

An Investor Framework for Operating Among Multiple Equilibria in the “New Normal”¹

The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds.

– John Maynard Keynes

We are in a market that will vacillate among *multiple equilibria*. This is a very difficult environment for any investor – professional or otherwise. Part of the reason is that many that work in the investment profession have burnished the skills to identify attractive investment opportunities solely. Rarely has it been the case that macro factors and technical considerations trump solid deep value analysis. We are in such a time and place and few determinedly narrow focused investors remain flexible enough to expand their sense of what matters. Witness the financial headlines of famed investment managers calling it quits as the market no longer makes sense to them.

What’s called for is a dynamic methodology and framework that harnesses the best of a manager’s skills, but requires additional considerations be addressed to protect the manager from the *current backseat of traditional research and selection*. It’s not news that things are different. But what isn’t often discussed are the range of the human market reactions and the opportunities and pitfalls this can cause. In my view, most investors will be slow to interpret data presented in these markets and make the best risk-adjusted decisions for how to participate. Further, many will simply *respond* as opposed to *act*, and in so doing, will miss short term opportunities, and given the high volume of noise in the massive amount of data we consume daily, many will *miss the secular trends* that can lead to significant opportunities.

Multiple Equilibria

Multiple equilibria can arise when there is the clash of “rational” market participants with those acting “irrationally.” We’d argue that with little obviously material information amongst the noise in July, August and September, we’ve seen radically different monthly performance of markets. I believe that we will continue to see *multiple equilibria* in the near term (perhaps years) and that an ability to glean the rational and temporary irrational behaviors in markets and then actively and ably trade these multiple equilibria will be essential to outperformance.

¹ With homage to Bill Gross and Mohamed El-Erian of PIMCO.



In an environment of multiple equilibria, which one is ultimately established? Although few academics or practitioners have emphasized this point, there is a broad division into two camps. On one side is the belief that the choice is essentially resolved by history: that past events set the preconditions that drive the economy or a market to one or another steady state. On the other side, however, is the view that the key determinant of choice of equilibrium is expectations: that there is a decisive element of self-fulfilling prophecy. Between here and there, however, there are opportunities, pitfalls and clues to the outcome for those with a dynamic investment methodology.

The Noise

The sheer volume of information we consume daily is distracting and numbing for even the most focused. There is a tendency to go one of three ways with it: 1) ignore it completely – old or existing metrics of value matter; 2) obsess over it and day trade a portfolio based on minutiae; or 3) retreat into cash. In any of these approaches, important secular changes that can lead to real outperformance can be missed. *Myopia, rashness or retreat can be offset with a dynamic investment process and flexibility.*



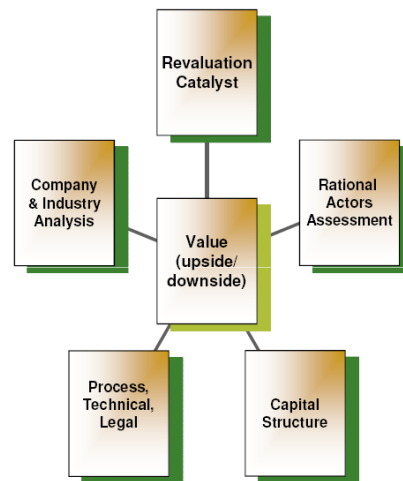
The Five Pronged Methodology

My firm, Tiburon Capital Management, utilizes what we describe as our *Five Pronged Methodology*² - an approach I've conceived and utilized dating back to my early investing years with deep value icon, Marty Whitman. We seek investment ideas that are cheap or rich on an intrinsic basis (to go long or short anywhere in a capital structure of a company), doing classic *Deep Value, bottom-up analysis*. We also perform a thorough *Capital Structure Review*, reading all bond indentures and credit agreements. Each investment idea must have some plausible *Revaluation Catalyst* (a hard event that should

² See <http://www.distressed-debt-investing.com/2009/09/exclusive-interview-with-hedge-fund.html> for a good discussion on the Five Pronged Methodology.



move a security's price up or down in a step-function change to fair value). The Revaluation Catalyst is the "belt" to our valuation work's "suspenders", ideally mitigating some of the volatility of holding the security and increasing the probability we achieve our target price.



The Rational Actor in Irrational Times

We employ game theory and conduct a *Rational Actors Assessment*. That is, who are the Rational Actors that can impact an outcome if they pursue their logical rational financial self-interest? Well in this time of multiple equilibria, there will be regular moments where Rational Actors behave *irrationally* – *for a period of time, perhaps brief*. For example, if you passed what appeared to be a \$100 bill on the street, would you rationally pass it by, under the theory that if it were genuine it would not be there, someone else would have picked it up? Noise and the herd can make otherwise rational investors overreact or fail to react.

It's not simply that market participants go nuts. Predominantly rational market participants are occasionally impacted by distortive influences (herd mentality, noise). As a consequence, dislocations can occur as the market adapts to some new reality. It is also not this simple. We are not saying that others will make mistakes and we will somehow divine the error of their judgment and benefit from it solely. It is more nuanced. It is also the case that it's possible that *the behaviors of the herd cause further distortions* on the way to some new market equilibrium – up or down. This is why it is integral to managing a portfolio in this time, to have a sense of the technicals as well. As part of our *Five Pronged Methodology*, we consider technicals (macro factors, inflows and outflows of capital into markets and market products, etc) as part of *Process, Technical, Legal* – the outward looking manifestation of our investment process.



Herd Mentality and Confirmation Bias

If much of our behaviors as investors are inextricably tied to our very human condition – and to our detriment, what must we do to liberate ourselves from this and “escape old ideas?” Surely the daily blather of talking heads on financial television, financial press, our friends and family, inform a sentiment. It’s not that we ignore this so much as within consistent themes, can we derive some important signal? The fact that people are thinking the same way is neither a reason to go the same way, nor necessarily as reason to go the other way. Other than how to trade and make money in the here and now, is there anything deeper that can be drawn from the noise? If so, have we identified a longer term theme to exploit to our investor’s benefit?

At the portfolio and trade level, we attempt to wring confirmation bias out of our decisions.³ That is, the instinct to seek out data that confirms our initial thesis. Great conviction that an outcome is likely does not, de facto, mean that it is highly probable. We utilize something we call *projected forensics* –we project the *exact opposite* outcome and back into the circumstances that can give rise to this. This makes the prospect of being wrong so much more real that it causes more reasoned probability weighting of events adopted as a given by the herd and ourselves as we self-select information to justify a point of view.

Core Position Trading *I made my money by selling too soon* – Bernard Baruch

No matter what your investment time horizon, why sacrifice performance in the short term because of longer term perspective? If, in fact, otherwise rational market participants are making temporarily irrational decisions, trading acumen is necessary in order to either profit or avoid predictable loss. Professional investors must cultivate the culture and possess the skill set to act. Part and parcel of Tiburon culture is a *Core Position Trading ethos*.⁴ We will trade around our core positions in order to take unsustainable gains, mitigate predictable hits to the Net Asset Value of our portfolios and take advantage of other technical anomalies. We are mindful of another human bias – “the disposition effect” – that is the tendency to hesitate to sell positions that have fallen below their purchase price. To this, and regarding our trading philosophy broadly, we often say, we “snap off the rear view mirror,” that is, historical price should have no bearing on real time buy and sell decisions.

³ See our white paper, http://tiburonholdings.net/uploads/Confirmation_Bias.pdf

⁴ See our white paper, http://tiburonholdings.net/uploads/Active_Core_Position_Trading_as_an_Alpha_Generator_and_Mitigator_of_Risk_2_2_.pdf



Remaining Solvent and Profiting During these Irrational Markets

In these times, a dynamic framework for working within markets is essential. Our *Five Pronged Methodology* affords us most of the tools necessary to determine the best risk-adjust trade ideas. Adherence to it will help us separate the noise from the signals and lead to periodic views of secular change that can lead to significant outperformance. A *Core Position Trading* ethos will allow us to take gains and avoid the pitfalls of a static portfolio, where as Keynes said, “markets can remain irrational longer than you can remain solvent.”

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