



Epsilon Theory

Pricing Power (pt. 3)

Government Collaboration

February 24, 2019



Tim the Enchanter: There he is!
King Arthur: Where?
Tim the Enchanter: There!
King Arthur: What? Behind the rabbit?
Tim the Enchanter: It IS the rabbit!
King Arthur: You silly sod!
Tim the Enchanter: What?
King Arthur: You got us all worked up!
Tim the Enchanter: Well, that's no ordinary rabbit.
King Arthur: Ohhhhh.
Tim the Enchanter: That's the most foul, cruel, and bad-tempered rodent you ever set eyes on!

- Monty Python and the Holy Grail (1975)



I feel like Tim the Enchanter a lot, especially when I spend much time on Twitter.

When an inflation regime shifts, there's only one question that really matters for your business model: *do you have pricing power?*

With apologies to the Monty Python troupe, I want to write about three forms of pricing power that often go unnoticed, but will be incredibly powerful as the great economic pendulum swings from deflation, falling rates and a wealth concentration zeitgeist to inflation, rising rates and a wealth distribution zeitgeist.

Because if you don't see that this is where we're going – a sea change reversal of the BS supply-side narrative that dominated our political zeitgeist for the past 40 years, now becoming the BS MMT narrative that will dominate our political zeitgeist for the next 40 years – then you're just not paying attention.

But these are the cards we've been dealt. Let's play them as well as we can.

I'm focusing on the financial services ecosystem in these notes, because this industry has already been totally wrecked by financial asset inflation, a tide that lifts all boats and squeezes all margins regardless of skill or smarts.

It's a margin-wrecking inflationary flood that is coming soon to all service industries.

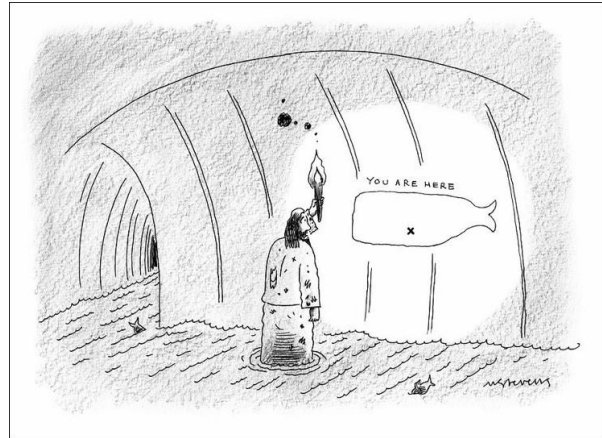
The skinny of "Pricing Power #1 – Client Ownership" is that pricing power in a services industry is found in your proximity to the client relationship, not the product that the client is buying. The problem, of course, is that it's really really hard to scale client relationships, or at least it's hard to scale the relationships that are worth scaling.

The skinny of "Pricing Power #2 – Intellectual Property" is something of the reverse. If you ARE on the product side of your industry, then the only way to maintain pricing power is through *narrative-rich* if not *mythic* intellectual property. Conversely, relationship owners always think that they can scale their nice little client-facing businesses with Technology IP. *They are always wrong.* The one (rare) exception is the use of Content IP, but even here you are scaling your client relationship depth, not your client relationship breadth.

The skinny of "Pricing Power #3 – Government Collaboration" is that the most dependable way to protect your margins and maintain pricing power is to partner with the government to provide a politically useful service. I don't mean an overt partnership. I don't mean becoming a government contractor (although sure, that works, too). **I mean identifying the *social meaning* of your services industry and implementing a business strategy that supports THAT.**

I know it sounds all touchy-feely to talk about the "social meaning" of this or that, and it is, in fact, completely intangible and invisible to the naked eye. But it's no less real for that.

Social meaning is another word for Zeitgeist, the spirit of the age. Here's the long-form Epsilon Theory note on that.

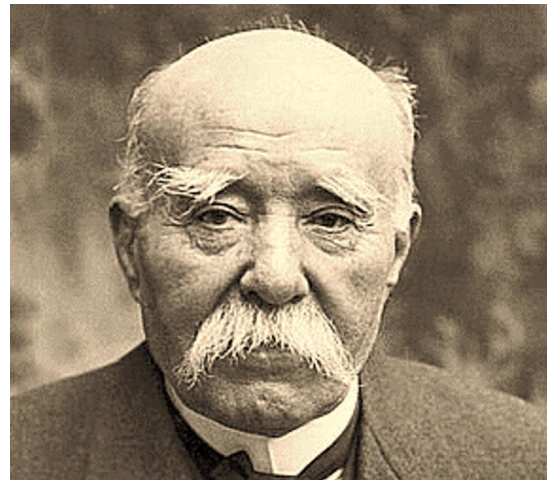


For the financial services industry, the Zeitgeist boils down to one core idea, one core dynamic:

Capital Markets are being transformed into a Political Utility

After the systemic near-death experience of The Great War, French President Georges Clemenceau famously said **“wars are too important to be left to the generals”**.

After the systemic near-death experience of The Great Financial Crisis, all political leaders – *of both the Right and the Left* – are saying **“asset prices are too important to be left to the investors”**.



How have political leaders wrested control of price-setting from investors in the 2010s, just as they wrested control of war-setting from generals in the 1920s? I'll start with a simple but (for many) painful fact, the end result of capital markets transformed into a political utility.

For the past 10 years, ever since the end of the GFC, active investing in general and value investing and quality investing in particular have failed.

And not just failed a little, but failed a lot.

The green line below is the S&P 500 index, including dividends. The blue line below is a market neutral Quality Index sponsored by Deutsche Bank. They look at 1,000 global large cap companies and evaluate them for return on equity, return on invested capital, and accounting accruals ... quantifiable proxies for the most common ways that investors think about quality. Because the goal is to isolate the Quality factor,

the index is long in equal amounts the top 20% of measured companies and short the bottom 20% (so market neutral), and has equal amounts invested long and short in the component sectors of the market (so sector neutral).



You've made a grand total of not quite 8% on your investment in this Quality-focused index ... not per year, but over the last DECADE.

Over the same time span, your passive investment in the S&P 500 has almost quintupled. With dividends, it's up more than 360%.

For the past TEN YEARS, Quality has been absolutely useless as an investment strategy.

Have the Quality stocks in your portfolio gone up? Yes, but it's not because of the Quality-ness of the companies. It's because ALL stocks have gone up, Crap and Quality alike. In lock step, with nary a blip either way.

And yes, I'm using this Quality index as a proxy for active portfolio management of all types. *Because it is.* Sure, quality – like beauty – is in the eye of the beholder. But the core bias of every discretionary manager, regardless of asset class or geography or whatever corner of the investment world they play in, is always the same – *buy the good stuff and avoid the crap.*

For the past decade, all of your smarts ... all of your efforts ... all of your time ... all of your money ... every resource you have devoted to distinguishing between good stuff and crappy stuff in large-cap public equity markets ... has been wasted. I'm not using the word "wasted" in a pejorative or judgmental sense. I'm using it in the technical sense. It has given you no better results than the less smart, less hard-working, less devoted, less well-resourced investors who just plopped their money willy-nilly into crappy stuff.

It's not fair.

But it is the truth.

As a result, your business model – which requires you to charge enough in fees to cover the cost of all these resources you have wasted – has been squeezed and squeezed and squeezed. Because no one is going to pay you more for less. Marketing alpha can only go so far. And when that runs out ... well, it's "family office" time.

Now here's the kicker.

The failure of active management is not an accident.

The political rule-setters for markets don't give a damn about rewarding quality companies and punishing crappy companies, much less rewarding smart investors and punishing stupid investors. They care about not doing 2008 again. Ever. Under any circumstances. They care about providing a rising tide that lifts all boats. And so that's what we're going to get.

The intentional transformation of capital markets into a political utility is the common thread of ALL of it ... all of the QE, all of the ZIRP, all of the negative interest rates, all of the forward guidance, all of the "communication policy", all of the Fed puts, all of the Dodd-Frank theater, all of the regulatory blindness towards too-big-to-fail banks, all of the Trump tweets about the market, all of the CNBC appearances by White House apparatchiks, all of the Chuck Schumer "buy-backs are evil" op-eds, all of the Green New Deals, all of the show trials to come (and there will be show trials). All. Of. It.

This is what a change in the financial services Zeitgeist feels like. This is what a change in the financial services Zeitgeist IS.

The Zeitgeist is a little white bunny rabbit. With killer teeth.

If you're an active manager or a value investor, the monster isn't hiding behind the Zeitgeist.

The monster IS the Zeitgeist.

Now I know what you're thinking, because I've thought it, too.

Is there some Holy Hand Grenade of Antioch available to blow the killer rabbit to smithereens?

Sorry, but no.

The answer here is that you don't fight the Fed. You don't fight City Hall. In fact, the real answer is that you fight on the SAME SIDE as the Fed. On the SAME SIDE as City Hall.

You know, like Saint Warren does on taxes.

Opinion | OP-ED CONTRIBUTOR

Stop Coddling the Super-Rich

By WARREN E. BUFFETT AUG. 14, 2011

MONEY

Ocasio-Cortez's 70% tax plan gets fierce response, but even Warren Buffett says rich should pay more

Catherine Clifford | 5:33 PM ET Mon, 7 Jan 2019



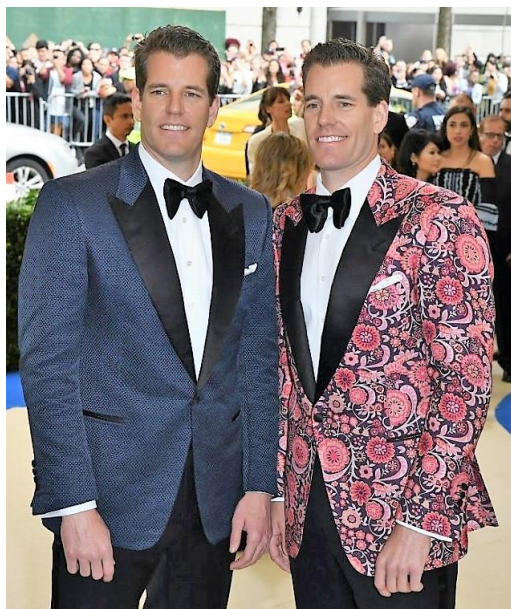
BUSINESS NEWS NOVEMBER 17, 2010 / 2:23 PM / 8 YEARS AGO

Obama to award Warren Buffett Medal of Freedom



I think that Berkshire Hathaway pocketed something like \$29 billion from the Trump tax cuts. But hey, rail against carried interest taxed as capital gains and you, too, can insulate yourself and your company from the Democratic 2020 anti-oligarch jihad.

Or like the Winklevi do with crypto.



I know that crypto bros (and they're all bros) love the anti-establishment mythos around Bitcoin. The social meaning of crypto – its Zeitgeist – was absolutely the halo effect of rebellion it provided. And what a convenient rebellion it was. Owning crypto was like getting a tattoo on your upper arm ... you could tease it when desired as a signifier of your counter-culture bona fides, but you could also cover it completely while working for the Man. And maybe get rich, to boot!

That's all gone today. Instead, you've got the Winklevoss Twins welcoming their new SEC overlords, intentionally setting themselves up as the squares. It's the smart move. I don't know if it will work ... without the cool kid mystique, I don't know how you drive crypto adoption

anywhere but in the neo-gold bug "just you wait until the System collapses" crowd, and that's such a depressing space. Sure, the Winklevi try to be personally cool, but it's just ludicrous ... they come across as Fonzie's, not as James Deans. But it's the smart move. IF crypto makes a comeback, I think Gemini will dominate the exchange space.

Or like Vanguard does with passively managed investment strategies.



The most amazing thing to me about Vanguard's advertising strategy is that sometimes I don't think there is a strategy. Does Vanguard even have a TV ad budget? My best guess on Vanguard's annual advertising budget is \$100 million, twice what they've said they spent a few years back. And yet the AUM just comes rolling in, billion after billion after billion ... trillion after trillion after trillion. THIS is the power

of a business model that fits the Zeitgeist of capital markets transformed into political utility. You don't have to convince people to give you money. You don't have to construct a winning brand or marketing alpha. The secret of Vanguard is not only that they're not wasting resources on unrewarded active investment management (in 2017, 45 employees managed \$2 trillion in AUM in Vanguard's equity indexing group ... that's \$44 billion per employee!), but also that their **cost of customer and asset acquisition is so low**.

I can't emphasize this point strongly enough. Financial services companies live and die on distribution. Clients come and clients go. But if you can keep your customer acquisition costs low, you will ALWAYS live to fight another day. No matter what happens to performance.

On the other side of that spectrum, you've got TD Ameritrade and their *incessant* advertising campaign for all active management, all of the time. My god, but I weary of the smarmy dude with the beard, telling me that trading options is "just like playing pool". And yeah, go ring that 24/5 bell, Lionel. All night long. Haha. How droll.



In 2018, TD Ameritrade spent \$293 million in direct advertising expenses, three times my estimate of Vanguard's spend for one-twelfth the net asset increase. Forget about all the employee comp associated with sales and marketing, I'm just talking about direct advertising costs. For this money, the company gained 510,000 net new accounts in the year, meaning that each net new account cost \$586 in direct expenses. Now is there churn on accounts, so that gross new accounts are more than 510k and customer acquisition costs are proportionally less? Yes. But I can't see any way it costs less than \$500 for TD Ameritrade to get a new client, before you even start considering employee comp. And these costs are going up. TD Ameritrade is guiding to \$320 million in advertising expenses this year. Lionel doesn't ring that bell for free, you know.

I'm not trying to make a direct comparison between TD Ameritrade and Vanguard. They play in different ballparks. I'm also not trying to say that one is a better managed company than the other. What I AM saying is that Vanguard has taken an easy business path and a robust business path, and TD Ameritrade has not. Vanguard fits the financial services Zeitgeist perfectly, and TD Ameritrade fits not at all.

All of this applies to people just as much as it applies to companies. More so, really.

There's a great scene in "The Holy Grail" when Arthur and his squire cloppety-clop their imaginary horses through a field where two peasants are toiling, and Arthur asks them about a castle up on the hill. The peasants aren't nearly as star-struck by the "King of the Britons" as the King of the Britons expects them to be, and it leads to this exchange:

Peasant Woman: Well, how'd you become king, then?

[An angelic choir begins...]

King Arthur: The Lady of the Lake, her arm clad in the purest shimmering samite, held aloft Excalibur from the bosom of the water, signifying by divine providence that I, Arthur, was to carry Excalibur. *[singing stops]*
That is why I am your king.

Dennis: Listen. *Strange women* lying in ponds distributing swords is no basis for a system of government. Supreme executive power derives from a mandate from the masses, not from some *farcical aquatic ceremony*.

King Arthur: Be quiet!

Dennis: You can't expect to wield *supreme executive power* just 'cause some watery tart threw a sword at you!

King Arthur: Shut up!

Dennis: I mean, if I went around saying I was an emperor just because some moistened bint had lobbed a scimitar at me, they'd put me away!

King Arthur: *[grabs Dennis]* Shut up! Will you *shut up?!*

Dennis: Ah, now we see the violence inherent in the system!



A lot of active managers are like King Arthur here.

They think that they are somehow OWED alpha because they're really smart guys and they think really hard about 10-Qs and 10-Ks if they're fundamental stock-pickers, or they think really hard about national accounts and balance of payments if they're macro guys.

For a lot of years, active managers were the king. And they acted like it. They acted like it was somehow a divine right to ... not just make a lot of money, but to make *orders of magnitude more money* than any other profession on earth. Why? Because it was Common Knowledge – everyone knew that everyone knew – that active management worked. Benjamin Graham or Warren Buffett or George Soros or Julian Robertson or some such had handed up an Excalibur of unfailing investment knowledge and process from the bosom of their waters to these knights and kings of active management.

Today, of course, the Common Knowledge is that this was all just a farcical aquatic ceremony.

Both views are silly. But I'll give you one guess which view fits the current financial services Zeitgeist of a public utility better. I'll give you one guess in which direction the investment world will continue to spin.

Here's the Truth with a capital T – the market owes you nothing. No matter how smart you are and no matter how hard you work, the market owes you nothing. But if you're very smart and you work very hard, you can take what the market is able to give you.

Today, unfortunately, the market is not able to give you a lot.

Not because prices are inflated or earnings growth is this or CAPE ratios are that.

Not because you haven't studied the holy texts of your investment creed carefully enough.

But because *private information* – which is the one and only source of *edge* in the investment business – is being slowly but surely sucked out of public markets as part of this transformation into a public utility.

In 2009 the SEC established an Office of Quantitative Research and an Office of Risk Assessment and Interactive Data, and – for operational surveillance – an Office of Analytics and Research within its Trading and Markets Division. In July 2013, the SEC announced the creation of a Center for Risk and Quantitative Analysis, to “provide guidance to the Enforcement Division’s leadership.” Taken together, these offices form the equivalent of the SEC’s version 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. And on the traditional surveillance side, the DOJ has been given amazing latitude by the courts of late to pursue widespread wire taps across a wide swath of the financial services industry.

I can’t emphasize strongly enough the importance of these surveillance institutions as a tool in the political effort to transform capital markets into a political utility.

How? By taking 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 – and using Big Data and Big Compute to turn them into powerful weapons.

Reg FD 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 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 – *which is by definition idiosyncratic outperformance, 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.

Let me say that again, with feeling: **since 2009, the SEC treats any idiosyncratic market outperformance in strategies they can easily monitor – i.e., stock-picking strategies – as prima facie evidence that you may have broken the law.**

To investigate this potential law-breaking, the SEC now routinely questions both active managers and corporate management teams who talk to active managers, *if and only if stock-picking alpha has occurred in that company’s securities.*

Before Reg FD, CEOs and CFOs would meet with active portfolio managers in private all the time. Active managers were your partners, and you told them what they needed to know. That does NOT mean that

you told them this quarter's earnings results, because that is NOT what active portfolio managers and their analysts need to know. Remember, these active managers are some of the smartest and hardest working people in the world. They don't need to be spoon-fed with insider information. They've done their homework.

No, active managers only need the answer to one simple question to supply all of their private information / alpha generating needs.



Is it safe?

So ... if you've never seen *Marathon Man*, you have my permission to stop reading this note and go watch the movie. It's why Laurence Olivier is an actor's actor. It's why it's taken me 40 years to get comfortable with a visit to the dentist, and I'm actually just saying that to be brave – I'll never be comfortable with a dentist.

Laurence Olivier's Nazi torture-dentist didn't need a full download from Dustin Hoffman's hapless grad student. He just needed to know if his overall plan had been blown. *Is it safe?*



That's all that active managers need to know, too. Has our overall investment plan been blown by ... I dunno, all you Kraft Heinz value investors, maybe an SEC investigation that hasn't been announced publicly yet and will crater the stock for a while? You're not looking to short the stock and you're not looking to play the quarter. You just want to get out of the way while the company goes through this rough patch, and you'll be right back in there buying the stock soon enough. Is that too much to ask? Because you believe in this company. You've done your homework. You're a long-term investor. *But is it safe?*

THIS is the true source of alpha back in the golden age of active management. Not your adherence to the Value Investor Bible. Not some magical Excalibur of process and smarts. Not some obvious criminality like tipping an imminent acquisition or quarterly earnings. It was all conversations like this, only in a suite at the Mandarin Oriental instead of a dentist's office, and with hotel catering instead of root canals. *Is it safe?*

Even after Reg FD was instituted in 2000, CEOs and CFOs *still* felt pretty comfortable communicating an answer to the "Is it safe?" question 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. Private meetings between active managers and corporate management became acts of theater, with a lot more private information "slippage" and a lot more active management "error". The private information gathering process for active managers was damaged. But not ruined. Call it the silver age of the active manager.

And then came the Great Financial Crisis. Then came the 2009 SEC surveillance weaponization.

So how do CEOs and CFOs interact with active managers today? With the knowledge that every 1x1 meeting can and will be used against them if the manager is extra successful in the stock? Today CEOs and CFOs duck the conversation entirely and have the IR VP sit in for them. Today they have large group meetings with as many people as possible in the room. Today they say NOTHING that has not already been said, word for word, in a 10-Q or an 8-K filing. Unless you're Elon Musk, of course, and look at what a lightning rod he's become for behavior that would have been totally ignored 20 years ago.

Now put yourself in the active portfolio manager's shoes. You don't want to take that 1x1 meeting with the CFO, either! But you still have to take big swings, 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. 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. But these are awfully poor substitutes for the private information that used to be at your fingertips, the answer to that simple question: *Is it safe?*

This isn't a chilling effect. This is a polar vortex effect.

This is why active managers, no matter how smart and how hard working, can't beat the market even BEFORE you take into consideration all of the QE and forward guidance and extraordinary monetary policy and (coming soon) extraordinary fiscal policy.

They have no edge. They have no private information. Not just because monetary policy has swamped fundamental or company-specific information as a mover of asset prices, but also because **since 2009, active management outperformance has been treated with regulatory prejudice.**

Regulatory prejudice is part of the killer bunny Zeitgeist, too.

In fact, I think it's the most important part of how capital markets have been transformed into a political utility. It's just not the most obvious.

Which leads me to what I think is the core question that active managers must wrestle with if they are to reclaim market relevance and – yes – pricing power in the financial services industry.

Where can we find legal private information about publicly traded companies?

You can rail about the Fed all you like. God knows I do it a lot. They're not going to listen and they're not going to change. In fact, they're going to do more. Scratch that, they're going to do MOAR.

You can wish for the good old days of meaningful 1x1s to return. They won't. There's nothing mean-reverting about the Surveillance State or the political benefits of going after Axe Capital wherever and whenever possible.

You can continue to spout the same old canards about how "you know your companies better than anyone" or how "your process works over a credit cycle" or whatever it is that you tell yourself to keep the old faith burning. Or at least smoldering. But spare me all that, okay?

Active investing is hard. It was always hard. It has gotten a lot harder over the past ten years. It will get even harder over the next ten years. It will probably never get easier, at least not in our lifetimes. That's the thing about golden ages. It's a one-way path down, never up.

Still with me? It's really okay if you're not. It's really okay to take the *Don't Fight 'Em, Join 'Em* road. It's really okay to take the Winklevi/Vanguard road. **It's the smart move.**

But it's not me.

I'd rather try to solve this really hard puzzle and fail than ignore the puzzle and be a successful soma distributor in this brave new world of political market utilities.

And I think we've identified a promising research program for solving this puzzle, at least in part. That research program is the game theory of narrative, and the research tool is natural language processing (NLP). That's our approach to finding legal private information about publicly traded companies, and you're welcome to join us. Here, **take a look.**

I don't know if our research program will pan out. And that's okay. You may not like this research program or want to do it your own way or try now for something completely different. And that's okay, too.

What I know for sure, though, is that we're asking the right question.

Where can we find legal private information about publicly traded companies?

That's what makes active management work. It's the only thing that has EVER made active management work. And it's the only thing that will make active management work again.



Next up ... yeah, I know I said this would be a three-part series, but it's just too much fun ... making do with what you've got, even if they're just coconuts. **The pricing power of real assets.**

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