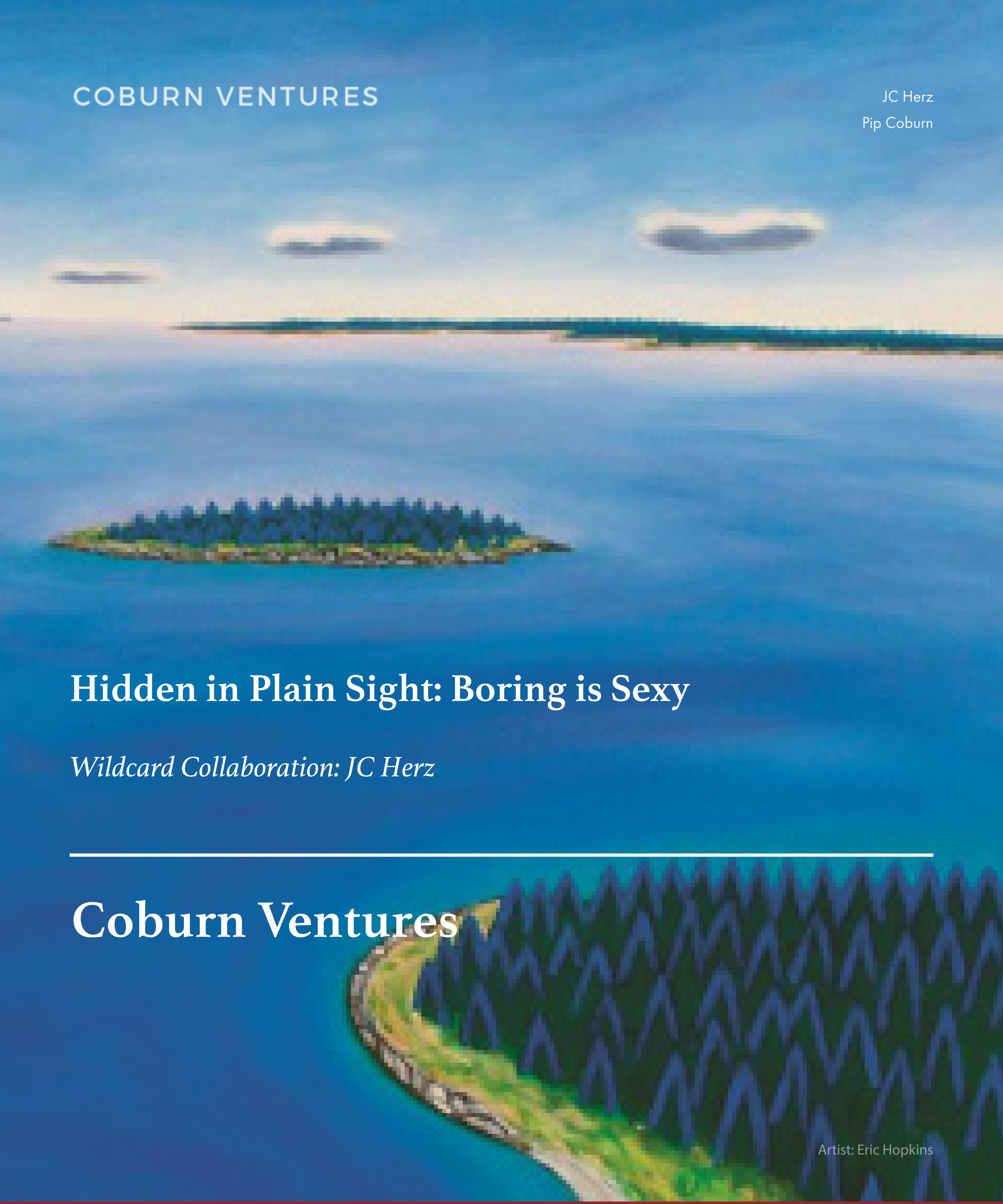

COBURN VENTURES

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Hidden in Plain Sight: Boring is Sexy

Wildcard Collaboration: JC Herz

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"Working definition of obliquity: pursuing a paradoxical path to get from A to B which surprisingly turns out to be exceptionally successful."

I recalled as a first grader in Miss Semarod's class – or maybe it was as a second-grader in Miss Baldwin's class – a children's story about a little boy who passed by a guard post when leaving the king's castle every day. All he had with him was a wheelbarrow full of sand. Each and every day, the guard would poke through all the sand to inspect that the little boy wasn't stealing something from the castle. The guard just knew something was up but he couldn't figure it out.

So finally, on the eve of his re-assignment, he gently confronts the little boy. Would the little boy, please, tell him what he has been stealing?

"Sure… I've been stealing wheelbarrows."

Apparently, this story is translated into many versions – including a worker in a Russian mine – but always with the guard missing what is hidden in plain sight.

I have been uttering the phrase "Hidden in plain sight" a great deal the past six months.

Perhaps it is that I am learning at a new level that the vocation of investing isn't so much about using all of our intelligence to see the infrared waves that no one else can see but, rather, to make sure our greatest intelligence isn't sabotaging ourselves in our investment process. Testing our intelligence by solving the trickiest questions! Trying hard!! Sabotaging ourselves…

"Try easy" is a refrain from one of my wife Kelly's yoga instructors, Baron Baptiste. It has been an extremely helpful method in counteracting my Midwest-hard-work ethic of "try hard." I'll blame it on my Ohio roots. How convenient for me.

Scene change: 1997. I was sitting in our firm's conference room near the kitchen interviewing someone just out of grad school – myself just a bit out of grad school myself. I asked a cliché question:

"What do you think you will love the most about being an investor?"

"The moments of seeing something that no one else in the entire world sees but me."

And I thought, **wow, that is a bad answer.**

How often will THAT actually happen across a career?

Might this desire lead to serial delusion if you so, so badly want to see something no one else in the entire world sees?

I mean, this is a BIG planet with billions of people and millions of the smartest and most motivated of those people are in our industry. How often will I truly see something that no one else in the entire world sees? And am I going to be wise enough so as not to make this pursuit a test of my intelligence and am I, myself, too hooked on the idea of having a career in which I can use every little ounce of my intelligence as a competitive challenge against all others?

Is my ego too involved in wanting to prove my intelligence by defining job satisfaction by something that will happen so rarely?

Is this more about me and my ego than it is about serving our clients?

A friend from long ago at one Sundance Retreat trained me in **"obliquity"**. I had heard the phrase before, but I didn't know what it meant. My poor working definition might be: **pursuing a paradoxical path to get from A to B which surprisingly turns out to be exceptionally successful.**

So, if everyone is "trying hard" then maybe I will succeed by "trying easy."

If everyone is attached to their stock quote screen, I might disable mine permanently.

If everyone is going wide and shallow, I might go deep.

If no one studies "change," well, maybe I will.

If everyone is building knowledge, I might strive for insight and study ways to get there.

If the world is paid to be right, I may be the first to say I was wrong.

In a world of experts, I might strive to be a student.

If everyone spends time in order to have a view of the stock market, I might shrug my shoulders and say, "I don't have any idea and I don't spend any time trying to figure it out."

If everyone is going to analyst days and listening to quarterly earnings calls, I might skip them.

And...

If everyone is lured into using their minds to break down exceptionally hard – though also incredibly alluring – puzzles about future marketplaces I might look for something simpler.

Pip

"The task is not so much to see what no one has yet seen, but to think what nobody yet has thought about that which everybody sees."
—ARTHUR SHOPENHAUER

FROM JC HERZ

By definition, analysts and investors with a change function orientation gravitate towards novelty and anomaly: signals and phenomena which are a) new and b) different. In the tech sector, where the change function often manifests, this often correlates with a number of other attributes:

1) It's created by young people who aren't inhibited by old-model assumptions or burdened by domain knowledge.

2) It's made-much-of in the media, because journalists are trained and rewarded to identify and craft narratives around the new and novel – that's why it's called "news." As this cognitive tendency verges towards its nth degree, it often distends into two tropes, a product fetish ("ooh shiny") and the hero-worship and celebrity-making of innovators. **Both of these tropes reinforce the idea that to drive the change function, something must not only be new and different, but also appeal to consumers and be created by interesting people.**

3) It connects with larger pseudo-religious narratives about saving and redeeming the world. The seductive power of latent religious messaging put our brains in a blender – especially if we're not religiously affiliated – could be an essay of its own.

There are a lot of assumptions baked into the presumed linkage between these attributes and market-moving change. Most are unexamined, partly because the myths around the mechanisms of impact of technological innovation are unexamined, and partly because this habit of mind has been so thoroughly and consistently rewarded in the last twenty years. If you're highly attuned to the new and different, and you've been able to draw the through-lines from the new and different to company growth in the last twenty years, you've probably made great career progress. **As human beings, we keep doing what we're rewarded for, and we resist revising or even acknowledging our assumptions, especially when things are going well.**

But I'm going to argue that, when it comes to any regulated sector, especially critical infrastructure – healthcare, energy, transportation, education – most of these assumptions are either 180 out or aren't relevant – they're stickers, not levers. **I'm going to argue that the real game right now – the things analysts and investors need to track in order to understand how the market is moving in the next 12-36 months - are a level-down (or two) in the pace layering model, at the levels of infrastructure and governance,** which means:

1) **The highly consequential changes aren't novel or interesting. They are excruciatingly, eye-glazingly boring** – so boring it's difficult to stay awake and cognizant while plowing through the evidence, which includes a lot of public records and rule amendments on the federal, state and local level.

2) **More bad news: in order to understand the implications, you or someone on your payroll needs relatively deep domain knowledge.** One of the reasons these lower-level tectonic shifts are so boring is that they're arcane. You can't just be a smart generalist, A+ student who knows how to tap market reports and use Google. You need to actually know the particularities of pricing mechanisms and contract clauses in particular industries, and how the constellations of incumbents

and new entrants are aligning as industry consortia and lobbying to tilt the board in their own favor.

When the change function is playing out at the deeper pace layers, the stakes are so high that everyone is lobbying. I live inside the Beltway, and everyone you think is too hip and disruptive and new-school to lobby? **They're** lobbying. They may not be doing it directly, but they're doing it. A shift in presidential administrations just throws lighter fluid on that.

3) No charismatic celebrities: the most significant, market-moving changes are put into motion by faceless middle-aged bureaucrats and legislative staffers. You will never read about these people. They don't talk to the media. They are playing a career game that has very little to do with the systems of validation that are familiar to financial analysts and investors. This is one of the reasons that lobbyists are so effective. They know who's who in the zoo. When the levers are being rejiggered, when a gajillion public sector dollars are in play, you need to know who's who in the zoo in order to take the initiative.

Investors are familiar with the argument that lobbying expenses by incumbents are a risk indicator, and that argument is valid – if you're paying lobbyists to hang on by your fingernails, that's a risk indicator. But there's an equally valid argument that lobbying by new market entrants and market disruptors is not a risk indicator. New market entrants who know how to lobby can force-multiply their value proposition by tilting the board, which is what lobbying really boils down to on a game-theoretic level.

A few examples of how these deeper-pace-layer dynamics play out:

TELEHEALTH AND COVID

COVID triggered an explosion of telehealth as people sought to avoid virus exposure in a doctor's office or hospital waiting room accessed newly available remote-consultation capabilities provided by their doctors and insurers. **To a technologically oriented new-and-novel pattern spotter, the proliferation of telehealth looked like a combination of technological innovation and consumer demand mingling in a beaker to unleash change.**

That's what it looked like. **But that's not what happened, as cause-and-effect. The main obstacle to telehealth, prior to COVID, was regulatory.** On a state and federal level, telehealth did not qualify for reimbursement as an office visit. Doctors couldn't get paid for it by insurers, so doctors didn't do it. The technology was there. Consumer demand was there. The financial mechanism wasn't there, and that constraint was regulatory. The CARES act granted reimbursement waivers for telehealth services during the pandemic and state regulators did the same. So, for the first time, it was possible for healthcare providers to bill insurance companies for a telehealth visit with an approved reimbursement code.

Voila, universal availability of tele-health as a doctor-patient encounter.

These waivers exist for the period of the pandemic. So now everyone involved with telehealth is lobbying to get the waivers made permanent. This doesn't happen by default – it needs staffers doing markup and a Congressional vote to happen. Lamar Alexander sponsored a Senate bill to get this done – but he's retiring. So, watch this space.

There is another reason telehealth might persist, at least for seniors, beyond the expiration of these waivers, and **this also has nothing to do with technology or consumer demand. It's driven by an arcane provision of the**

Medicare Advantage reimbursement procedures called risk. The government pays insurers who offer Medicare Advantage plans on a risk-adjusted basis for each patient, using a list of pre-existing conditions called Hierarchical Condition Categories (HCCs'…you're getting sleepy, verrrrrrry sleeeepy….). When a Medicare Advantage enrollee goes to the doctor for a checkup after enrolling in a plan, the doctor codes up the HCCs for that enrollee: heart disease, diabetes, rheumatoid arthritis, etc. Those HCCs stack up into a risk-adjustment premium payment from the government to the insurer, less for healthy people, more for people with a lot of HCCs. The table of which HCCs are worth how much money per person per month is not revised often, because of the financial and operational torque created by any change in the guts of back-office payment systems.

Here's the rub: according to government rules, HCCs have to be coded up every year – they don't carry over from year to year. It may be that the intent of this rule was to make sure that seniors get seen at least once a year. But there are unintended consequences. One unintended consequence is a cottage industry in HCC arbitrage that allows insurers to recruit people who look risky according to the formula, but actually produce predictable margins, before the government formula catches up. If you want to know what Medicare Advantage actually is from a financial-flow perspective, it's a giant arbitrage of what the insurer knows about a person's health risk-and-cost vs. the blunt actuarial instruments the government uses to pay that person's premiums.

So: what happens when Medicare Advantage enrollees don't go to the doctor to get coded up in a new plan year because they're concerned about getting COVID in a waiting room? Insurers stand to lose hundreds of millions of dollars on risk adjustment premium payments. It gets even worse if those enrollees, because they're not getting care, fail to manage their HCCs altogether: now the payer has higher costs in 2021 but is being reimbursed at a lower rate than 2020 because they couldn't get the person coded up in a face-to-face visit. They're under on the over/under.

Insurers with big Medicare Advantage portfolios now love them some telehealth, because they can use it to get enrollees coded up for 2021 risk adjustment. The technology may be great and consumers may love it. But technical innovation and consumer preference are a sideshow. The drivers are financial mechanisms in the regulatory pace layer that incentivize adoption and financially punish failure to adopt telehealth for a particular market segment, even in the absence of waiver extensions that make this service billable in the first place.

The cogs and gears are boring. The money isn't boring.

SOLAR POWER AND UTILITY METERING

Residential solar is another example of how the narrative diverges from the boring nitty-gritty of how money actually flows. There hasn't been a great deal of technical innovation in solar over the last few decades, and there isn't a lot of consumer demand. The real innovation is regulatory engineering that created subsidies and statutory mandates in California, where new home construction requires rooftop solar, and state net-metering policies that require utilities to buy residential solar power from homeowners at the retail power price, vs. the wholesale price that utility pays for the power it generates or buys off the grid. This reduces the cost of solar panels and installation for homeowners who want to be greener, transferring the cost of net-metered electricity to a broader base of ratepayers. Net-metering also decrements utility revenue available to maintain and modernize the grid.

Whether you're for or against residential rooftop solar, the financial flows in this market category are regulated by some dense and not-very-mediagenic pricing and policy mechanisms that no media outlet

will cover because it's not a story. There's no "if it bleeds it leads" narrative that's going to win approval in editorial meetings – editors demand drama to capture the attention of their dwindling readership, and solar pricing mechanisms do not deliver drama. If any of this breaks into public consciousness, it will likely play out as a political fight about whether affluent homeowners' electricity should be subsidized by working-class renters. With a shift in administration and a pendulum-swing back to solar-friendly policy-making, this is likely to play out on a national level, with sparks flying around public-sector grants and loans to private companies backed by Democratic donors (Solyndra Round 2).

Regardless, the actionable information has nothing to do with technological innovation or consumer sentiment. It's the section-subsection-paragraph details of utility regulation markup in the House Energy and Commerce Committee, or EPA calls-for-commentary on proposed rule changes. **If explaining the details makes you a boring party guest, you're probably onto something.**

QUESTIONS WORTH ASKING

Many of these deep-pace-layer change functions are slow wheels turning on wicked problems – there's a lot of complexity and confounding factors in these domains, which is why they end up in the governance layer. It's daunting to think about taming this complexity, even if only to make an investment decision. But in my experience, the complexity of any domain tends to collapse when you ask two simple questions: **Where does the money come from, and how does it get there?**

You can break the most impermeable high-level rah-rah marketing presentation with those two simple questions in rapid succession. Where does the money come from, and how does it get there. If people's feet start shuffling, there are a few more questions worth asking:

- Is this a two-party purchase – a direct transaction between consumers and suppliers? Or are there more than two parties involved?
- If there's a third party in the mix, where does its money come from?
- Are there any subsidies or mandates involved?
- Does any of this require a license?
- Is any element of the product price dependent on regulation or statute?

If so, it's worth pulling the string until the sweater unravels. If you can find someone who knows how the pachinko machine works, it can be one of the sweetest experiences in the world to listen to them explain it, because at every turn they'll ask, are you really interested in this? Am I boring you? And when you say no, I'm actually really interested in this, and you explain why, and how helpful it is, you get to see someone who's passionate about something most people don't care about find someone who actually cares. And that is, in its own unexciting way, new and interesting.

FROM PIP

If I am going to pursue having joy in seeing something no one else sees, perhaps my best path is an obliquitous one. To make sure my ego is not engaged. But, more simply, to consider what perhaps no one else is bothering to inspect.

Something hidden in plain sight.

Seeing the wheelbarrows that a child of a mere five years is walking past me with each day.

JC's note – "Boring is sexy" – is all about THAT.

What are the systematic places where massive amounts of money might be changing hands while investors' eyes are glazing over?

Obliquity. Wheelbarrows. "Try Easy." Hidden in plain sight.

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JC HERZ'S BIO

I am the COO of Ion Channel, a software supply chain platform for third party risk management and ongoing assurance of technology used in critical infrastructure. My analysis and strategy work in complex systems includes healthcare, national security and media.

"The significant problems we face cannot be solved at the same level of thinking we were at when we created them" —ALBERT EINSTEIN

COMMUNITY FOR CHANGE