OPINION | MONEY STUFF

# Anomalies, Pitches and Promises

Also a Renaissance lawsuit, VIX, millicorns, unicorns and pie.

By Matt Levine
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**Anomalies.**

The efficient-markets hypothesis -- the idea that there is no predictable way to beat the stock market -- is at the heart of modern academic finance. But the main activity of many finance academics is to find and publish "anomalies," patterns that make stock prices predictable, places where the efficient-markets hypothesis breaks down a little. It is sort of a weird activity, like a physics department whose members all go around looking for cool feathers that don't obey the law of gravity.

Also many of those anomalies might be fake:

> *The anomalies literature is infested with widespread p-hacking. We replicate the entire anomalies literature in finance and accounting by compiling a largest-to-date data library that contains 447 anomaly variables. With microcaps alleviated via New York Stock Exchange breakpoints and value-weighted returns, 286 anomalies (64%) including 95 out of 102 liquidity variables (93%) are insignificant at the conventional 5% level. Imposing the cutoff t-value of three raises the number of insignificance to 380 (85%). Even for the 161 significant anomalies, their*

> *magnitudes are often much lower than originally reported.*

That's from a paper <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2961979> by Kewei Hou, Chen Xue and Lu Zhang. In a sense this result should be obvious as a simple matter of market meta-efficiency: If academics could make guaranteed money trading stocks, why would they be academics? "In all, capital markets are more efficient than previously recognized," say the authors, but "there is no free lunch in academic papers" is a quite weak form of market efficiency. You could have a model of financial academia that includes an *anti*-publication bias <https://en.wikipedia.org/wiki/Publication_bias> : If you have a statistically or economically marginal anomaly, sure, publish it and get tenure, but if you have a reliable way to create vast wealth, maybe just do that instead and keep it to yourself?

There is a more specific objection to many of the anomalies, though:

> *Why does our replication differ so much from original studies? The key word is microcaps. Fama and French (2008) show that microcaps represent only 3% of the total market capitalization of the NYSE-Amex-NASDAQ universe, but account for 60% of the number of stocks. Microcaps not only have the highest equal-weighted returns, but also the largest cross-sectional standard deviations in returns and anomaly variables among microcaps, small stocks, and big stocks. Many studies overweight microcaps with equal-weighted returns, and often together with NYSE-Amex-NASDAQ breakpoints, in portfolio sorts. Many studies also use Fama-MacBeth (1973) cross-sectional regressions of returns on anomaly variables, assigning even higher weights to microcaps than equal-weights in portfoio sorts, because regressions impose a linear functional form. Unfortunately, because of high costs in trading these stocks, anomalies in microcaps are more apparent than real.*

All sorts of dumb stuff occurs in micro-cap stocks, but you mostly can't do anything about it, because trading costs would eat all your anomalous returns. The micro-caps are a fun laboratory where academics can find violations of market efficiency, but it's hard to scale those discoveries up from the lab into the real world of making money.

**Sohn.**

Elsewhere in anomalies, a bunch of famous investors pitched trades yesterday at the Sohn Investment Conference. Is there a Sohn anomaly? Can you predictably make money betting on the Sohn picks? Or by betting against them? I am unaware of rigorous academic studies that answer that question, but past results are decidedly mixed. (Here's a roundup <https://www.bloomberg.com/news/articles/2017-05-08/as-sohn-opens-here-s-how-hedge-fund-titans-fared-with-16-picks> of last year's performance.)

You can read summaries of this year's conference from Bloomberg <https://www.bloomberg.com/news/articles/2017-05-08/from-einhorn-to-gundlach-sohn-conference-s-2017-trade-ideas> , the Wall Street Journal <http://www.wsj.com/livecoverage/ira-sohn-investment-conference-2017/> and Josh Brown (part 1 <http://thereformedbroker.com/2017/05/08/my-notes-from-the-sohn-investment-conference-part-i/> , part 2 <http://thereformedbroker.com/2017/05/08/notes-from-the-sohn-investment-conference-part-ii/> ). Mostly it was, you know, stock picks, but some of the presentations touched on themes we like to talk about around here. For instance, Jeffrey Gundlach is short indexing. His trade <https://www.bloomberg.com/news/articles/2017-05-08/gundlach-says-to-short-s-p-500-and-go-long-emerging-market-etf> is short the S&P 500 Index and long the MSCI Emerging Markets index, but in a larger sense his pitch is short the concept of indexing <http://www.wsj.com/livecoverage/ira-sohn-investment-conference-2017/card/1494276699> :

> *He backed into the idea by noting that, amid the billions flowing into passive investment funds, "passive investing is just a myth." He notes that that even indexes such as the S&P 500 rely on a committee to maintain and select stocks. There are "no rigid rules," he said. "There's a committee,*

> *which means it's actively managed."*

The premise of index investing is that active managers, in the aggregate, cannot beat the aggregate performance of the market, so if you just accept the market performance you will do at least as well as the aggregate active managers (and better after fees). But to get the market performance, you need to define the market, and the market definition is not an objective external fact about the world. Some committee decides that some particular list of stocks -- based on size and float and headquarters location and listing type and corporate-governance factors and whatever else the committee cares about -- is "the market." And then if you buy that list of stocks you will exactly match the performance of that list of stocks, and you will exactly match the aggregate performance of other managers who limit themselves to, and measure themselves by, that list of stocks. But some other list of stocks could still be better.

Meanwhile, Altimeter Capital Management founder Brad Gerstner is long airlines. His trade is long United Continental Holdings Inc., but in a larger sense his pitch is long the idea that airlines are becoming less competitive <http://www.wsj.com/livecoverage/ira-sohn-investment-conference-2017/card/1494278173> :

> *"Excess competition has led to atrocious financial results ... which has led to near permanent investor skepticism. Everybody in this audience, three generations of investors, have been trained not to be fooled that it's different this time."*
>
> *Yet airlines are actually better off today than they were 10 years ago, Mr. Gerstner argues.*
>
> *Dramatic consolidation among U.S. air carriers has strengthened companies, "making all the difference."*

"Pricing power is the lynchpin <http://thereformedbroker.com/2017/05/08/notes-from-the-sohn-investment-conference-part-ii/> that separates good businesses from bad ones," and now airlines have it. United Continental is Altimeter's biggest holding <https://www.sec.gov/Archives/edgar/data/1541617/000114420417008913/xslForm13F_X01/infotable.xml> , but it also owns chunks of Alaska Air Group Inc., American Airlines Group Inc., and Delta Air Lines Inc. We talk <https://www.bloomberg.com/view/articles/2015-04-16/should-mutual-funds-be-illegal-> from time <https://www.bloomberg.com/view/articles/2017-04-12/airline-shares-and-whistleblowers> to time <https://www.bloomberg.com/view/articles/2017-05-01/airlines-poker-and-disclosure> about the theory that investors who own stakes in multiple airlines would prefer that those airlines not compete against each other too vigorously on price. Gerstner seems to prefer it, anyway.

**Don't make any big promises.**

Who is more likely to pay you back:

1. Jane, who says "hey can I borrow 10 bucks," or
2. Joe, who says "hey can I borrow 10 bucks, I promise I'll pay you back"?

Obviously Jane, right? Joe's promise to pay you back is *so* fishy. Jane just assumes that she'll pay you back, and that you assume that, while Joe's need to make things explicit means that the possibility of not paying you back has occurred to him. You wouldn't hire a babysitter who says "I promise I won't murder your child."

Anyway here's some science <http://nymag.com/scienceofus/2017/05/what-the-words-you-use-in-a-loan-application-reveal.html> , based on an academic study of loan application language and defaults at peer-to-peer lending site Prosper:

> *Generally, if someone tells you he will pay you back, he will not pay you back. The more assertive the promise, the more likely he will break it. If someone writes "I promise I will pay back, so help me God," he is among the least likely to pay you back. Appealing to your mercy—explaining that he needs the money because he has a relative in the "hospital"—also means he is unlikely to pay you back. In fact, mentioning any family member—a husband, wife, son, daughter, mother or father—is a sign someone with not*

> *be paying back. Another word that indicates default is "explain," meaning if people are trying to explain why they are going to be able to pay back a loan, they likely won't.*

Of course Bagehot knew this <http://www.econlib.org/library/Bagehot/bagLom2.html> a century and a half ago: "Every banker knows that if he has to *prove* that he is worthy of credit, however good may be his arguments, in fact his credit is gone." I don't know if these results are exactly applicable to high finance -- not a lot of appeals to family, or God, there -- but they can be useful heuristics in your personal investing. Vanguard Group's account-opening page <https://personal.vanguard.com/open-account/oax/app/triage#/> is bland and businesslike, and doesn't even bother to mention that you can get your money back; that Nigerian prince who emailed you is full of promises and explanations.

## How are things at Renaissance?

A few months ago, the Wall Street Journal published an article <https://www.wsj.com/articles/you-have-to-stop-renaissance-executive-tells-boss-about-trump-support-1487845803> about Renaissance Technologies LLC executive David Magerman criticizing his boss Robert Mercer for supporting Donald Trump. The natural reaction to reading that article was: "I cannot believe this guy hasn't been fired yet, and sued." Well, he was fired late last month (after a poker-tournament incident <https://www.wsj.com/articles/renaissance-feud-spills-over-to-hedge-fund-poker-night-1493424763> ), and now he has sued <https://www.bloomberg.com/politics/articles/2017-05-08/trump-backer-mercer-sued-by-employee-fired-after-speaking-out> . Magerman's complaint <https://assets.bwbx.io/documents/users/iqjWHBFdfxIU/r_fprZimGOhU/v0> is pretty amazing, describing a January phone call in which, allegedly, Mercer "made a series of racist comments," including that "the Civil Rights Act 'infantilized' African Americans by making them dependent on government" and that "the only racist people remaining in the United States are black."

> *Magerman was stunned by these comments and pushed back, pointing out that society was segregated before the Civil Rights Act and African Americans were required to use separate and inferior schools, water fountains, and other everyday services and items.*

> *Mercer responded that those issues were not important.*

How did that all ... come up? Like, did Magerman call Mercer to talk about Obamacare, and Mercer was like "hang on, never mind that, you'll never believe what *else* I think"? And it *kept* coming up; there was a follow-up call in which Mercer allegedly went back over the highlights of his previous rant. On that call, Magerman "was skeptical of the supposed data that Mercer relied on, but nonetheless pointed out that, even if it was true, there is more to someone's well-being than money." But "Mercer scoffed at this suggestion." If you were writing this scene for a movie about an evil hedge-fund manager who loves only money, you would probably tone it down a bit.

My favorite part of the lawsuit, though, is not Mercer's alleged glee in saying terrible things, but what Magerman did next. He "sent a written memorandum to several Renaissance executives, including General Counsel Carla Porter, Chief Compliance Officer Mark Silber and Director of Human Resources Lavonne Wesner," basically telling them that he was going to the press and hoped they were cool with that. That email <https://assets.bwbx.io/documents/users/iqjWHBFdfxIU/rJ.iOUAaR4Z4/v0> is attached to the complaint, and it is a lovely piece of amateur lawyering, quoting bits of the Renaissance employee handbook and explaining why Magerman's plans don't violate them. You will not exactly endear yourself to your bosses if you send them an email like that, and it won't prevent you from getting fired (it'll probably hasten your firing), and it might not even help you win the lawsuit that becomes inevitable the moment you hit "send." But you'll feel such a deep sense of satisfaction when you attach the email to your lawsuit. "I was right all along," you'll think to yourself as you staple it to the complaint, and isn't that the whole point of all of this?

**People are worried that people aren't worried enough.**

This worry -- that low levels of stock market implied volatility as reflected by the VIX index reflect a dangerous "complacency" in the market -- has really come into the mainstream over the past month or so, and during that time the VIX has gone down. Yesterday it closed at 9.77, the lowest since 1993, and there was positive panic. From Bloomberg <https://www.bloomberg.com/news/articles

/2017-05-08/market-trance-deepens-as-another-empty-threat-sends-vix-below-10?cmpid=BBD050917_MKT&utm_medium=email&utm_source=newsletter&utm_term=170509&utm_campaign=markets> :

> *"Complacency has returned in such quick fashion that it's starting to feel like 2005-06, when nothing seemed to faze the broader markets," George Goncalves, a fixed income strategist at Nomura, wrote in a note to clients.*

The Wall Street Journal <https://www.wsj.com/articles/markets-fear-gauge-nears-1993-low-1494263976> :

> *Former Federal Reserve Gov. Kevin Warsh warned Monday at the Sohn Investment Conference that market risks haven't vanished. "I would not take comfort; I would take fear," he said of the VIX's low level.*

The Financial Times <https://www.ft.com/content/456629ce-343a-11e7-bce4-9023f8c0fd2e> :

> *"The more volatility gets compressed, the more volatility expands when it is released," said Nigol Koulajian, the chief investment officer of Quest Partners, a $1.3bn hedge fund. "When something happens, it's going to be really bad . . . Volatility has become completely useless as a measure of risk."*

The New York Times <https://www.nytimes.com/2017/05/08/business/dealbook/movers-fed-akzo.html?ref=dealbook&_r=0> :

> *Yet a lack of volatility may in itself be a cause of worry.*

Société Générale's Kit Juckes <https://ftalphaville.ft.com/2017/05/09/2188522/snap-av-remain-weirdly-calm-like-its-1993/> :

> *Beyond the immediate reaction though, too little vol is too much of a good thing. Is it evidence of a quiet, news-free world? Not really. It's mostly evidence that the Fed is predictable and steady, but you can have too much of that. For steady, read slow and for predictable read complacent.*

If you interpret the low VIX as proof of complacency, what do you make of all these warnings? Perhaps financial market participants are blithely ignoring the risk that volatility will return, but these days they'd have to make a serious effort to do so. It seems to be all anyone is talking about. There are stories everywhere about how volatility is too low and complacency is dangerous. And yet volatility keeps getting lower.

Elsewhere: Happy Hindenburg Omen <http://www.cnbc.com/2017/05/05/questionable-crash-indicator-hindenburg-omen-was-triggered-this-week.html> !

**Millicorns?**

What do you call a company with a trillion-dollar equity market capitalization? Unicorn, from the Latin for "one horn," now means a startup with a billion-dollar valuation, and we've had decacorns <http://www.businessinsider.com/decacorn-is-the-new-unicorn-2015-3> and quinquagintacorns <https://www.bloomberg.com/view/articles/2015-05-11/unicorns-sphinxes-and-bitcoin-for-stocks> ($10 billion, $50 billion), so I guess the way corporate zoology works is that you grow a horn for every billion dollars of valuation. That would make a trillion-dollar company a millicorn, a thousand-horned beast that would not be much fun to pet. Or perhaps at a trillion dollars you grow an entirely different appendage, a fluffy tail or an extra ear or something. Anyway Apple Inc. and Saudi Arabian Oil Co. are in a race <https://www.buzzfeed.com/matthewzeitlin/the-race-is-on-for-the-first-trillion-dollar-company?utm_term=.mkzx9DvxGl#.scEDq3lDM9> to be the first millicorn.

**People are worried about unicorns.**

Here is a story about alleged failures to pay overtime <https://www.bloomberg.com/news/articles/2017-05-08/as-wework-grew-some-employees-say-they-were-mistreated> at $18 billion office-space unicorn WeWork Cos., but no overtime-pay abuse could be as offensive as this:

> *All staffers are expected to attend weekly meetings, called Thank God It's*

> *Monday, that could last for several hours after their shifts ended at 6 p.m.*

It is difficult to come up with a worse combination than (1) having mandatory multi-hour meetings on Monday nights and (2) *calling them* "Thank God It's Monday." If you were writing this scene for a television show about a tone-deaf startup founder who loves only work, you would probably tone it down a bit. Steve Cohen used to <https://dealbook.nytimes.com/2014/11/20/steven-cohens-firm-to-stop-paying-bonuses-for-best-trading-ideas/> make portfolio managers come to Sunday morning meetings, but at least he didn't call them "Boy We Are Having a Great Weekend." I am going to start a company where all employees have to come in at midnight on Saturdays to do data entry for a project called "Making the Least Depressing Possible Use of Our Brief Precious Time on This Planet." It will be at least a centicorn.

Elsewhere: "With an IPO on the shelf, SoFi lets employees sell <http://www.cnbc.com/2017/05/08/sofi-lets-employees-sell-20-percent-of-stock-in-337-million-secondary.html> 20 percent of vested stock." And: "Prosecutors Explore Options With Uber <https://www.nytimes.com/2017/05/08/business/dealbook/prosecutors-explore-options-with-uber.html> ."

**Pie in face.**

Here is a story <https://au.news.yahoo.com/wa/a/35368652/qantas-alan-joyce-gets-pie-in-face/#page1> about Qantas Airways Ltd. Chief Executive Officer Alan Joyce getting a cream pie to the face "while speaking to a packed business breakfast in Perth," but what is truly exceptional about the video <https://twitter.com/7NewsSydney/status/861758510903590912> is that he gets pied while standing at a podium in front of a big screen saying "Leadership Matters." All pies to the face should be delivered in front of screens saying "Leadership Matters."

**Things happen.**

Goldman Sachs Makes Biggest Investment-Bank Leadership Changes <https://www.wsj.com/articles/goldman-sachs-makes-biggest-investment-bank-

leadership-changes-in-decade-1494253981> in Decade. SEC Probes Rental Home Values <https://www.bloomberg.com/news/articles/2017-05-08/sec-probes-rental-home-values-backing-private-equity-bond-deals> Backing Private-Equity Bond Deals. Puerto Rico's Fate Will Come Down to Decisions of a Single Judge <https://www.bloomberg.com/news/articles/2017-05-08/puerto-rico-s-fate-will-come-down-to-decisions-of-a-single-judge> . Mitu Gulati and Robert Rasmussen <http://blogs.harvard.edu/bankruptcyroundtable/2017/05/09/puerto-rico-and-the-netherworld-of-sovereign-debt-restructuring/> : "In light of the conditions that gave rise to PROMESA, we explore whether, in the first place, Congress has the power to bar Puerto Rico from enacting a restructuring mechanism without offering an alternative. We submit that the answer is no." Manmohan Singh: Collateral Reuse <http://www.imf.org/en/Publications/WP/Issues/2017/05/08/Collateral-Reuse-and-Balance-Sheet-Space-44892> and Balance Sheet Space. China's Deleveraging Pain <https://www.bloomberg.com/news/articles/2017-05-09/china-s-deleveraging-pain-puts-investors-on-alert-for-contagion> Puts Investors on Alert for Contagion. Banks Want Mnuchin to Intervene <https://www.wsj.com/articles/banks-want-treasury-secretary-mnuchin-to-intervene-in-fight-over-new-loan-rule-1494265009?tesla=y> in Fight Over New Loan Rule. Bank of America Pays Peanuts <https://www.wsj.com/articles/bank-of-america-pays-peanuts-for-deposits-but-the-money-keeps-flowing-in-1494235801?tesla=y> for Deposits, but the Money Keeps Flowing In. Exchange Wants to Shake Up End-of-Day Stock Trading <https://www.bloomberg.com/news/articles/2017-05-08/an-exchange-wants-to-shake-up-how-end-of-day-stock-trading-works> Format. Elliott Takes Akzo to Court to Oust Chairman in PPG Battle <https://www.bloomberg.com/news/articles/2017-05-09/elliott-seeks-akzo-chairman-s-ouster-in-court-over-ppg-bid> . Former Dewey & LeBoeuf Executive Convicted <https://www.nytimes.com/2017/05/08/business/dealbook/dewey-leboeuf-verdict.html> in Split Verdict. Harvard Is Trying to Sell $2.5 Billion in Endowment Assets <https://www.bloomberg.com/news/articles/2017-05-08/harvard-said-to-seek-sale-of-2-5-billion-in-endowment-assets> . Do stress tests <http://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2054.en.pdf?c42be8125e6b3913630ad5c10fa1ae77> matter? One reason why women beat men when it comes to investing: Testosterone <http://www.marketwatch.com/story/this-is-why-women-are-better-investors-than-men-2017-05-08> . Home Capital Stalls a Nascent Canadian Mortgage Bond

Market <https://www.bloomberg.com/news/articles/2017-05-08/home-capital-said-to-stall-a-nascent-canada-mortgage-bond-market> . "Only shops selling artisanal ice cream <https://www.theguardian.com/world/2017/may/05/venice-bans-kebab-shops-preserve-decorum-traditions-city> will be spared from the measure." Upscale pet food <https://www.wsj.com/articles/beef-stroganoff-for-your-dog-pet-food-goes-upscale-1494235800?tesla=y> . Rooftop driving school <http://shanghaiist.com/2017/05/08/rooftop-driving-school.php> . Insecurity questions <http://www.newyorker.com/humor/daily-shouts/insecurity-questions?mbid=social_twitter> . Deep in Macron Country <http://www.newstatesman.com/world/europe/2017/05/deep-macron-country> .

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