

## How Not to Be a Thanksgiving Turkey

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Let me begin by saying I've spent most of my professional life as a long-term bottom-up value investor. In the 1980s I had more ideas than money. However, since the peak in speculative contagion in 2000, I've been increasingly leery of investors' acceptance of ever-expanding and equally dangerous systemic risks as the new normal. Let me explain why.

The mother of all harmful investment errors is mistaking the absence of evidence... for the evidence of absence. In other words, assuming that just because historically infrequent and potentially catastrophic events, known as Black Swans, haven't happened... they won't.

In reference to the title of this presentation, a turkey is fed for months by a farmer; every day, the turkey confirms "with increased statistical confidence" that the farmer loves him. The farmer keeps feeding the turkey until a few days before Thanksgiving. So when confronted by the farmer wielding a meat cleaver the turkey has a revision of belief, a rude awakening — right when its confidence in the farmer's love is maximal, life is good, and everything seems predictable. By then, of course, it's too late.

Investors today are in love with the farmer who fattens their portfolios of risk assets with easy money. While I'm sure many wonder about this apparent exception to the free lunch rule, the food is so delicious and the conversation so affirming that few can back away from the table.

With history as our guide, the bill for the free lunch will come due. It always does. To the extent that an unexpected future rude awakening results in lower prices for risk assets, I'm also worried that most investors have been conditioned to expect that it will follow the turkey wishbone shape of late 2008 and early 2009. You know, like the fellow who has forever eaten too much and exercised too little taking a few days off to have quadruple bypass surgery and then going back to his old ways. If a future event is expected to actually change behaviors, I doubt we'll get off that easy.

Even after two earlier costly free lunch episodes, upon which my firm capitalized,<sup>1</sup> I fear the underlying causes, deeply rooted in human nature, were deemed too unsettling to address forthrightly at the time. They are tomorrow's problem – and they are accumulating.

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<sup>1</sup> Past performance is no guarantee of future results.

With a little help from an obscure Frenchman, years ago I concluded that investment success is more likely to come to those who have some clue about the counterintuitive way that the thought processes and subsequent behaviors of crowds differ from individuals in isolation. Individuals who submit to the will of a crowd are effectively hypnotized, and behaviors become emotional, impulsive, and difficult to terminate.

Gustave LeBon, a student of the French revolution whose work I discovered in a rare bookstore years ago, wrote *The Crowd: A Study of the Popular Mind* in 1895.<sup>2</sup> His logic was so shockingly simple to understand and to apply that some of the most heinous mass crimes of the 20th century were perpetrated by men who used Le Bon's logic to manipulate crowds. For those whose interest in understanding crowds is more inclined toward self-preservation and benevolence, Le Bon leads us to believe that independent individuals of adequately high intelligence may in fact be functionally smarter than a crowd of geniuses.

Crowds elevate their heroes and role models to disproportionate heights. And the powers of persuasion for those iconic figures are most acute when their suggestions appear simple, irrespective of their connection to reality.

The crowd, as Le Bon would have predicted, gravitated to Alan Greenspan's beguilingly simple suggestion during the "Great Moderation," a policy that became known as the "Greenspan put." As has become apparent in 2013, it has been nearly impossible to terminate. Investors' confidence in the Fed's love is maximal, life is good, and everything seems predictable, just like the mood of Thanksgiving turkeys as the day of truth draws ever nearer.

Those who move prices are part of an amorphous, synthetic and increasingly global crowd like never before in history – due in large part to the explosion of electronic media with connectivity so instantaneous that there's no time to think. Thus, the crowd knows the price of everything... and the value of nothing.<sup>3</sup>

The market crowd's message is particularly insidious today because it lacks the tympanic rumble of a typical bubble. It is a herd of the needy, not the greedy. The effect is the same, but without the telltale clamor.

Investing is not rocket science. Temperament and understanding predictably irrational human nature is likely more important than raw intelligence. It's a great relief to know I don't have to be a Stephen Hawking to rise above the tyranny of the crowd. The lone wolf can accomplish the unexpected if he keeps his wits while those around him are losing theirs.

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<sup>2</sup> *The Crowd: A Study of the Popular Mind*, Gustave Le Bon (Originally published in 1895 – Schastlivye Books, 2013)

<sup>3</sup> From *Lady Windermere's Fan* (Act III) by Oscar Wilde (1892). The actual quote reads: "What is a cynic? A man who knows the price of everything and the value of nothing. And a sentimentalist, my dear Darlington, is a man who sees an absurd value in everything, and doesn't know the market place of any single thing."

There is one conspicuous flaw of the crowd's susceptibility to suggestion that fiercely independent investors can exploit. Greenspan reveals the irony if not the "fatal conceit"<sup>4</sup> of economic forecasters in his just released book, *The Map and the Territory: Risk, Human Nature, and the Future of Forecasting*.<sup>5</sup> He says, "Even repeated forecasting failure will not deter the unachievable pursuit of prescience, because our nature demands it." Undeterred by the facts and acquiescing to the presumed supremacy of human nature, people continue to listen to forecasters. It may be human nature, but it's not mine.

Value investors are not market forecasters: They don't predict prices, they react to prices set by others. Accordingly, Seth Klarman cautions that the success of an investment firm is not solely a function of the quality of its work. "It is also necessarily dependent on the actions of others. The collective behavior of the entire community of investors determines market prices, and price fluctuations, in turn, drive investment opportunity. When buyers are numerous and sellers are scarce, opportunity is bound to be limited. But when sellers are plentiful and highly motivated and potential buyers are reticent, great opportunities tend to surface."<sup>6</sup>

All of this brings us to Nassim Taleb's notion of being "antifragile"<sup>7</sup> as a way to avoid becoming the Thanksgiving Turkey and even profit without relying on forecasts. Fragile systems break when exposed to random shocks. On the other hand, antifragile systems are not merely robust, they usually get stronger when exposed to unpredictable stresses or mistakes. One need not forecast to protect oneself from random risks. One need only apply a simple test of asymmetry to decisions: Anything that has more upside than downside from random events or certain shocks is antifragile; the opposite is fragile.

Think of the body's immune system. It gradually becomes antifragile only if exposed to outside bacteria. The price of temporary physical discomfort is the buildup of antibodies in our immune system.

The capital markets have evolved over the millennia as natural complex systems. Generations of investors have historically been exposed to periodic random stresses that have kept them relatively antifragile. The occasional setbacks and shocks have made them stronger and more resilient in much the same way as the human body's immune system. Not only did the capital markets survive the panic of 1907 and the crash of 1929, but perhaps because of, rather than in spite of the devastation, investors developed antibodies to ward off speculative contagion. That is, an acute aversion to risk.

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<sup>4</sup> The misguided belief that humans can control highly complex systems like economies, from *The Fatal Conceit: The Errors of Socialism*, F.A. Hayek (University of Chicago Press, 1988)

<sup>5</sup> *The Map and the Territory: Risk, Human Nature, and the Future of Forecasting*, Alan Greenspan (Penguin Group, 2013)

<sup>6</sup> The quote is from a transcription of Seth Klarman's 2012 annual letter to Baupost clients. While the content of the letter has been widely reported in the media, the official version is not publicly circulated.

<sup>7</sup> *Antifragile: Things That Gain from Disorder*, Nassim Nicholas Taleb (Random House, 2012)

At great sacrifice, generations of investors became less fragile because they were calcinated, tempered, and hardened in the crucible of adversity. Thus strengthened, they won by not losing in the face of much misfortune for decades to come.

That is ... until after the Great Moderation of the 80s and 90s. Interventions in the natural order of things since then have compromised the market's natural immune system: In tampering with its delicate pricing mechanism, our one-sided monetary policy regime truncates market declines but foments runaway bubbles on the other end and the economy seems increasingly resistant to an ever-growing ratio of debt per dollar of GDP. In the name of short-term pain avoidance by those who have no skin in the game, monetary policy antibiotics have been overprescribed. The once antifragile system is becoming more and more susceptible to comparatively benign shocks, and with consequences that could be catastrophic. As a medical parallel, three weeks ago the US Centers for Disease Control declared we've entered the post-antibiotic era. After decades of over-prescribed antibiotics, some bacteria have become resistant and the human body has been made correspondingly more fragile.

Moving from the conceptual to the real world, I spend the bulk of my day reading the work of others whom I respect. Besides Dave Rosenberg, there are other estimable Canadians. A former Torontonian who now lives in Basel, Switzerland, William White served as chief economist for the leading edge Bank for International Settlements from 1994-2008. His credibility was established at Jackson Hole in 2003 when he and Claudio Borio warned Greenspan of the dangers of perpetually easy money.<sup>8</sup> Their recommendations fell on deaf ears. As recently as two months ago, White said the five years since the Lehman collapse have been largely wasted, leaving a financial system that is even more fragile and possibly running out of remedies and lifelines.<sup>9</sup> The world, he observes, has become addicted to easy money with rates falling ever lower with each cycle... which leaves very little ammunition if the system buckles again.

He went on to say, "All the previous imbalances are there. Total public and private debt levels are 30% higher as a share of GDP in the advanced countries than they were in 2006." Leveraged loans to junk rated companies in the US will reach a record of \$1 *trillion* in 2013 compared to \$160 *billion* in 2009.

As for the unwitting individual investor, Bill White observed that the hunt for yield in a zero-bound interest rate environment is luring crowds into investments with higher risks than they realize. He describes it as "a phenomenon reminiscent of the exuberance prior to the global financial crisis."<sup>10</sup>

During periods such as the present, portfolios can be protected by holding anti-fragile assets. Cash is foremost among them. Now before you roll me out of the conference hall in a straightjacket, let me

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<sup>8</sup> "Whither Monetary and Financial Stability? The Implications of Evolving Policy Regimes" – Claudio Borio and William White. Speech delivered at the Federal Reserve Bank of Dallas symposium in Jackson Hole, Wyoming – August 30, 2003. <http://www.bis.org/publ/work147.pdf>

<sup>9</sup> "BIS Veteran Says Global Credit Excess Worse Than Pre-Lehman," *The Telegraph*, September 15, 2013.

<sup>10</sup> Ibid.

justify my insanity. For the longest continuous period in modern history, cash pays nothing – in fact, it pays *less* than nothing when inflation is taken into consideration. Illogical as it may seem, the best time to own cash is when no one else wants it. Why is that? Because the crowd is scrambling to put its money in something – *anything* – that does pay a return. That leaves the scales unbalanced.

Interest rates are so low, eventually they have nowhere to go but up. And when that occurs, the prices of stocks and bonds will go down. As Warren Buffett has observed, cash is much more than an asset that currently yields zero – it is a call option on any asset with no expiration date and no strike price.

For the more opportunistic, one can position oneself to profit from unpredictable events that have catastrophic effects on fragile assets. Michael Lewis brought Dr. Michael Burry out of obscurity in the best-selling book, *The Big Short: Inside the Doomsday Machine*.<sup>11</sup> Interestingly, Burry caught the eyes of his hedge fund sponsors with adroit stock selection earlier in the decade. But the trade that put Burry on the map was buying CDS's on toxic pools of securitized mortgages he didn't even own. In our parlance, he went "long the short side."

While Burry saw extreme fragility in the securitized mortgage pools, the same vulnerability was apparent to me among the once-prominent investment banks on which I purchased more mundane put options, first in the summer of 2007. Both of us realized the potentially huge asymmetrical payoff—while exposing most of our capital to minimum risk of permanent loss.<sup>12</sup> Because we opposed crowd sentiment, it was not a happy time for either of us.

In short and at the risk of dredging up well-worn clichés, it's easier to fish a stocked pond than it is to find needles in haystacks. In true value-investing style, it's all about stacking the odds in your favor by understanding Mr. Market (aka/ "the crowd") and patiently waiting for him to make you a deal you simply can't refuse. I have no doubt that one of these days I will again have more ideas than money. Between now and then, Mr. Market's seeming indifference to risk may provide nonconventional ways to enhance wealth without putting one's portfolio squarely in the path of the farmer's cleaver.

— Frank K. Martin

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<sup>11</sup> *The Big Short: Inside the Doomsday Machine*, Michael Lewis (W.W. Norton, 2010)

<sup>12</sup> Past performance is no guarantee of future results.

## Bibliography

Recommended and cited books alphabetically by title:

- *Adapt: Why Success Always Starts with Failure*, Tim Harford (Farrar, Straus and Giroux, 2011)
- *All the Devils Are Here: The Hidden History of the Financial Crisis*, Bethany McLean and Joe Nocera (Portfolio / Penguin, 2010, 2011)
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- *The Big Short: Inside the Doomsday Machine*, Michael Lewis (W.W. Norton, 2010)
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- *The Crowd: A Study of the Popular Mind*, Gustave Le Bon (Originally published in 1895 – Schastlivye Books, 2013)
- *Currency Wars: The Making of the Next Global Crisis*, James Rickards (Portfolio / Penguin, 2011)
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- *This Time Is Different: Eight Centuries of Financial Folly*, Carmen Reinhart & Kenneth Rogoff (Princeton University Press, 2009)
- *Willful Blindness: Why We Ignore the Obvious at Our Peril*, Margaret Heffernan (Walker, 2012)

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- “Whither Monetary and Financial Stability? The Implications of Evolving Policy Regimes” – Claudio Borio and William White. Speech delivered at the Federal Reserve Bank of Dallas symposium in Jackson Hole, Wyoming – August 30, 2003. <http://www.bis.org/publ/work147.pdf>
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