly if your firm is governed by the 2003 general consent decree. **What Galvin is suggesting is that there should also be rules for what the buy-side can ask and when they can ask it, or at least that there should be a burden placed on the buy-side to confirm that they are not receiving or acting on information "illegally" provided by a sell-side analyst.** That legal burden already exists if an investor receives material and non-public *information* about a publicly-traded company from anyone, including sell-side analysts. This is the current definition of insider trading. What's germinating here is an expansion of the definition of insider trading to include material and non-public *opinions* developed by an employee of a regulated broker dealer. That may sound like a minor thing, but I can promise you that it's not.

If we are entering a regulatory environment where the questions posed by these SAC analysts will be characterized as criminal behavior, then any active investment strategy based on the fundamental analysis of companies is finished. Dead. This is the mother of all chilling effects. Asking these questions is what fundamental analysts DO … all day, every day. They call and email and visit sell-side analysts a lot, management (usually someone in investor relations) occasionally, and each other rarely. This is how a buy-side analyst "knows his companies". This is how a stock-picking investment strategy develops an "edge". If coming into possession of a sell-side analyst's opinion might land you in jail … if every investor must not only ask "is this opinion right?", but also "is it legal for me to *have* this opinion?" … well, these conversations will stop happening. We will all read the same research reports at the same time, get on the same conference calls, attend the same publicly broadcast meetings. We will receive these opinions legally, which is to say publicly, and everyone will know exactly the same things at exactly the same time about public companies directly, as well as what everyone on the sell-side *thinks* about those public companies. No investor will "know his companies" any better than the next guy, which means there will be no edge to any stock-picking investment strategy. Which means that there is no alpha in these strategies. Sorry, but that's a cold, hard fact.

Here's the thing. **This is exactly what politicians want from their regulatory efforts. They want a world of pure beta and zero alpha.** This is the ultimate "level playing field", where no one knows anything that everyone else doesn't also know. The presumption within regulatory bodies today is that you must be cheating if you are generating alpha. How's that? Alpha generation requires private information. Private information, however acquired, is defined as insider information. Insider information is cheating. Thus, alpha generation is cheating. QED.

Why would politicians want an alpha-free market? Because a "fair" market with a "level playing field" is an enormously popular Narrative for every US Attorney who wants to be Attorney General, every Attorney General who wants to be Governor, and every Governor who wants to be President … which is to say all US Attorneys and all Attorneys General and all Governors. Because criminalizing private information in public markets ensures a steady stream of rich criminals for show trials in the future. Because the political stability of the American regime depends on a widely dispersed, non-zero-sum price appreciation of all financial assets – beta – not the concentrated, zero-sum price appreciation of idiosyncratic securities. **Because public confidence in the government's control of public institutions like the market must be restored at all costs, even if that confidence is misplaced and even if the side-effects of that restoration are immense.** Here's a telling quote:

> Insider trading tells everybody at precisely the wrong time that everything is rigged, and only people who have a billion dollars and have access to and are best friends with people who are on boards of directors of major companies – they're the only ones who can make a true buck.
>
> *– Preet Bharara, U.S. Attorney for the Southern District of New York*

What does that mean, that it's "precisely the wrong time" for insider trading to exist? Why isn't insider trading an equally bad thing anytime? It's precisely the wrong time because the financial collapse of 2008 and the subsequent federal bail-out of everyone from AIG to GM to GE to Goldman Sachs revealed that the system IS rigged. Now I think that anyone with half a brain should thank God that the system is rigged, because the alternative was a good old-fashioned Götterdämmerung, but it's pretty hard to deny that the events of 2008 – 2009 revealed the raw sinews of power that exist beneath our pleasing Narrative of democratic rule and a "level playing field". Now the Narrative must be restored. We've seen the iron fist … time to put the velvet glove back on. There is no more important task for the American regime.

Fortunately for Bharara and unfortunately for active equity managers, there are tools available to regulators and prosecutors today that were not available in, say, the 1930's to enforce an alpha-free market. These are the tools of Big Data and electronic surveillance, and as we have seen with recent revelations around the NSA and its collection and analysis of *all* US telecommunications, it is a powerful toolkit, indeed. On the Big Data side, in 2009 the SEC established an Office of Quantitative Research and an Office of Risk Assessment and Interactive Data within its Economic and Risk Analysis Division, and – for operational surveillance – an Office of Analytics and Research within its Trading and Markets

Division. Just this July, the SEC announced a new Center for Risk and Quantitative Analysis, which will directly "provide guidance to the Enforcement Division's leadership." This is the SEC's equivalent of the CIA. These Offices are extremely well funded, draw some really top-notch people from the private sector, and coordinate closely with the FBI. Today's SEC may not quite be the functional equivalent of the NSA from a data gathering and pattern inference perspective, but it's nothing to sneeze at, either. The NSA is a little bigger and faster, that's all. On the traditional surveillance side, Bharara and his colleagues in the DOJ have been given amazing latitude by the courts to pursue widespread wire taps across a wide swath of the financial services industry.

The importance of these surveillance and data analysis capabilities cannot be overemphasized, as they transformed sleepy regulatory edicts that were on the books but extremely hard to prosecute – such as the 2003 Global Research Analyst Settlement or, more importantly, Reg FD, originally adopted way back in August, 2000 – into powerful weapons. Take, for example, Reg FD, which requires publicly traded companies to eliminate selective disclosure of any information that could be deemed to be material and non-public. Not only does Reg FD place a burden on company management not to disclose material and non-public information to anyone unless it is disclosed to everyone, but as described above it also places a burden on the receiving party (typically the investor) not to act on the improperly disclosed information. Prior to 2009 it was very difficult for the SEC or FBI to identify any but the most egregious infractions of Reg FD, such as an email leaked by a disgruntled employee or a massive dumping or purchase of a stock. Since 2009, however, the SEC can sift through all of the trading in a company's stock, look for what they consider to be suspicious patterns (i.e., alpha generation), and then work backwards to create a link with, say, a 1-on-1 meeting at a sell-side conference between the company's CFO and an analyst from the trading firm. As a result, company management today is extremely tightlipped, not just on the obvious topics such as quarterly earnings or some other business metric, but on anything other than what has been very publicly disclosed. Before 2009 you could almost always get a read on the "body language" of senior management, the overall behavioral equivalent of a wink or nod to the general business conditions facing the company. Those days are gone, and that makes the stock-picker's job – particularly at really large asset managers – so much harder.

Why is the loss of body language and other seemingly generic signaling so important? Because there's only one question you truly need answered if you're a good stock-picker who has done his homework on a company. That question is NOT "what are your earnings going to be this quarter?" or "how are gross margins looking?" or "did you hit your revenue guidance?" The only question that really matters is what Laurence Olivier's Nazi dentist asked Dustin Hoffman in *The Marathon Man*: **Is it safe?**

If you've never seen *The Marathon Man* … well, let's just say that you may never have the same level of comfort in the dentist's chair after watching it. Olivier needs to know if his transit route for a shipment of diamonds has been blown – **Is it safe?** – and he believes that Hoffman knows the answer. Hoffman doesn't, but that doesn't stop Olivier from torturing Hoffman in ways that only a skilled Nazi dentist could devise.

Fortunately for senior company management, institutional investors may be annoying, but they are rarely torture experts. The question, though, is identical. Put yourself in the CEO's shoes. A big fund has had a position in your stock for a couple of years. They've done their work and they have a positive, long-term investment opinion. They don't need you to confirm their investment opinion in every detail (although that would certainly be nice if you were so inclined), and they're patient investors. You've gotten to know them over time, and while you wouldn't call them friends you've developed something of a warm familiarity and more than a little mutual trust. They're on your side. Now you're on a private call or at a conference 1-on-1 meeting, and the CIO of the fund tells you that they are planning on turning their current position into a very large position. He has only one question. **Is it safe?**

Before Reg FD you told the CIO everything he wanted to know. Not just whether it was safe, but all the degrees of safeness and what the fund should look for to see how that safety developed. After Reg FD in

2000 but before the 2009 SEC jihad you still felt pretty comfortable communicating an answer with a hem and a haw, maybe a reference to a prior period in the company's history or a generic expression of caution or excitement … body language. Today you duck the conversation entirely and have the IR VP sit in for you. You have large group meetings with lots of people in the room. You say nothing that has not already been said, word for word, in a 10-Q or an 8-K filing.

Now put yourself in the CIO's shoes. You still have to take big swings with your portfolio, both because you've got a lot of money to put to work and you have to distinguish yourself against your benchmark. Maybe you can seek safety in the consensual validation of other managers, a Common Knowledge answer to the "Is it safe?" question, which is why there is such a pronounced herding behavior among active managers today in stocks like Apple. Or maybe you move towards an activist strategy, where you can once again acquire private information about a company and influence management directly, albeit at the significant risk of locking yourself into an investment you cannot easily exit. The bottom line is that without an answer to the "Is it safe?" question you've got less private information and more risk for the same reward.

Over time and across the population of active investment managers, more risk for the same reward translates directly into less alpha. Such is the "level playing field" of full disclosure, a structural shift in market rules that will persist no matter what happens to corporate earnings or Fed monetary policy.

In future notes I'll explore the portfolio and risk management implications of these changing rules. Is alpha even possible under these new rules? I believe it is, but not through the old lenses, or at least not easily. Alpha still depends on private information, and I intend to look for that private information through the lens of behavioral patterns, not through the traditional lens of company-specific information or opinions. I hope you'll join me in that search at Follow Epsilon Theory.

Ben Hunt

Redding, Connecticut