



Epsilon Theory
Margin Call

March 16, 2020



There are two cartoons which lead both investors and nations to ruin.

The first kind treats a false measure as a true one.

The second kind treats a model of reality as if it were reality.

Both cartoons are perilous in the face of uncertainty. The first, the **measurement cartoon**, empowers actions based on a false confidence about the *current* state of a thing. The second, the **model cartoon**, empowers actions based on a false confidence about the *future* behavior of a thing.

Yet while both are perilous, their perils are not equal.

When we pretend our measurement cartoons tell us true things to guide our response to uncertain events, unless we are protected by a shield of time, law, arcane GAAP rules or an iron-clad, authoritarian grip on information, truth will typically out. It is difficult to hide bodies forever. Even if the true underlying reality being measured remains elusive, common knowledge about the cartoon in the face of sufficient contrary information may not. Eventually everybody knows that everybody knows that the cartoon is a fraud.

When we pretend that our model cartoons tell us true things about uncertain events, we may never realize that the predictions from our complicated models of reality weren't necessarily so.

Often until it is too late.

The perils of measurement cartoons have been the chief focus of our essays thus far. These are stories about how various institutions acted to suppress the discovery, measurement and reporting of the true extent of infected individuals. They are also stories about how policies of governments, corporations and other institutions were designed around those constructed realities.

Stories about the CCP.

Body Count



China is fighting nCov2019 exactly like the US fought North Vietnam ... with policy driven more by narrative control than by what's best to win the war. That was a disastrous strategic mistake for the US then, and it's a disastrous strategic mistake for China today.

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Stories about the WHO.

The Industrially Necessary Doctor Tedros



To date, WHO leadership has simply been part of the Chinese narrative machine. It's more than a disgrace. It's more than a humiliation of the people who do good and important work through WHO. It's a betrayal of the entire world.

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Stories about the US federal and state governments.

Don't Test, Don't Tell



The CDC's Don't Test, Don't Tell policy came crashing down last night. So did Trump's "buh, buh the flu" and "Yay, Containment!" narratives. Now let's get to work preparing for the fight to come. Not in panic. Not in fear. But with resolve, sacrifice and righteous anger for those who would use us instrumentally for their own political ends.

Clear eyes. Full hearts. Can't lose.

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Fortunately, as (almost) the entire world has slowly come around to the realization of the reality underlying the measurement cartoon, policies have changed rapidly. Damage was done, but now further damage is being limited. It can be our finest hour, and we believe it will be.

Tick-Tock



For the first time our federal government is treating the fight against this virus like the war that it is. Is it pathetic and sad and a corrupt betrayal of the public trust that it took this long? Absolutely. But now here we go. And there is no country in the world that mobilizes for war more effectively than the United States.

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True to form, however, it is the institutions who have relied on **model cartoons** who have not yet acted to limit damage.

In markets, that obstinacy is **still** coming to head today, especially for a swath of global macro, relative value and multi-strategy hedge funds. These institutions aren't full of idiots. They no doubt saw the uncertainty associated with Covid-19 and its policy response. But they believed in their estimates of correlations among financial assets. Even so, it isn't just that they *believed* in them. There is no shame in being process-oriented. It is that they continued to bet on those models of correlation with (often) significantly leveraged positions, despite everything in the world screaming at them that their models had become representations of something that looked nothing like the world that was unfolding.

Do you think **only one** horror story will come out of this? Do you think Sunday's emergency Fed action had *our* credit availability in mind? That it was designed to make sure *we* could still apply for a Capital One card or refinance our mortgages and access short-term capital to keep paying our small business's employees for a few weeks? Don't get me wrong about this – a lot of good hedge fund managers will lose money in March. This isn't about whether you got the trade right. It's about whether your process empowered you – whether systematically or intuitively – to recognize when the world of risk and cross-asset relationships your models represented wasn't the world at all, but a cartoon.

That's why what I worry about more than anything today is the United Kingdom, which is continuing to pursue a strategy which combines vague, conflicting recommendations with targeted social distancing. It's a strategy effectively built on a foundation of four models: (1) behavioral response models for quarantined humans, (2) seasonality models, (3) mutation properties and (4) 'herd immunity' models. I worry not because I have any special knowledge about whether they are *correct*. I worry because by knowingly permitting the spread of a pandemic of many unknown qualities on the basis of models with hugely uncertain parameters, they are effectively leveraging up 66 million lives to the accuracy of those models.

Only the call you get when these trades blow up isn't a margin call.

Here, too, I have hope. The Brits are pragmatic to a fault. They don't need the government to tell them to keep granddad at home. Many of them have been doing it for weeks. There's a practicality to their academics, too, an army of which **quickly emerged to voice their opposition to the plan unveiled by Boris Johnson's government**. There is some evidence that closures and additional recommendations are forthcoming. The claims of herd immunity aims have been softened. I believe that the UK government will get it right. Eventually. For God's sake, I named my firstborn son after Churchill, so I've got to be pretty sure they're going to get their shit together at some point.

But for our readers and friends there, please don't wait for that to happen. As Taleb and Norman wrote correctly yesterday, our civic obligation to the whole in the situation **is individual overreaction**. The best time was two weeks ago, but the second best time is now.

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