

A Dogmatic Slumber



WAR IS PEACE
FREEDOM IS SLAVERY
IGNORANCE IS STRENGTH
– George Orwell, *"1984"*

SECRETS ARE LIES
SHARING IS CARING
PRIVACY IS THEFT
– Dave Eggers, *"The Circle"*

Beauty is no quality in things themselves: It exists merely in the mind which contemplates them; and each mind perceives a different beauty. One person may even perceive deformity, where another is sensible of beauty; and every individual ought to acquiesce in his own sentiment, without pretending to regulate those of others.

– David Hume, *"Of the Standard of Taste and Other Essays"* (1748)

I freely admit that the remembrance of David Hume was the very thing that many years ago first interrupted my dogmatic slumber.

– Immanuel Kant, *"Prolegomena to Any Future Metaphysics"* (1783)

All that is required for this enlightenment is *freedom*; and particularly the least harmful of all that may be called freedom, namely, the freedom for man to make public use of his reason in all matters. But I hear people clamor on all sides: Don't argue! The officer says: Don't argue, drill! The tax collector: Don't argue, pay! The pastor: Don't argue, believe!

– Immanuel Kant, *"What is Enlightenment?"* (1784)

There's nothing to be afraid of. They were right. It's painless. It's good. Come. Sleep. Matthew.

– Elizabeth Driscoll, *"Invasion of the Body Snatchers"* (1978)

"And that's my point," Mae said, nodding to Stenton. "The technology has never been there before."

– Dave Eggers, *"The Circle"* (2013)

I want to start this week's note with an extended passage from Orwell's *1984*. Trust me, it's worth it.

"What are the stars?" said O'Brien indifferently. "They are bits of fire a few kilometres away. We could reach them if we wanted to. Or we could blot them out. The earth is the centre of the universe. The sun and the stars go round it."

Winston made another convulsive movement. This time he did not say anything. O'Brien continued as though answering a spoken objection:

"For certain purposes, of course, that is not true. When we navigate the ocean, or when we predict an eclipse, we often find it convenient to assume that the earth goes round the sun and that the stars are millions upon millions of kilometres away. But what of it? Do you suppose it is beyond us to produce a dual system of astronomy? The stars can be near or distant, according as we need them. Do you suppose our mathematicians are unequal to that? Have you forgotten doublethink?"

Winston shrank back upon the bed. Whatever he said, the swift answer crushed him like a bludgeon. And yet he knew, he knew, that he was in the right. The belief that nothing exists outside your own mind -- surely there must be some way of demonstrating that it was false? Had it not been exposed long ago as a fallacy? There was even a name for it, which he had forgotten. A faint smile twitched the corners of O'Brien's mouth as he looked down at him.

"I told you, Winston," he said, "that metaphysics is not your strong point. The word you are trying to think of is solipsism. But you are mistaken. This is not solipsism. Collective solipsism, if you like. But that is a different thing: in fact, the opposite thing."

If there is a better example of the overwhelming power of Common Knowledge than the Collective Solipsism of *1984*, I have yet to find it. As O'Brien patiently explains to Winston between torture sessions, Collective Solipsism is the *voluntary* abdication of empirical and independent thought by a large group of humans. It is the opposite of solipsism in its usual definition – a pathological egocentrism where reality is defined by an individual's mental perceptions and conceptions – as Collective Solipsism annihilates the individual's perception of reality in favor of some group perception of reality. This group perception is the foundation of a robust and equilibrium totalitarian state because everyone *believes* in the crowd-based reality they have constructed. In the end ... Winston loves Big Brother.

The modern dystopia of Dave Egger's *The Circle* is similarly based on the voluntary nature of stable totalitarianism. It's a fascist corporatist state with a giant smiley face, full of "likes" and "friends" and really good healthcare plans, but a fascist corporatist state nonetheless. What Eggers captures wonderfully is the insatiable hunger and constant aggrandizement of a collectivist philosophy – any collectivist philosophy, even one with cool technology and efficient services – that believes we know your self-interest better than you know your self-interest.

The totalitarian worlds of *1984* and *The Circle* are so powerful in our imaginations because we have all heard the siren call of Common Knowledge and Collective Solipsism. It's not only comforting to be part of the crowd watching the crowd in its experience of a social behavior ... any social behavior, from a football game to an IPO ... it's fun. We like it. As social animals we are hard wired not only to participate in the crowd but also to *believe* in the crowd and *enjoy* the crowd. It's our nature.

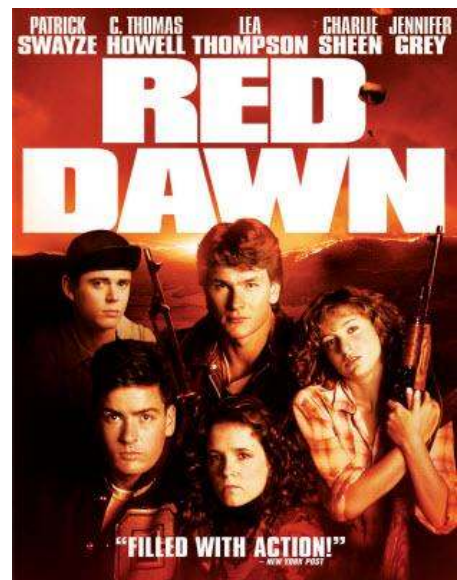
But it's also our nature to think for ourselves and try to do better than the crowd, to strive for some sort of personal advancement or success in whatever way we define it, and this is the behavioral foundation



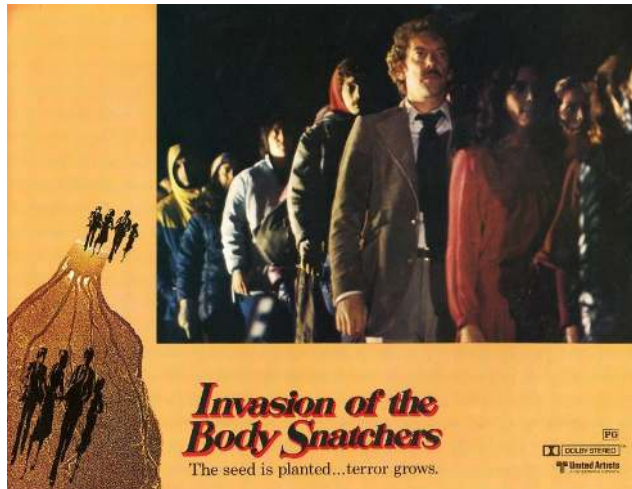
of the two most powerful institutionalized social forces in our lives: the politics of liberal democracy and the economics of liberal markets. The ideas of small-I liberalism are a few hundred years old, but the way David Hume and Immanuel Kant expressed those ideas seem as fresh today as they did in the mid-18th century. If you don't know what Hume and Kant were all about ... well, I can't begin to do them justice here. Suffice it to say that they are two of the Mount Rushmore figures for small-I liberalism. Hume in particular is an intellectual hero of mine, and – like Kant – when I first read his essays I felt as if I were awakening from a

“dogmatic slumber”. **Hume is the red pill.**

But Hume and Kant lived in a world that was blissfully ignorant of collectivism and media technology on a mass scale, a world that experienced tyranny and freedom in a “Red Dawn” sort of way, where tyranny is an occupying Russian army and freedom is a scrappy bunch of right-thinking Colorado teenagers. There's no question here about identifying the oppressors and the oppressed. There's no conflict between the internal exercise of your freedom to think for yourself and your external behavior. There's no omnipresent social media, no cacophony of commercial voices, no GPS chips, no algorithms that can predict your likes and dislikes better than you can yourself. It's just faceless soldiers with AK-47's trying to impose their will on Patrick Swayze's external behavior. It's a movie that would have made as much sense (more?) in 1784 as it did when released in 1984.



Our world isn't "Red Dawn," it's "Invasion of the Body Snatchers." Control over our behaviors isn't as



much physical as it is mental, not so much externally imposed as it is internally embraced.

If you're reading this note, the problem is not that you are in a dogmatic slumber and need to be woken up. The problem is that you know it's in your best economic interest to act as if you're still asleep. In a world overrun by pod people, the big losers are the people who can't fake their pod-ness and ultimately get outed by Donald Sutherland.

I don't know anyone who believes that open-ended QE and ZIRP-forever monetary policy does much of anything for job creation, even though that's the ostensible rationale. I don't know anyone who believes that Modern Portfolio Theory and its quantifications are anything more than rules-of-thumb or guardrails for portfolio construction and risk management. Actually, let me qualify that a bit. I know *lots* of academic and institutional economists – [the clerics of our modern Church of Economic Science](#) – who believe wholeheartedly in all of this as some sort of received wisdom from on high. I don't know any practicing money manager who does. But by the same token I also don't know any practicing money manager who doesn't genuflect to these beliefs, who doesn't mouth the words of our modern market catechisms. We all believe in the market-moving power of the *institutions* that promote these ideas, whether it's the Fed or a mega-asset management firm or a bulge-bracket bank; very few of us believe in the *ideas themselves*. But so long as "everyone knows" that these institutionally promoted ideas are the only thing that really matters for investment performance or asset allocations, nothing will change in our behaviors. We will continue to *act as if* we are true-believers, too.

As much as it pains me to say this, Hume and Kant and Smith and the rest of the small-I liberal pantheon don't have a whole lot to offer in our efforts to survive a pod people world. **A voluntary acquiescence to the collectivist behavior demanded by the Common Knowledge game poses a huge problem for Hume and Kant and traditional liberalism.** What if your independent use of reason and free will leads you to deny your independent use of reason and free will? What if the most effective way to *act as if* you believe that the Emperor is wearing beautiful clothes is to give yourself over to the crowd-generated reality and *actually believe* that the Emperor is wearing beautiful clothes?

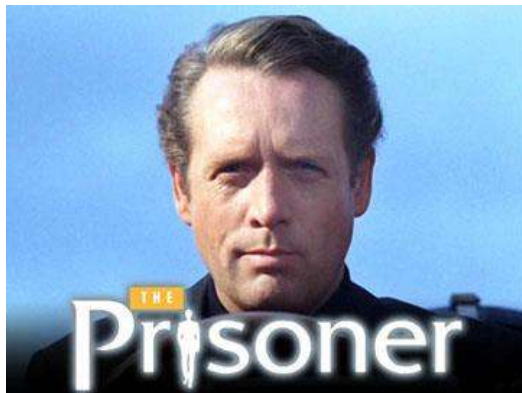
A problem for Hume and Kant is a problem for each and every one of us, because all of modern microeconomic theory – ALL of it – and by extension all of macroeconomic theory, too, is based on the liberal idea of independent self-interested decisions. The more that assumption is off base, the more that we are captured by the Common Knowledge game and act on the basis of a crowd-generated reality rather than our direct individual assessment of the world ... the more our entire edifice of modern Economic Science becomes a false teaching, a dogma. By false I don't mean that the equations are miswritten or simply need another mathematical term appended. I mean that the entire enterprise of economic theory becomes less useful, a collection of prayers that we recite by rote because we must in order to pass, not because they have any intrinsic *meaning* to us. Modern economics is becoming an institutionalized superstition rather than an effective toolkit for the pursuit of life, liberty, and the pursuit of happiness. And that's a shame.

Or at least it's a shame from a liberal, individualist perspective. From the perspective of the institutions that promote these dogmas it's all good. This voluntary and entirely rational participation in a crowd-generated reality makes the current social equilibrium even more stable, the current institutional control over the means of mental production ([as Marx would call it](#)) even more pronounced. Until some alternative conception of markets emerges that is more useful than current theory AND that alternative conception serves the interests of powerful institutions, nothing will change. The Copernican theory of a helio-centric solar system didn't prevail because it was right; it prevailed because the secular powers of post-Reformation Northern Europe found it useful in their bloody fight with the Catholic Church.

The good news, though, is that I think there are powerful financial institutions today that are in fact deeply dissatisfied with the status quo and are actively seeking an alternative conception of market behavior. Partly this is a function of the fact that institutions are led by actual human beings, many of whom are genuinely concerned about the long-term health of liberal institutions like markets as they are hollowed out from within by the cancer of Collective Solipsism. Partly (probably more so) this is a function of the fact that there is a significant business opportunity for financial institutions that can provide a more useful and effective vision of how to think about investing today. Regardless of the motive, I see this hunger for a new perspective on markets every day in the responses I receive to Epsilon Theory, including responses from the Powers That Be in the financial world. Something big is brewing here, and I truly believe it's going to make a difference. Help – or at least a meaningful alternative – is on the way.

Where should we look to find this alternative? I think we need to think about markets from a biological or evolutionary perspective rather than the traditional perspective of liberal thought. Hume and Kant might not have much to say about how a pod people world develops and how a population of non-believers can thrive in that world, but Charles Darwin and E.O. Wilson sure do. The best game theory research today is found in the fields of linguistics and evolutionary biology, not economics, and over the past six months [I've written about how to use these ideas to understand better a wide range of market behaviors](#). Now I want to tie all this together in a concept that I call **Adaptive Investing**, a name that reflects the central dynamic of evolutionary theory, where *populations* of self-interested organisms take on persistent characteristics and behaviors in response to environmental challenges and opportunities. It's a perspective that takes seriously both individual self-interest as well as collective imperatives, and I believe it will be useful for investors and allocators alike.

My goal here is to find a third way, some other path than either sitting out these markets until they return to "normal" or falling asleep in a dogmatic slumber and becoming a pod person. I think the former path – just sitting this out – is both wishful thinking and a luxury that very few of us possess. Maybe a reckoning of sorts is just around the corner, [but I doubt it](#). In H.G. Wells' *War of the Worlds*, the



Martian invasion peters out when the aliens catch a cold and die off. Somehow I think it unlikely that the pod people will fall prey to the same sort of *deus ex machina*, and I'm certain that CNBC and Twitter and ETF's and high-frequency trading [are not going to be un-invented](#). As for the latter path ... sorry, once you choose the red pill there's no going back. As Prisoner Six would say, "I am not a number. I am a free man!"

But all of the great historical observers of the human condition – whether it's Gautama or Lau Tzu or Jesus or Marx or Hume – need to be interpreted in the context of how we live today, not parroted as some sort of talisman from the past. Like it or not, we live in a mass society where the technological and social inventions of the past 200 years challenge the concepts of liberalism in ways that Hume et al did not foresee. Political and economic institutions have already adapted to these innovations (they always do!) in order to protect their core interests. Now it's our turn. I think that game theoretic applications of evolutionary biology and population dynamics can help in that effort, with actionable insights for how to think about investing, and that's where I'm taking [Epsilon Theory](#). I hope you'll [join me](#).