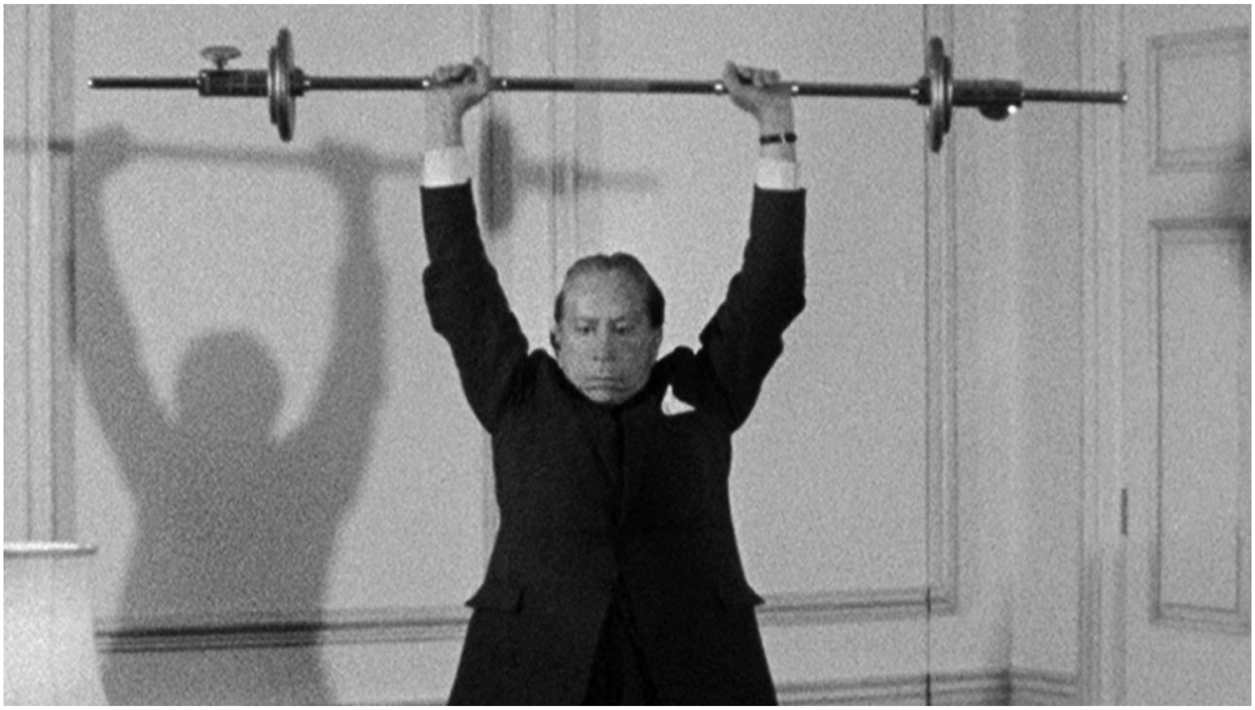
Epsilon Theory

Too Connected to Fail

May 4, 2020



If you owe the bank $100 that's your problem. If you owe the bank $100 million, that's the bank's problem.

Attributed to J. Paul Getty in The Five Rules for Successful Stock Investing

I don't know how much life wisdom it is possible to extract from the life of J. Paul Getty.

On the one hand, Getty became fabulously wealthy by taking actual risk and doing things (like, say, learning Arabic) that no one else was willing to do at the time. On the other hand, he famously bartered for the life of his abducted grandson, seeking to whittle down the ransom demands to an amount that would be fully tax-deductible. Gee thanks, Gramps.

The Ridley Scott film chronicling this affair is a pretty fascinating story in its own right. Filmed and nearly ready for distribution right before the revelation of sexual assault allegations against Kevin Spacey, Ridley's picture leaned on the great Christopher Plummer to step in and reshoot every scene featuring the, um, protagonist. It is an underrated film too overshadowed by the attendant real-life drama, and Plummer positively *owned* the Getty role.

Whether or not the notoriously miserly bastard – Getty, not Plummer – had much wisdom to commend him in other areas, however, his famous and possibly apocryphal description of the relationship between *exposure* and *co-dependency* remains powerful. It is the staple concept of the Too Big To Fail genre of global financial crisis thinkpieces, since it at once describes the nature of interdependence between banks and other banks, between banks and large institutional clients (e.g. hedge funds, some corporate hedgers, some asset owners), and between banks and the financial system at large.

But like Getty's expression, TBTF is fundamentally an expression of the ability of *scale* to create systemic co-dependencies. It is accordingly, and appropriately, the rallying cry for those who seek to decentralize how reliant we are on any social or political institution, industry, business or individual by reducing and limiting the scale of our reliance on them. For those more inclined to ignore the extent to which government institutions are *not* organs of the people but petty powers to themselves, that usually means regulation. For those more inclined toward skepticism about state solutions to concentrated power but naivete toward the Ponzi-like self-dealing that has typified most good-sounding efforts to decentralize power, that usually means buying into the vision of this or that tech oligarch.

Yet there is a similar class of systemic risks which exist independent of scale. That is, they exist because everybody knows that everybody knows that an institution affects too many other issues or areas of society to be left 'unmanaged'. They are often fulcrums on which some other policy or important issue rests, or otherwise carry external political implications.

In short, they are too *connected* to fail.

Yes, there is a financial markets observation coming, but a couple examples first.

Like, say, corn.

I grew up three houses down from a cornfield in Illinois. I used to get lost in that cornfield. I saw a tornado rip up that cornfield. I consider wrong opinions about cornbread fighting words under the precedent of *Chaplinsky v. New Hampshire*. I maintain a bottle of corn oil for the sole purpose of use in my green chile pork stew. Sometimes I think about corn.

You should, too.

Leave aside the decades of silliness of ethanol or the years in which low fat, high sugar diets rich in high fructose corn syrupy goodness were pushed by nutritionists and American food safety and health officials on American families. Instead, think about what you say when you talk about corn with friends and neighbors. What, you don't talk about corn?

OK, fine, for the sake of argument let's pretend that *you* are the normal one here. Still, I'm willing to wager that you, like I, have opinions on "farmers" and the US as the "Breadbasket of the World." I'll bet you know at least a little about ethanol's ability to make us "energy independent" and something-something environment, something-something Chevy commercial mumbled under the breath of a lobbyist stinking of an artificially maple-flavored bourbon with a mash bill that runs awful heavy on the corn. Maybe you even know a bit about how corn was going to be how we built a diplomatic rapport with Brazil?

You and I know those things because there was a concerted missionary effort over decades to make the narrative of this particular agricultural commodity *connected* to things that do matter to us. Our country. Blue collar families. Health. Safety. In turn, those efforts manifested in rhetorically powerful policies which have become third rails in states with arbitrarily disproportionate influence on national primaries and senate composition.

Corn is not too big to fail. In both real-world and narrative-world, corn is too connected to fail.

Or, say, public education.

I went to public school and it worked out great for me. Still, my wife and I homeschool our boys, and not just in the way all of us are sort of having to do that right now. It is a life and lifestyle we have chosen. I still think about education and public school a lot.

You should, too. And you probably do.

When you discuss educational outcomes with friends, family and neighbors, what is the framing for your discussion? Do you talk about pedagogy? Singapore math vs. common core vs. the point-counting system and carry-the-one stuff we used to do when we grew up? Do you talk about the specific educational outcomes you want for your child, their predispositions and where they might be best-suited to focus efforts? Or do you, like the rest of us, mostly talk about "what we can do to improve our schools?" About how you can best support the teachers and staff at the local school?

Those aren't necessarily bad things to discuss. The point isn't that you or I are thinking and talking about the wrong things. It is simply worthwhile to know that we have accepted a dialogue which presupposes both the incumbent institution and the framing of the issue in terms of the producer of something we need.

Why do we do that?

We may certainly do it in part because of earnest conviction by many that compulsory public education is the best, fairest and most socially cohesive way to organize childhood learning. We may also do it in part because of decades of missionary-promoted narratives arguing that "support for public schools", "opposition to non-public education" and "support for teachers" are rhetorically identical to "belief in education." As many American families have discovered over the recent months, we may do it because our lives are (and for many of us, must be!) designed completely around subsidized supervision of our kids between the hours of 8AM and 3PM every day. And yes, we may do it because the tax-advantaged credentialing and real estate acquisition business we call the American university system actively penalizes thinking about childhood education in any other context. In the end, it is these entrenched connections that force the framing of our conversations about the topic.

Our current public education system is not too big to fail. In both real-world and narrative-world, it is too connected to fail.

You may well be fine with that. And that's fine!

After all, calling something 'too connected to fail' is not a pejorative expression. It is a descriptive expression. Maybe you even read the above and said to yourself, "Well, what you're describing sounds kind of like a description of public utilities." No. What I described isn't *kind of like* public utilities. I literally described what we treat as public utilities – entities which everybody knows everybody knows deliver a necessary public good.

But that is the fundamental risk of things that are too connected to fail. They expand the definition of "necessary" from "*things we die from or suffer greatly if we don't get*" to "*things which would upset the political balance*" or "*things which would shed light on a structural problem elsewhere in society if they broke*" or "*things which would be really, really inconvenient for someone in a place of political power if things went wrong*."

In other words, public utilities are not only what we *call* public utilities. Public utilities are also the industries and institutions whose narratives have connected them inextricably to other social and political objectives and needs. Everybody knows that everybody knows a failure in these things would have ripple effects on a variety of other institutions and issues of one kind or another. Effects we often aren't willing to contemplate. And in the wake of the COVID-19 pandemic, we can officially add one more to the list:

Capital markets.

Don’t get me wrong. Capital markets have been deeply connected to other American institutions and concerns for just about our entire history. And they very obviously have a scale issue too, if it is even appropriate to think about them as a monolithic institution. It depends on the context.

However, I think the connections today are different in both kind and magnitude. In light of recent policy responses from the Federal Reserve in particular, they are worthy of consideration. To wit:

- State and municipal pension systems are today both vastly underfunded and utterly reliant on the returns of US equity markets. In some cases that reliance can no longer be qualified by “over the long term”. Short- and medium-term stock market returns are now “necessary” to ensure a functioning pension system for tens of millions of American households.
- With the exception of legacy systems, corporate defined benefit programs have gone away, replaced with defined contribution systems which eliminate the obligation for any party to fund a retirement benefit, replaced by the “necessity” of positive short- and medium-term stock market returns. This is especially true for the concentrated cohort of oft-referenced Boomers approaching or at retirement age.
- Memes of “Yay, Alignment!” have shifted executive and board compensation programs toward equity-linked incentives from cash compensation, creating “necessity” on the part of many institutions to ensure share price stability and appreciation over short horizons.
- Politicians such as Donald Trump have become increasingly explicit about messaging that stock market returns be used as the measuring stick for their presidency.
- Media outlets have, in turn and where appropriate for their editorial aims, selectively done the same as part of a broader abstraction of the economy into “the stock market.” There is very little *economic* or *business* news in 2020. There is only *market* news.

What’s more, these connections in both real-world and narrative-world have become common knowledge. They are things we all know that we all know, beliefs about the true purpose of capital markets that are now being said out loud. Political strategists openly discuss and social media promotes data on the stock market’s impact on election outcomes. The St. Louis Fed openly celebrates the impact of nominally liquidity-focused intervention policies on short-term equity market returns. White House officials call the personal mobile phones of stock market-covering morning show hosts live and on-the-air.

The common knowledge about what markets are for is no longer “to direct capital to its most productive ends”.

The common knowledge about what markets are for is now “to give us the returns we need.”

Sure, markets have always directed capital and provided some return in exchange. This isn’t new. It’s kind of the point of the whole thing, after all. But capital markets that are **for** directing capital where it should go even if that doesn’t give us the returns we need right now will tend to do that. And capital markets that are **for** giving us the returns we need right now even if that doesn’t direct capital to the most productive places will tend to do that. This isn’t complicated.

Any time we change through word and deed what we all agree something "is for", it is a Big Deal.

It is a Big Deal because once you accept the common knowledge primary purpose of capital markets as a "return-generating machine", and once you implement policies which are designed to ensure that returns keep being generated at whatever cost (remember, it's "necessary"), it is extremely difficult to walk those policies back.

It is a Big Deal because it fosters and promotes blind acceptance of policies that are designed to ensure equity prices and credit spreads hold within certain acceptable boundaries under the laughably thin veneer of "maintaining liquidity" by huge swaths of market participants who are among those who "need the returns".

It is a Big Deal because it will permit and encourage the allocation of capital based on the expectations of policy intervention rather than on the expectations of turning that capital into future cash flow. That will reduce the value of everything we create together as a society over our lifetimes.

It is a Big Deal because it will make our children poorer and the world they inherit less vibrant, less dynamic and less prosperous.

Clear Eyes: In the coming weeks and months, if you hear anyone dismissing concerns about moral hazards of or the impact on long-term returns and cash flow generation of policies intervening in the prices of risky assets, know that you are speaking to someone who at best doesn't believe in the basic function of markets and more likely doesn't have a foundational belief in why markets work in the first place. They believe in returns, not markets. That is because they *need* market returns (e.g. someone with a large, AUM-based management fee business) more than they *want* long-term prosperity for all of us. Don't waste time arguing with them. They are too entangled in the *too connected to fail* problem.

Full Hearts: If trying to build a pack here has taught us anything, it is that there are people in every corner of this industry – asset owners, fund managers, individual investors, strategists – who are interested in creating an environment where it is still possible to continue *investing*. You know, things like evaluating value, cash flow, growth prospects and the capital stewardship traits of management? Lawful good doesn't mean lawful stupid, and there is no need to needlessly fight the Fed or the broad treatment of markets as public utilities. But there ARE ways to add value as investors that don't require becoming entangled with what makes capital markets too connected to fail.

Embracing some of those methods will be hard. Really hard.

Can full-hearted board members overseeing large asset pools grapple with the risk of killing off consensus-driven models based on Wilshire TUCS universes and asset consultants that keep investors entangled with the too connected to fail problems of capital markets?

Can full-hearted corporate executives and boards move on from the *Yay, Alignment!* memes that permit stock- and option-based compensation models that favor an emphasis on short-time price appreciation?

Can full-hearted asset managers begin to consider moving away from AUM-based compensation models that drive behaviors, methods and positioning toward industry norms to protect the management fee franchise?

If change must come from the top down, the answer is no. But from the bottom up? From a group of people who recognize that the net social good of financial markets is the proper direction of capital to its most productive ends? From people who are committed enough to that idea that they are willing to take career and business risk?

Maybe.

With the COVID-19 pandemic putting a damper on our in-person ET Forum plans for later this year, we are planning something else. We want to use this unique time in history to help build regional networks of asset owners, business leaders and asset managers who think capital markets still matter. Networks that are too connected to fail – but in the *right* way.

Look for more from us on this effort over the coming weeks.
