Every pretext needs a principle, and in finance that principle is invariably alpha. When someone says her job “is all about risk management,” it’s rarely about risk management, properly understood. This creates a massive disconnect, as entrants become cynical about the games being played. You need to be aware of signaling, misdirection, coalitions, and cooperation necessary to understand alpha. Any science dealing with people, not particles, needs to address this. The story of the fish that does not understand what water is underscores that the most obvious, ubiquitous, important realities are often the ones that are the hardest to see and talk about. Alpha deception is a *prima facie* example. It is ubiquitous, and it must be done. You cannot avoid it, and you cannot talk about it explicitly with those you interact with. But humans are social creatures, and after adolescence the Ayn Rand fantasy of being financially and socially rewarded for objective excellence without playing politics, or of science being about disinterestedly observing facts and testing theories, or public servants designing laws to maximize social welfare, all gives way to the fact that you have to compete and persuade in a world of uncertainty, coalitions, and duplicity.

Alpha is ephemeral. It is also takes many guises, combining products such as in convertible arb, or patterns as in pairs, or concepts like volatility, as in the dispersion trade, or finding better ways for investors to tap into equity analysis. Furthermore, exploiting it is very rare for someone without institutional access to markets, so one must find partners. But another important point about alpha is that it is generally intentionally concealed and misrepresented. Understanding this is essential, because as an investor, most opportunities will involve a crucial partnership with someone who has something you need to actually implement your idea. Alternatively, most of those with alpha would be foolish to reveal it fully to their capital providers; the equilibrium is a compromise between two parties who need each other but recognize the self-interest of the other party, not a victory for one side over
the other. As the latest book on Warren Buffett notes, the Buffett-Munger approach is to “invert, always invert. Look at it backward. What’s in it for the other guy”?\(^1\)

Because alpha is generally recognized as something that is righteously deserving of profits, almost every profit center stresses the alpha component of their revenues that is usually based on an individual *je ne sais quoi*. Thus if you ask a specialist on the NYSE, who has monopoly access to retail flow and loses money at most a handful of days a year, if he makes money off his monopoly control, he will strenuously object, noting he is maintaining an orderly market, providing liquidity to an otherwise highly volatile marketplace through deft risk management.

Alpha can only exist because there are not enough people who are arbitraging it out of the market. Thus, either people are good at keeping secrets, or people do not believe the alpha vendor when they pitch their strategy. The more conventional the alpha, the more similar it is to some previously successful alpha, the easier it will be to sell, but then the more secrecy needed. That is, with high frequency data, if you have a sure money maker you can prove this in short order, so the issue of getting support is not as important as keeping your potential partners from stealing your idea. A really unconventional idea without high frequency data, in contrast, no matter how simple, is often viewed skeptically merely because it is unconventional, as this is true risk, doing what others are not doing, and is not *obviously* feasible as evidenced by the lack of other people doing it.

The essence of Hayek’s prophetic critique of socialist economies turned out to be in his paper “The Use of Knowledge in Society,” which noted that information needed to run an economy is necessarily dispersed.\(^2\) Socialist economist Oscar Lange argued in the 1930s debate with Ludwig von Mises that a socialist economy could elicit this information through trial and error looking at surpluses and shortages. While von Mises focused on the absence of a price for capital making this impossible, Hayek argued that you cannot compare a competitive outcome to a command-and-control outcome, assuming they have the same information, because only in a competitive system will those with the parochial information about supply and demand be motivated to get this information into resource allocation, and quite indirectly. In the end, information is never fully revealed to any one person. The profits implied by a moment’s constellation of prices, situations in an unimaginable set of situations, sets in motion many actors, uncoordinated, whose net effect is the fabled Invisible Hand. Simply seeing the resulting shortages in razor blades and bread is not sufficient because the dispersed information in an economy is not then acting efficiently to the various supply and demand elasticities for the many input and substitutes to these final items. That is, is the shortage because of a lack of alternatives?
Input shortages? Which inputs? Without market prices all along the chain, reverse engineering this problem is impossible.

Similarly, alpha is essentially dispersed, and assuming it is available for a final, top-down algorithm such as in mean-variance analysis, is just as misguided as assuming a politburo in Moscow has the information to run an economy. Getting information from the diverse sources takes a recognition that alpha is ultimately private information, never revealed like a table available for mass readership.

The key thing you need to understand is that dishonesty, like gossip, is a part of life. These things are often portrayed as mere vices, yet in moderation are necessary and serve a purpose, and to think otherwise is naïve. The lies in business made out of a calculated self-interest that serve no greater good are the prominent lies we understand and universally loathe. These include the use of pretexts masking as principle, such as when liquor store owners support legislation that would allow the sale of wine and beer in grocery stores (competitors) using rhetoric from teetotalers. But the fact is that many times they are successful pretexts, and so groups can eventually truly take their pretexts as principle, such is the ability of people to rationalize their self-interest.

Another business lie is more of a lie-to-children type lie, where the idea is that the audience is not quite ready for the truth, such as when you tell children “The stork brought you.” The problem here is that those outside the circle of trust need the lies-to-children version of the truth—they may not actually be children, but they’re not going to grasp the full complexity, or while they may understand, they may not hold this information with the proper discretion. This process attenuates as we leave childhood, but never really disappears, as every field likes to omit certain unattractive features, exaggerating the charitable aspects of one’s industry, as when corporations spend a good deal of advertising on the compulsory United Way activities of their employees (for example, “Giving back is a large part of what we do here at Amalgamated Financial Derivatives”). It is a sad fact that over 200 years after Adam Smith, admitting that, say, most companies, and their employees, are primarily self-interested, is a breach of protocol even among the most libertarian of companies.

Unfortunately, this creates the sort of cynicism resonant in Catcher in the Rye, where Holden Caulfield is so frustrated when he discovers, as all adolescents do, the intrinsic phoniness of so many adults. It underlies the book Liar’s Poker, where the author Michael Lewis, who worked on Wall Street for a mere three years while in his twenties, presents the major actors as big phonies, merely aggressive alpha males, dishonest and ignorant. If you have worked in a field for more than 10 years, you know how little you understood when you had only a few years’ experience. The impressions of
a young Caulfield, or a young Michael Lewis, highlight that to a really self-aware person who does not see the bigger picture, the whole process looks like a big scam and horribly suboptimal. Successful people seem merely better at irrelevancies, and *everything* is a pretext for self-interest. This is because they precociously see through the pretexts and sense the deception, but because they are ignorant of the alternatives, the value of coalitions versus raw intelligence, do not see any greater good. It is a hard thing for a young, thoughtful person to grudgingly acknowledge the realistic optimum from a system built on the unintended effects of moral and intellectual inferiors who perhaps never so intended it.

These people truly “can’t handle the truth,” because they don’t see the bigger picture. It’s like if you plopped an earnest young, progressive person back into the Middle Ages, and had them lecture everyone on how the Church is just an institution for perpetuating myths to maintain an unjust hegemony by a patriarchal squirearchy. Well, kind of, but it also tends to be an efficient structure given the state of ethics and technology at that time. Simply removing all the myths and misconceptions does not take one in one giant leap to Sweden in 2009, but rather, back to anarchy. The ethics of business implies a willingness to compromise, to flatter and lie, and patience for fools. In a large organization, motivating a productive effort involves a certain amount of cognitive dissonance, because if everyone were brutally aware of their value and purpose in the group, there would be incessant squabbles over rights and responsibilities because many would find themselves insufficiently appreciated, if not cheated. These practicalities are remote from the ideals of youth. Business naïfs are often prigs about the truth, and this hurts them in large organizations. I know I do not have the ability to fake sincerity sufficiently to lead a large public corporation, given the inevitably large amount of incompetent middle managers one needs to placate.

The Marxist Stephen Marglin wrote a much-discussed piece in 1974 titled “What Do Bosses Do?,” in which he argued bosses basically withheld information from workers so they could appropriate more of the profit for the owners. The popularity of Marglin’s piece came from the fact that there’s some truth to this, where bosses are often sneaky and think of themselves first. The problem with Marglin’s piece is that it goes too far. Bosses don’t *merely* conceal information, but instruct, motivate, strategize, prioritize, solve personnel problems, and so forth. Nonetheless, bosses, like everyone engaged in alpha deception, do conceal, from employees, customers, investors, and their bosses.

Most of the profits in finance involve a significant amount of alpha deception, where people are generally trying to convince you their profits are due to good old-fashioned Yankee ingenuity. But even within alpha,
very little is from more efficient pricing, but rather from standard issues of intermediation: selling customers that a certain product fits their needs, bundling services together, taking advantage of the scale of their enterprise, their brand, and the barrier to entry their alpha deception creates. And the problem with selling something simple is that it is too easy to copy, so there will always be someone willing to do it for a little less. The key is to keep competitors confused as to what you actually do, and make customers think you do more than you actually do.

Think about the value you would receive as a U.S. resident trying to make a phone call in Europe, with their differing country and city codes. It is terribly confusing if you have no experience with it. It would be very valuable for a U.S. resident to be able to pay $5 and have someone say, “These are the rules, you silly foreigner.” Two-minute conversation. But the seller then needs a brand name so the buyer knows he is getting correct information, and sellers will compete not on cost but auxiliary features, pointing out they also can tell you where coffee shops are. But the bottom line is, if there’s a value to something pretty simple—informing ignorant foreigners about regional phone protocols—any service that addresses it will inevitably be much more complex than it should be.

The fact is that every profit opportunity presented at a parochial level is identified, at some point, by an individual. So every profit opportunity needs two things: One person to see the opportunity, and the resources to take advantage of the opportunity. The person who sees the opportunity needs to conceal a little bit of her insights so as to retain her interest in the alpha, because if she merely tells those with resources about it, she may as well be working for free. Consider telling a sophisticated investor about pairs in the early 1990s, a strategy very easy to explain, simple, and highly profitable. How does one communicate the idea so that it is both convincing, yet is not fully revealed? I have known several firms that use interviews with potential fund managers primarily to generate ideas they then investigate; free R&D. Other firms hire quantitative portfolio managers and understandably ask for a full detail of the model that will be exposing their firm’s capital to risk. Once they become sufficiently confident they understand the model, they then make life uncomfortable for him, he leaves, and they no longer have to pay him for the strategy. Indeed, everyone in the field seems to acknowledge this occurs, but everyone also always stresses her firm would never do such a thing (beware anyone who stresses their integrity on these issues).

Most financial companies, even successful ones, are infused with petty politics about alpha, and much of one’s day is involved not in deriving alpha, but the politics around it. Consider the alpha described in the previous chapter. The essence of the alpha is explainable in a couple of minutes to
perhaps a few days, depending on your understanding of statistics and the markets. If John Bogle discovered the index fund back in 1975, it would be unfair to say that he has done nothing since, even if there has been little change in his company’s product menu. The key to office politics in finance, is that it plays off alpha. Without alpha, people are fighting over nothing. With alpha, the politics complicates to a different dimension because of the gains from reciprocal altruism in a corporate environment.

**BENIGN DECEPTION**

Honesty, like all virtues, is good only in moderation. For example, you don’t tell your friend his daughter is homely, or tell your customer that you are asking her about her weekend merely because you want to sell her more copying equipment, even if true. At a deep level, a lot of small talk is disingenuous, but that gets into semantics. Base and higher motives are often consistent, as with the famous Invisible Hand where selfishness leads to a social optimum, even if the base motive is the true driver. Being brutally honest is often just an excuse to be cruel.

There are opportunities opened up by ambiguity, allowing people to make proposals they can then rescind, or make commands that would otherwise flout some interpersonal norms. For example, Steve Pinker writes about the use of indirect speech, and how being indirect or vague is helpful for a number of reasons. Given that there are three major social relationship structures—dominance, communal, and reciprocal—indirect requests allow someone to respond without bringing dominance into play (“If you could pass the guacamole, that would be awesome”). Also, in cases where the speakers are not sure of each other’s values or intentions, it allows space for negotiation without offense being taken, like asking a date if she would like to come in and see your etchings. People’s speech and actions are rarely straightforward, and it is this tricky intentionality that many of those with Asperger’s Syndrome, who have a hard time empathizing, find so unsettling in humans, and so comforting in animals that lack this attribute.³

To be persuasive, you need to be an advocate, not a judge, and advocates are selectively interested in the truth. Truth underlies the real data, and it helps tremendously to have the data on your side, but it is not essential, especially in the short run. Deliberate deception takes considerable effort, because one then has to consciously suppress the truth. To reduce the tension of such a mindset, good persuaders tend to make themselves believe what they are saying. Self-deception does not require people to sit down and decide they are going to lie to themselves. It usually happens subtly instead, without the person even being aware of it, as they tendentiously ignore
some information and highlight other information to rationalize something in their self-interest. This does not have to be monetary, and many people have principles or theories they consider righteous and just, and not merely true, such as that all men are created equal, or their religion. These bigger picture truths then force less important theories and facts to be consistent, because to do otherwise would invalidate their bigger idea.

A glass of red wine a day is a tonic, but too much will destroy your liver. The key is that just as poison is a function of dosage, so are the bad effects of deception and ignorance. A common alpha deceptor is merely blithely deluded about their role. Consider the signature players in the market whose pictures are on the front page of the business section when the market has a big day, the floor traders who make money off the bid-ask spread from customers, who think that they are excellent speculators. Or economists who are paid to do PR, but think they are paid to figure out where interest rates are going. One of the biggest things people do is persuade others; and to be a good persuader, it helps to truly believe in what you are selling.

Navin Johnson best sums it up in the economic primer The Jerk, starring Steve Martin, where Navin is lamenting his poor skills as an amusement park weight guesser:

\[\textit{Navin:} \quad \text{Frosty, I'm no good at this.}\]
\[\textit{Frosty:} \quad \text{Aw, come on Navin, you're doing fine.}\]
\[\textit{Navin:} \quad \text{I've already given away eight pencils, two hula dolls and an ashtray, and I've only taken in 15 dollars.}\]
\[\textit{Frosty:} \quad \text{Navin, you have taken in 15 dollars and given away 50 cents worth of crap, which gives us a net profit of 14 dollars and 50 cents.}\]
\[\textit{Navin:} \quad \text{Ah! It's a profit deal!}\]

Navin probably got more customers because his enthusiastic, delusional belief that he was trying to be a good weight guesser, and when you won and he grimaced, that was the real payoff, not the pencils. A cynical guy who knew it was just a scam would not seem so engaged and would be much less fun, and people are all about putting meaning into things that have very little importance in the big picture. As Ghandi said, "Almost everything you do will be insignificant, but it is very important you do it." There are a lot of weight guessers out there, whose actual task is doing something that is, unknown to them, slightly deceptive in its true purpose.

Consider that market makers spend most of their time looking at current price changes, and the changes of prices related to what they are making markets in. They often have explicit models that figure out the price of their assets based on the movements in these other prices, as in the obvious case of an options trader looking at the change in the underlying stock, and
using Black-Scholes to adjust his option prices; or it could be a trader in a stock moving his bid-ask spread up as the S&P500 moves, even though nothing has changed in the order book for his specific stock. The main thing the market maker has to do is keep his model inputs fresh, post prices to potential buyers and sellers, fill market orders, and pick off stale limit orders. Quickness is the key, which is why these guys tend to be young and aggressive (they also tend to be male). Customers generally have access to older prices, and in a situation where the current price moves every second, this clearly puts a trader at an informational advantage, which is why it can be such a lucrative field.

Market makers generate most of their money by their seat, the franchise value of being attached to a well-known institution, and the implied contacts. Many of the most highly paid traders in the 1990s were merely those fortunate to be a market maker for a popular stock like Microsoft. Their profit was pretty much volume times the bid-ask spread, and as the ask-bid was about 1/8 for most stocks in the 1990s, and the daily volume on Microsoft about $10 billion per year, assuming a 10 percent of profits bonus, this created many millionaire “traders,” who would then regale their friends and neighbors about their financial insights.

Yet, much of being a trader is encouraging trading activity from a hesitant broker, or giving insights that the broker will pass on to a hesitant client, and so many traders are quite adept at presenting themselves as more than middlemen, but also men with an angle or a story. A good trader is probably truly delusional about his prognostic abilities because this allows him to appear sincere in his sales pitch for the latest trade idea; those who don’t believe their own stories make weak sales pitches. Most of these traders are certain they could make money without their customer flow, merely reading the tape, because the same self-deception that serves them well chatting up brokers or impressing their boss generates delusions of strategic grandeur. Supreme self-assurance, even if undeserved, just as much as knowing your Greeks, makes for a good trader. A manager of traders might well find encouraging their delusions a benign myth. Indeed, I have known such market makers, and worked with several such organizations. I would say many—especially in the 1990s before computers made this less apparent—sincerely believed they were primarily good at what they do because of their alpha, their ability to read the tape and anticipate market changes, as opposed to their privileged access to customer orders.

Or consider the fundamental analyst. Most of their value is in their ability to excite readers into thinking their familiarity with a trend or concept means they have an edge investing in various industries. Henry Blodget worked for two years as a journalist and came to Wall Street with a degree in English and a little financial journalism. In the Internet bubble, he boldly stated that Amazon would rise to $400 when it was trading at only $240,
which was already quite high, and it hit that target in a few weeks. All the sudden, everyone wanted to hear his opinion on everything, though his experience in equity research, as well as Internet technology, was objectively limited. He was very valuable to his employer, and if you read his writings, you see he is a witty, thoughtful guy. He was not good at what his explicit job was—identifying which stocks to buy—but he was good at writing and speaking in a way that people find engaging and persuasive. His actual alpha was in generating retail trading, his purported alpha was in stock picking.

There are many products that are sold with a little misdirection. The classic is the razor, which is sold at a low price. The replacement blades, however, designed for this specific razor, are quite pricey. The razor is the hook, and should be priced low, because if he buys that, you have a lot of money coming it. Lots of products are built on this misdirection, usually lowballing an up-front investment, hoping the impatient and greedy consumer is preoccupied by their great deal on some more immediate bauble. I had a summer job in high school selling magazine subscriptions door to door, and if I did not want to deal with someone, the easiest way to avoid an involvement is to state the bald truth “Do you want to buy some magazine subscriptions?” A certain “no,” was the response, but this closed them off to listening to our highly convoluted sales pitch, which many found appealing. Unlike naive ignorance, this is a little more calculated, a little less salutary. After all, you are taking advantage of people’s impatience. To the extent you play upon people’s behavioral biases, you are manipulating them in an adverse way. But then again, if you did not do it, someone else would, and at the end the day, you do have the best razor available. Being brutally honest can work in some areas, at some levels, but sales necessitate a pitch that is misleading on some level.

Of course, not all delusional alpha has a trade-off. Going back to the delusional market makers and traders, those who did not realize they are mainly there to make money off of volume may have been a useful myth. Yet, in the long run, to the extent this myth deeply pervaded a trading operation, it discouraged the development of systems that would allow them to compete going forward. Many trading operations of various sorts have been automated to some degree, and so those organizations that truly understood their alpha were in a better position to create computer systems that are now making markets. But this is anticipating a regime change, and so one can imagine many groups, fighting to maintain their status as traders and speculators, receiving fat bonuses until a merger occurs, and their trade flow is routed to the new group that has the automated system. Relegated to trading without flow, their edge mysteriously disappears, and they retire into other fields.

To the extent someone believes he has an edge where he really does not can be merely wasteful. Before 1997, within an interstate bank, each state
bank was managed somewhat independently for regulatory reasons. First Interstate and KeyCorp, where I both worked, for a long time had little asset and liability committees that would take independent interest rate bets, based partially on their state bank’s need to hit an earnings number in their annual “plan.” If one state was running low on loan volume and needed more earnings to meet this year’s earning target, the one that triggers executive bonuses, how could the ALCO committee hit the target? One way was to put on some yield curve trade that basically generates positive cash flow up front in exchange for negative cash flows further out—these swap trades are zero-sum. This was also done in reverse during good times, like burying nuts for the winter. Alternatively, an easier way was to exploit the large amount of securities not marked to market, kept at historical cost in the banking book, that you can strategically sell to realize gains, or losses, as needed. It is so easy to do this that to this day I ignore income statement data from financial institutions. I regularly attended such meetings in asset and liability committee meetings many times, and this was never an explicitly stated tactic, but such is cognitive dissonance.

Top down, this was inefficient, because the multistate bank has, say, 20 different banks plying many offsetting interest rate bets that just generate excess commissions to Wall Street, and if you pay your group based on their profit and loss, you basically pay out a large bonus on Utah, which made $10 million betting on interest rates, and received nothing back on the loss by Colorado of the same amount, meaning, the corporation lost money on the trade, after commissions and bonus. Also, interpreting your profit and loss from your divisions is complicated because they are a distraction to how they are doing at their core business. After deregulation ended the need to keep state banks separate, and the disastrous yield curve trades of 1994 (when rates rose, exposing many of these income-smoothing trades), these multiple inconsistent asset and liability committees went the way of the office ashtray. This alpha delusion had little benefit and large costs.

THE FAVOR BANK

The “Favor Bank” was coined by Tom Wolfe in his work The Bonfire of the Vanities.

*Everything...operates on favors. Everyone does favors for everybody else....If you make a mistake, you can be in a whole lotta trouble, and you're going to need a whole lotta help in a hurry....But if you’ve been making your regular deposits in the Favor Bank, then you’re in a position to make contracts. That’s why they call big favors, contracts.*
The quid pro quos of finance are often quite complicated, but highlight an important point. Finance is mainly about being a middle man, intermediation, providing business with savings, and consumers with investments. When you play intermediator, you are not doing one deal; you are managing a set of relationships and a sequence of deals. Furthermore, in a large financial institution, many of your customers and suppliers are within your own company. You need to manage these relationships, often without the benefit of explicit payment. Having alpha in this area means seeing the big picture, how you act cascades in a web of favors, and how you can make trades that are not obvious.

An infamous case exemplifying the complexity of Wall Street’s incentive structure, and its inherent combination with alpha deception, was Jack Grubman, an Institutional Investor all star. People hung on his every utterance. Salomon Smith Barney’s army of nearly 13,000 brokers shared his picks with clients. When Grubman’s e-mail updates hit the newswires, they’d be immediately picked up on CNBC. And when he spoke, stocks moved. On January 20, 2000, after he raised his price target on fiber-optic networker Level 3, its stock rose 12 percent, pumping up its market value by $4.9 billion. Telecom equity underwritings peaked in 2000 at $74 billion, while debt issuance topped out in 2001 at $116 billion. Grubman’s firm raked in $1.8 billion in telecom fees in just four years. Looking at his picks in February 1999, they suffered a subsequent 75 percent loss.6

His investment prescience was just as lousy as everyone else’s, but what is so amusing, is that he had such credibility, when the essence of at least one of his opinions is part of a labyrinth of favors more complex than the Krebs Cycle. In 1999, Grubman was the father of 2-year-old twins, and sought the help of Sanford Weill, Citigroup’s co-chair of the board, in placing his children at the prestigious 92nd Street Y Nursery School. Grubman had raised his rating of stock in AT&T from unfavorable to favorable as a favor to Weill. Citigroup, in the meantime, pledged to donate a million dollars to the Y, and Weill did some lobbying for Grubman with the school’s board. Grubman wanted a more favorable rating for AT&T because AT&T was about to issue stock for their wireless subsidiary that would have meant about $65 million in fees for Citi, and he wanted the vote of AT&T Chairman Michael Armstrong, who was also on the board at Citigroup, so he could outflank Weill’s nettlesome co-chair of the board, John Reed. This is shown in Figure 12.1.

The key is that often, for various reasons, explicit payment between parties in a position to do each other favors is impossible, either because it is illegal, or too blatantly self-serving relative to the group they officially represent. Thus, like in barter economies, where you need to get around the infrequent double coincidence of wants (when the butcher wants shoes, and the shoemaker wants meat), you get highly convoluted transactions,
as when the butcher wants shoes, the shoemaker wants a new wagon, and the carpenter wants meat. When money is not the medium of exchange, you have to find multiple parties to engage in a profitable transaction. These transactions all need pretexts consistent with their regular course of business, making them seem insanely complicated, but in actuality these kinds of exchanges occur all the time in high school (Cindy lets Britney have her seat in study hall because she likes Jake whose friend Adrian likes Cindy who . . .).

The most famous research adviser was esteemed by everyone for a decade, as a supposed fount of fundamental wisdom on business. Instead, he was merely an articulate, but indiscriminate cheerleader, who would promote any company as a part of a constellation of favors one could not fathom. This is not as bizarre as it sounds, because senior government officials are often given plumb senior positions at financial institutions with no financial background and make millions. For example, Jamie Gorelick was a lifetime lawyer, a deputy attorney general in the Clinton Administration from 1994 to 1997. With no experience in banking, she became a top executive at Fannie Mae, pulling in $26 million over the 1997-to-2003 period. Lifelong political organizer and Clinton White House adviser Rahm Emanuel took three years off from government to make $18 million as an
investment banker for Dresdner Klienwort Wasserstein. I knew a finance executive who hired a prominent consulting firm for many projects, and when he was let go, the consulting firm hired him so that he would retain an aura of respectability in his job hunt. When he got his new executive position, the consulting firm now had a new big customer. Many banks hire ex-regulators into senior risk management positions, and the regulators anticipate this. Thus, senior positions, those people making the big decisions in financial institutions, are often not chosen for their trenchant understanding of interest rates, derivatives, or the nature of the product being financed, but rather, access and influence with people who are in a position to trade favors, where financial transactions are merely a single payment in a sequence of people with very different objectives, who all need each other. Evaluating a single financial transaction in isolation, through its stated objective, often reveals a pretext based on some kind of value creation, often misleading colleagues as much as outsiders. Many highly paid financial executives are well paid precisely because they can help in exchanging favors, all the while emphasizing maximizing shareholder value via their alpha.

The favor bank in alpha environments can be very fertile for creating complex barriers of entry. For example, assume you are a trader with zero alpha, but your boss does not fully understand your role—what the average commissions are, does not monitor price impact, does not have appropriate benchmarks, and so forth. Because it's a large desk, he pays you $500K a year, that is, as if you do have alpha. You need to show some alpha to your boss. So you transfer $250K a year to a broker by overpaying on commissions. He then gives you access to initial public offerings (IPOs). The IPO game is basically a way for brokers to capture the one-day pop in IPO prices. Generally, IPOs generate 12 percent return on their first day of trading, and most IPO investors sell in the first couple of days (though, of course, their broker discourages this, to little avail).

For the broker issuing the IPO, by giving these only to clients who pay extra commissions, that first-day return is all capturable. Generally, in 2001, a hedge fund might have paid two cents a share for bare bones trading, and five cents a share for trading bundled with research and trade ideas. Of course, this research is worthless on average and the hedge fund knows it, but it leads to getting on the IPO list. Thus, you capture the one-day pop through the implicit overcharge on commissions to get access to the IPO. To summarize: The investment bank captures the 12 percent one-day spike in the IPO price through overpriced research sold to a fund, which is needed because the issuing firm would not appreciate paying the broker an 8 percent fee plus giving them the benefit of the first-day pop. The hedge fund trades commission dollars for the one-day return from IPOs to help fool his boss. The portfolio manager benefits because this zero-sum trade makes
him look good to his boss, as his boss does not notice that commissions are higher than otherwise but does see the IPO gains—explained as deft selection of new issues. A final benefit is achieved by helping the broker, who can be among the best headhunters when a portfolio manager is out of work. Both are better off, and the capital provider and his representatives are basically clueless. The favor bank is complicated, but a very useful tool, and the pretext in this game is always alpha at every step. To the extent someone is using alpha as a pretext for trading favors, they are basically taking advantage of some informational advantage to the detriment of others. Regardless of one’s situation, it is useful to understand the true reason transactions are made, because they are rarely one-off decisions made in isolation, and these reasons are rarely explicitly discussed.

**MANAGERIAL ALPHA**

The most numerous successful players in finance are managers, not quants. Jamie Dimon, Charles Schwab, Walter Wriston. There is a skill to managing people, and this is something most pure innovators are not good at. The key to managing efficiently is understanding where the power in the organization comes from, which in finance means, where the alpha originates. Furthermore, it means understanding not merely where the alpha comes from, but the best way to approach this with customers, bosses, and underlings, each of whom has different interests and incentives.

For example, if you are an executive at Fannie Mae, making millions for your access to legislators and their continued support of your government support, you need to keep the current board of directors and other executives fresh with recent government officials who still have many contacts in government. You also need to understand that this kind of alpha is not something your clients or the public should know, so you mention the value of the mission of encouraging home ownership in PR campaigns, and downplay your executive focus on lobbying Congress for special status. The mission becomes like the lie in the Soviet states that their purpose was all about “the people,” as no one in power would even privately admit the truth while they enjoyed their country dachas.

Assume you run a trade floor for a premier investment bank. Your alpha is from making markets, by your brand name and set of connections. That is, you do not speculate, or try to make money off predicting future changes in prices. You should not mention this too much to your boss, because emphasizing it only highlights how your value is perhaps not worth 10 percent of the revenue. Indeed, mentioning this too much to your boss
might signal you mention this too much to his boss, which might make him look bad depending on how your boss presents himself to his boss. Highlight to your customers your existing set of other customers, because this merely increases your value to them—they are coming to you because they think you hear all the latest gossip, the latest trade information. You should understand that good traders are worth a piece of their profits, but not too much. The more a senior manager knows about what is involved in trading bonds, or swaps, or swaptions, the less the company has to pay its employees out of ignorance of the alpha generated from those writing the trade tickets. You pay someone 50 percent-plus of profits if you think she did it by sheer foresight, while you would pay her a salary of $50K if you thought she was merely taking orders. The reality is somewhere in between, and this is where having knowledgeable managers helps, because when people are wildly overpaid, such people have great incentives to misrepresent their activities and block information, and this is a cancer in an organization.

The key is the more you know about the essence of alpha in your organization, the more relevant you can be. If you understand that everyone has different incentives, and not everyone needs to be in on every strategy, and some simple white lies are good.

The good news for most people is that management is not just a comparative advantage, but an absolute advantage to those who are not really smart. It is very difficult for someone to feign interest in the activities of someone more than two, if not one, standard deviations in intelligence below them, and so the smarter the person is, the greater their inability to really connect with the large mass of workers who inevitably make up the core of a large organization. One can try, but this is often unsuccessful, because there are all sorts of nonverbal tells that signal a listener is really uninterested, if not dismissive, about what is being said. For this reason, people do not like working for someone much more intelligent or proficient, because these people often do not appreciate, and cannot even pretend to appreciate, their work. Stress is not so much caused by bad times, but by working where you feel your talents are being underappreciated. For a similar reason, salesmen who are too smart are not good salesmen, because they appear to be sneering at their average client’s ignorant questions and observations. Someone who sincerely notes that the boss will be very interested in a client’s banal suggestion (for example, that they measure risk only by looking at the downside volatility) makes this client feel important and appreciated.

Large organizations are invariably hierarchical in some respect, and a prominent characteristic of human civilization. Strangely, this has been a U-shaped pattern in our evolution. Dominance hierarchies are characteristic of all nonhuman hominid societies, an extreme example being the
tiny-testicled, alpha-male gorilla lording it over his band, and are found in many other species of animal—as in the proverbial pecking order among chickens, dogs, seals, and so on. Likewise, dominance hierarchies are a defining characteristic—in fact, an overwhelming feature—of every known civilization before modern times. But dominance hierarchies are rare in the ethnographic literature describing hunting-and-gathering societies—and thus, presumably, also rare in hunting-and-gathering societies as they existed during much of our common evolutionary past. We started in dominance hierarchies, lost it, and regained it.

To account for this fact, an anthropologist at UCLA named Christopher Boehm proposed the idea of a reverse dominance hierarchy. The gist of his idea is that a love of dominance was so bred into the human species during their long, shared hominid past, that they developed an innate distaste of being dominated by others. “All men seek to rule, but if they cannot rule they prefer to remain equal,” says Harold Schneider, an insight consistent with the relative risk utility function. Without weapons, the biggest and strongest can dominate others by hand-to-hand combat and other intimidations. With weapons, however, even the smallest can have a say in matters. Thus, a gorilla has to manually fight the dominant male to take over his harem of females, and sucker punching the alpha Silverback male who has proven himself in combat, is a highly risky career move. However, humans and our ancestors, with their ability to hunt big game, can easily use a spear and kill even the most powerful man in his sleep. With weapons, a simple conspiracy makes the homicide of a lone, powerful male relatively easy, and is why in simple human societies a strong man, without a coalition, cannot dominate his tribe.

The mechanisms used to enforce equality in these simple hunter-gatherer tribes are based on an innate set of morals that shame hubris, bragging, and personal dominance, and promote ideals like generosity and immodesty. In societies where the gains from a wise leader are small, the leader is mainly chosen for his tact, generosity, ability to serve as an even-handed mediator, and oratory skills that make everyone feel appreciated. The tribe defines the ideal society in a way such that no main political actor gets to dominate another. Then they see to it, as a group, that anyone who tries to infringe on this rule is himself dominated, at first by subtle tactics like gossip, then outright ridicule, but leading to ostracism and even execution. This leader is really a puppet—though one with some selfish satisfaction in his figurehead role—merely articulating a consensus once he recognizes it, as opposed to actually making key decisions. Thus, in these simple societies, the hierarchy is in reverse, because those who are superficially being ruled, are actually dominating the ruler.
In more complex societies, where a leader’s decisiveness and strategic vision has a first-order effect on the success of the group, these altruistic skills are still important, but there is now a greater trade-off, because the success of the group also needs strategic vision and tactical know-how, skills that are independent, if not in opposition, to those other skills. Furthermore, in modern civilization people’s assets are large and stationary, meaning that, unlike the hunter-gatherer, they have something valuable to steal. The politics of any large organization thus necessitates that leaders are a mix of those attributes that lead to the successful direction of the group, such as decisiveness and wisdom, but yet are balanced by qualities that give the leader support, such as modesty and generosity that does not threaten the more numerous subordinates. They need to sufficiently tax those who have more than the more numerous masses, yet not so much that these wealthier people conspire against the leader. Individuals trying to maximize their success in businesses must engage in coalitions, pretexts, and favor bank trades. It is not sufficient to merely be wise about business strategy because individuals will withhold support for a wise man who appears to not appreciate their efforts. For a middle manager, no amount of wisdom or efficacy by the big boss compensates for being moved down the hierarchy. The tension between needing someone smart and decisive enough to make good decisions, versus needing a leader who makes his workers feel appreciated, creates the common leader who is good at doing both, but in fact is mainly good at this game: appearing to do both. Thus, we should not expect the boss to be the smartest man in the room, either in IQ, or knowledge of the product, but rather to pull this off successfully, the boss should be blithely ignorant about the inconsistent objectives articulated to the team, such as trying to simultaneously prioritize innovation and tradition, a meritocracy that recognizes everyone, or a strong sexual harassment policy and a fun Christmas party. People who are really good at logical puzzles, who excel at finding alpha in quantitative finance, are often not very good at managing people, because they cannot, or will not, empathize well with the most people. Thus, in spite of conspicuous examples where the highest-IQ person is both an idea generator and the boss, such as Larry Ellison or Bill Gates, in general the functions involve different skill sets. For that reason, your average person doesn’t envy those really smart guys; he thinks they are like idiot savants, smart in one dimension but clueless in what is really important, such as leading a large organization or having lots of sex (alas, adolescent sexual activity and IQ are inversely correlated for IQs above 100). The result is a leader in a modern reverse dominance hierarchy, somewhere between the dominating male silverback gorilla, and the submissive chief of the foraging tribe.
THE ALPHA IN RISK MANAGEMENT

Around 1994, coming out of graduate school, I had an interview to work with JPMorgan in their risk management group. It was all very intimidating as I grew up in a pretty modest middle class background, and at the age of 28 never pulled a salary greater than $21K per year. I was intimidated by their small talk about which ski resorts had the best powder—didn’t anyone go camping? At JPMorgan, all the furniture was mahogany, and everyone I met had a nice suit and a fresh haircut. It is reasonable to give a rich person the benefit of the doubt because presumably they are getting paid a lot of money because they have some kind of alpha.

One of the guys I met was a senior risk management executive, who told me that at JPMorgan, they did not eliminate, or even minimize risk, rather, they got paid to take on risk. The implication was that risk management was the gatekeeper for strategies and tactics, filtering in the good risks, and out the bad. This was meant to be profound statement. They understood risk as risk managers better than others, that was their alpha, their edge, why all the guys had $50 ties and mahogany desks. It sounded intriguing, and indeed, I had seen it previously at a local brokerage I worked at in Chicago. They offered some simple investments, and had a glossy brochure that noted they were experts at managing the risk of their investments. This was explained mainly by a neat graphic in classic mean-variance space that had a fade effect between the light corner near the origin of zero risk-zero return, and the dark space where risk and returns were infinite (“thar be dragons”), with a little dot implying “we are here” in the middle, usually strictly dominating the S&P in both return and risk space, which is placed there to give a transparent exhibit of a risk-return relation, such as an equity index (see Figure 12.2). The discussions always excluded any concrete definition of what risk was, specifically, because we all know that while equities are riskier than T-bills, sophisticates know this is not merely volatility or beta.

The idea is ubiquitous in finance: The experts, who make a lot of money, can manage risk better than our competitors. Risk is such a slippery concept that is a perfect pretext for managers, because by conflating idiosyncratic risk, or risk of default, with a risk factor that is correlated with expected (that is, average over the cycle) returns, you can work in specific examples that make sense (high yield bonds have higher risk and higher yields) and yet still avoid inconsistencies (high yield bonds have higher risk and equal returns), merely by switching the subject at convenient junctures (such as when the higher stated yield on higher defaulting securities is presented as evidence of risk begetting return). Most people miss the sleight of hand involved. Getting into discussions about expected returns, in contrast, invites much greater audience participation, and potentially, skepticism.
It was an attractive idea, and I had been contemplating risk for a long time, and I was very interested in seeing the practical advantage of understanding risk better than others. Of course, I had no idea exactly what they meant, but I had been used to that listening to Minsky talk about how risk is the Most Important Thing, and also indefinable. Like learning to meditate, or knowing God, or true love, something I had not experienced but clearly many others had, and one day I would just “get it.” I knew risk was a slippery subject, so I was indulgent with their vagueness, and eagerly wanted to join the guild of people who made money off risk. I figured, they were living this difference.

The neat thing about risk management was it played into my skill set of math, computers, and statistics, but was also universally praised as the essence of finance. Everything came down to risk management, it seemed, at least publicly. Many much better-paid executives, who certainly didn’t wish to switch places with my career, would on occasion remark to the press, or in meetings, that they “considered themselves fundamentally a risk manager.”

But then, in practice they did not seem to venerate risk management as I understood it. Our CEO, who supposedly had a bond trading background from the 1970s, was rather indifferent to the duration or convexity risk in the bank’s balance sheet. Some of the managers were incredibly ignorant of the products and services they were providing. We had one executive ask, since we were making so much money on one asset, but losing on the hedge, why don’t we get rid of the hedge? The very basics of financial risk
management, from a pure risk management perspective, were foreign to a good percentage of senior executives.

I remember Ron Dembo, the founder of the risk management software Algorithmics, coming by, and talking about how his software would help you see risk, and manage it by having some neat 3-D graphics on exposures to factors such as delta, theta, gamma, whatever is relevant to your trading group. That is, his vision was you would have a large screen, with real-time visualization of our current risk exposure in various dimensions, perhaps on several screens, and throughout the day we could see this information, and use it offensively. Indeed, people in risk management are always talking about turning risk management into a proactive business tool, not just a measure of risk. It was a neat vision. There was no interest in this by the traders. Many other risk managers told of knowing some company where risk managers had the power to reverse a trader’s exposure if they decided he was taking too much risk, so for example, in the Risk Management Star Chamber, you would see Trader Number Seven having a long futures position in Treasury bonds, and you would short this position in a different account unbeknownst to him, saving the firm.

What you soon learn as a risk manager is that most business lines are more than happy with existing risk metrics or hedging tools, because these are not the first-order impacts on their bonus. Indeed, several times I worked hard on developing algorithms to show how various trading desks could derive a more efficient hedging algorithm, using some of their actual data, and they responded with a shrug at best. They saw me as trying to muscle in on their bonus pool, if not their job, and as market makers had Sharpe ratios well above 10, so who cares about minimizing the volatility by 5 percent? As for the lending lines, their business was mainly about selling more product, not estimating risk better. If the business of selling car loans made sense at a portfolio size of $10 million, it made sense at $1 billion, so given that their business model worked—that is, the amortized losses imputed into pricing made the profit positive after a capital charge—getting the expected loss correct to the next decimal was not interesting to them. Rather, they were interested merely in getting more business. Most of finance does not involve buying assets traded on secondary markets and warehousing them, it is originating deals to new buyers; supply is not constrained by risk appetite so much as your ability to sell.

I later became a portfolio manager, and would occasionally be presented with unsolicited advice by the risk manager, and as a former risk manager myself, was sympathetic. These were usually innocuous, but often, when they really tried to help, they were irrelevant or worse. They would often make blatant mistakes because they were unfamiliar with my particular data and how they were warehoused, or they would get excited about some
intraday measurement that in theory would be really cool, but in practice involved a huge amount of effort for insignificant benefit, usually some plan to centralize data, or create some new tool that would allow them real time monitoring of various positions.

No matter how clueless a financial executive, they were all smart enough to know that saying you made money off risk sounded a lot better than the truth. Making money off rich and lazy customers who come to you because of your brand name, and then selling them something almost identical to what 10 other banks are selling, hardly makes a good signal to customers, your underlings, investors, or your boss. Making money by risk management magic, that's nontransferable alpha, and the beautiful thing about risk is that when someone asks for specifics, you can look back incredulously, and say, that's a silly question: in practice risk is highly mathematical and undefinable, like the Trinity in its apparent inconsistency and importance.

There is truth in their elevation of risk management as a concept, just not in how it is usually understood. The key is that risk management as a separate silo in any organization is necessary because of the incentives offered to those on the front line. Their independent monitoring is essential, because a business line that is usually paid a bonus based on annual revenues has an incentive to take more risk than the firm wants. If he is gambling with someone else's capital, especially when payoffs are often very asymmetric (such as positive during expansions, negative only during recessions), his incentive is to take as much risk as possible. If he loses, he goes to a new firm, and blames the mess on someone else, and outsiders are rarely able to sort this out. Financial institutions are especially prone to this problem because they are highly leveraged, and some businesses can buy an infinite amount of exposure, whereas, say, a media lending business, can sell only so many loans.

The primary need of risk management is to make sure business lines did not do anything stupid or fraudulent, and so risk management’s main role is independence, not accuracy. They are necessary to make sure businesses within the corporation do not commit fraud or violate agreed-upon risk limits. In practice, risk management is like an audit, only in real time. Most of the blowups of the past 20 years are what are known as operational risks, which is jargon for something that would never have been done if management knew the risk they were taking, such as Orange County betting on interest rates, or a rogue trader who loses billions. Before the fact, no one putatively in charge knew these risks were being taken. The key job of risk managers is monitoring the acknowledged, known risks, so that their underlings do not take them, preventing operational risk.

In practice, risk management’s practicalities are rather boring, like transfer pricing—a cost that is essential and not obvious, but still, just something
to monitor and minimize. A risk manager estimates this cost objectively, without any skin in the game, and his independent view is valuable to a system where the business line has better information about these risks, yet is self-interested in understating them—at least to the degree he is short-sighted (common enough). In some sense, a risk manager is like the cop in the bank branch who carries a pistol and supposedly puts his life on the line, but his mere presence is sufficient to dissuade most troublemakers, so you are mainly paying them to stand there. Traders, and business lines, can wreck a company very quickly, so they need monitoring. Risk management as a separate business line obviously do their job better, and are more satisfied with their job, if they feel appreciated, and so everyone talking about the importance of risk management has the additional benefit of making these groups feel important.

A SINGULAR RISK MANAGEMENT DECISION

But the viability of a firm, or a business group, depends on risk management of a very different type. The business heads are the judges of the ultimate risks, and risk management very rarely has much influence over these strategic decisions. Consider the recent subprime housing disaster. In the bad old days, one needed a 20 percent down payment, a good credit rating and proof of employment to get a mortgage. In 1989, Congress amended the Home Mortgage Disclosure Act to force banks to collect race data on mortgage applicants. It showed that blacks were rejected at higher rates than whites, which is not surprising because on average blacks have lower incomes, wealth, and credit scores than whites. Several newspapers mined this data, and won Pulitzer prizes based on simple statistics showing blacks getting disproportionate rejections. A 1992 study commissioned by the Boston Fed, led by its president, Richard Syron, argued that even after controlling for credit risk, minorities were rejected at a higher rate. Of course, the databases did not “control for credit risk” but rather just income—as highlighted by the fact that default rates for both races was the same, suggesting fairness—but many in a position to legislate and regulate had seen enough.9 “This study is definitive,” said a spokeswoman for the Office of the Comptroller of the Currency.10 “I don’t think you need a lot more studies like this,” said Richard Syron.

The study implied that simple racial discrimination was prevalent among mortgage lenders, and the Boston Fed warned the mortgage lenders they regulated: “Discrimination may be observed when a lender’s underwriting policies contain arbitrary or outdated criteria that effectively disqualify many urban or lower-income minority applicants.”11 Such “outdated”
criteria included having a credit history, income verification, or a significant down payment. In 1993 the Justice Department head Janet Reno noted that eliminating mortgage lending bias (read disparities) was a priority, and issued various actions against banks accused of discriminatory lending. In the 1990s Fannie Mae and Freddie Mac, under the direction of the U.S. Department of Housing and Urban Development, developed quotas for lending to lower-income borrowers that were continually increased. With the government now mandating such lending, government regulators who might otherwise have warned against such lending, based on inadequate down payments or other underwriting criteria, found themselves having to encourage such lending innovations. Like slowly boiling a frog, underwriting standards degraded over a period with increasing housing prices and no one noticed the effect on default risk, so that as of 2006 everyone still thought “mortgage risk” merely referred to anticipating the complex prepayment option.

Dick Syron was made the CEO of Freddie Mac, in large part because he was a forceful advocate for the pretext need to get support from legislators in maintaining their monopoly: helping increase home ownership by the poor, especially minorities (note the complex nature of the favor bank). Freddie Mac’s chief risk officer, David A. Andrukonis, told Syron in mid-2004, that the company was buying bad loans that “would likely pose an enormous financial and reputational risk to the company and the country.” Yet at that time, these government-sponsored enterprises that guarantee a large amount of mortgages, Fannie Mae and Freddie Mac, were under criticism for an unrelated accounting fraud issue. An embattled Fannie and Freddie emphasized their mission to financing low-income and affordable housing, and after a long battle, in 2005, new legislation designed to curb Fannie and Freddie’s power was killed in the Senate’s Committee on Banking, Housing, and Urban Affairs.

While these underwriting standards are theoretically related to defaults in obvious ways, as these adjustments were made throughout the decade and a half before 2006, the effect of these changes on aggregate mortgage performance was negligible, mainly because the increase in housing prices meant borrower credit was irrelevant because the collateral was increasing in value. Stan Liebowitz, who had written criticisms of the initial Boston Fed studies to little effect in the 1990s, noted that no one highlighted the pernicious credit risks of these changes before 2006. Other large mortgage lenders adjusted to the government-sponsored enterprise’s lead, and new entrants and existing lenders like Countrywide explicitly targeted these new loans, and rating agencies, like everyone else, were cowed by the theory that the old criteria were arbitrary and racist in effect, as well as the data: No increase in losses appeared. Thus, Moody’s and the S&P did not alter
the loss assumptions that underlay the complex of derivatives built upon mortgage pools: mortgage-backed securities, credit default swaps based on these securities, or collateralized debt obligations based on these securities. It all started with a lack of adjustment in expected losses to changes in underwriting, something that in the context seemed not just empirically true, but morally right. Andrukonis left Freddie Mac to teach in 2004, while Syron personally pocketed a total of $38 million before Freddie was taken over by the government in September 2008.

The key risk driver in the upcoming debacle was that a relaxation of underwriting criteria would stand as a levee in times of adversity, such as when housing prices decline. In a financial institution, a risk manager bucking the collective wisdom of the business line (who benefits from excessive risk with firm capital), regulators, academia, investors (who had no qualms before 2007) and our largest home loan underwriter or their CEO, in the absence of any actual loss data, is powerless to seriously question such mortgage innovations. To have argued against this in real time, you would have suffered the fate of Andrukonis versus the success of Syron. And this difference was not constrained to greedy businessmen. Alicia Munnell's flawed 1992 piece on mortgage discrimination led this erstwhile Federal Reserve vice president to go become, among economists, wildly successful: Her paper became published in the *American Economic Review*, the leading publication of economists, member of the National Bureau of Economic Research, part of the Council of Economic Advisors to the President, and is a full professor at Boston College. Meanwhile, Liebowitz's rebuttal of Munnell only made the *Economic Inquiry*, a good journal, ranked thirty-sixth in one study, and is doing good work at the University of Texas at Dallas, yet clearly was less rewarded.

There are a lot of books on valuing derivatives based on mortgages, managing things like the prepayments, interest rates, and credit losses. These are complicated problems, and it takes many months to program algorithms that can capture these structures correctly. The default risk was historically a third-order risk for mortgages, and housing prices in aggregate had never had significant year-over-year declines since World War II. As earlier calls from the 1990s that underwriting adjustments would be disastrous did not materialize, by the time of the Bush administration, concerns about default risk were overwhelmed by a phalanx of policies that conspired to increase mortgage production under the pretext of increasing home ownership and removing discrimination. The motives of the players in this complex of nonmonetary favors (banks trying to appease regulators, who were bucking for promotions into the gold mine patronage jobs at Fannie, who were supporting congressmen, who helped mortgage companies, who made charitable contributions to community activists, and so on) meant that with only
theory and no data of losses, the full-time risk manager was powerless to prevent this.

This is a signature case of how risk management does not have the authority, in practice, to overrule the major risks that affect a business. Clearly this debacle represents an extreme case, yet in the same way, a full-time risk manager does not have the power to affect most strategic decisions of a large institution, which are usually more a function of the firm’s mission statement than some specific risk score. That a risk manager’s work will, with hindsight, appear tendentious, biased, and incomplete and is a consequence of this reality.

Risk management as a separate line of business is about catching logical mistakes, fraud, violations of agreed-upon limits by renegade subunits. They enforce rules, help modify them in nonthreatening ways, but they do not create the most important of those rules. As those in charge knew the right answer, they merely had to find those risk managers who would generate the analysis to support their conclusions (for example, in 2006 UBS risk managers applied a 10-day value at risk based on data from the benign 2000–2005 period in traded residential mortgage-backed securities, vastly underestimating their risk). Yet, blaming the risk manager is misplaced, because this was outside the scope of her authority. In the subprime boom, regulators, the federal government, nonprofits, community activists, legislators, and not least investors all wanted more mortgages for people without the ability to pay them back using the standard underwriting criteria.22

Indeed, the subprime crisis highlights an additional insight of the relative risk approach. If everyone is doing something, people feel it would be risky not to do it, and as bank acquirers touted ever larger CRA lending targets, opting out of this mania would have implied that those drinking the Kool-Aid such as Countrywide or Washington Mutual would have acquired your bank in short order. CRA commitments skyrocketed under George W. Bush, as during 2003–2004 bank acquirers pledged over $2 trillion in new loans for traditionally underserved communities, a number so large it could only create a large, deep web of enablers and advocates, and disastrous new tactics, such as no income documentation or down payments, necessary to meet these targets. Not playing the game in 2005 and 2006 would have implied you were asking to be taken over.

RISK MANAGEMENT LIKE AUDIT

In the 1990s, I was on the leading edge in capital allocations in financial institutions after leading a consulting project by First Manhattan to institute a comprehensive risk capital allocation mechanism within KeyCorp, which
was about the eighth largest U.S. bank at the time. I was talking to Robert Mark at a risk conference, and he was often speaking on risk management and economic capital allocations. He and his team were doing one of the better jobs of capital allocations at CIBC, a large bank based in Toronto. In the late 1990s, he noted in one of his talks, "It's funny this is not reflected in our stock price." Yet, over the subsequent 10 years, CIBC has been hurt just as much as any other bank in the subsequent banking problems. This is because the risk management he was talking about, and doing such a good job at, was merely measuring better what we see on the books that everyone agrees is a risk that should be minimized. Measuring that kind of risk better is good, just like having great Internet security is good, but that won’t affect your company’s P/E ratio. It is much less important than the job of making strategic decisions that could be wrong, and are thus risky, which is rarely the subject of extended analytical study, because it so parochial.

The business heads who have the real power, who make decisions about where to expand, new sales incentives, or pricing plans, are the ones making the really risky decisions within a bank. Such decisions, however, are not up for a general debate by their subordinates, and especially those underneath them. To placate these people, risk management is something they can all agree is important and that they all work on. This allows the business heads to retain power, which is important because business hierarchies purport to be meritocracies that work for shareholders, but anyone in charge does not want to be like an NFL player having to prove himself in spring training every year. Thus, the subordinates are basically excluded from the strategic debates among the real alpha males in the organization, though not so explicitly that they then withhold support for these same individuals.

So, in one sense, the risk manager at JPMorgan was correct. His company does make or lose money for its shareholders to the extent that it manages risk. But he was either really good at playing the game, or deluded, to think that risk management as a separate line of business was managing those risks. Every financial executive is fundamentally a risk manager, and evaluates strategies based on analogies to the past as well as the behavior of their peers. Such an executive encourages hundreds, if not thousands within his organization to offer opinions and solutions in their limited domain, not emphasizing its second-order effect on the business. The really intelligent workers of risk management, who are not as good at creating coalitions, but who excel in the complex issues of derivatives and pricing models, are satisfied, and those at the top who are often quite clueless of some of these basic issues, stay in charge. Businesses are far from perfect, but they have to play in a game populated by highly imperfect people. Given the distribution of talents, and the relatively poor managerial skills of the quants, and the way businesses play off of access and reputation, this probably does serve
the overall company well, a greater good. Given the average amount of intelli-
gence, integrity, greed, people skills, envy, and intellectual courage, it is not an absurd state of affairs.

**OVERPAID ALPHA DECEPTORS**

The problem is usually based on someone being vastly overpaid for doing something without a lot of management responsibility. A “Head of Global Equity Derivatives,” or “Chief Investment Officer,” is often in a position where she can receive an unnecessary zero and the end of her annual bonus. This is a classic moral hazard in that it encourages bad behavior from otherwise good people. They become like Gollum in *The Lord of the Rings*, seduced by power and turned into something paranoid, greedy, and pathetic.

If you are getting vastly overpaid, you have a problem. Someone might find out you really are not worth $1 million a year. Your firm could hire someone to do it for $200K, just as well. How do you keep your bosses from figuring this out? Well, first, if one is being vastly overpaid, then they probably are also working for someone who really does not understand what they are doing. If they did, they would not be paying him so much more than they should. Thus, given the boss is ignorant about how this desk generates its profit—that is, its alpha—one needs to perpetuate this misconception. This involves not being helpful with your risk managers and misrepresenting yourself to your boss, mainly by not volunteering information. The best lies are lies of omission, because no one can prosecute you for not volunteering information; mistruths are damnable evidence.

Second, you need to make sure no one very smart and experienced is hired in your group. If your second-in-command is clearly a close substitute and you throw your weekly temper tantrum, you may get fired, and never make that much money again. Thus, hire demonstrably inferior people, and avoid giving any responsibility to anyone bright you may have inherited. I saw this once, and thought it was a particularly insecure person, but then I saw it a couple of more times. In two of the cases, the person actually articulated this goal to me or to people I knew: to hire someone who would not be so good as to be a potential replacement. Whenever someone is insecure, as overpaid millionaires tend to be, he deliberately made sure his lieutenant, the guy who would step in for him when he was out on vacation or sick, was tangibly inferior. As long as the Number Two was demonstrably inferior, Number One was safe.

These people are especially cancerous in that they generally are head of a group making a lot of revenue. This gives them a lot of power. Their habits carry over to other areas, because if you can convince people your
group does not need some extra risk assessment, it should not be applied to others, either. Overpaid people do not respect those they trust, and do not trust those they respect. In a sort of reverse catch-22, the only people who understand the futility of their situation working for these people are anxious to escape it, leaving a circle of ignorant and deluded co-conspirators.

Consider the extreme, where alpha is not present, but exists merely from the position. For example, a seat on the NYSE costs about $1 million to buy. This is because, if you are on the exchange floor, that space is worth $1 million to the average, marginal trader—lots of retail flow and the bid-ask spread. If you have alpha on the exchange floor, you should buy this seat, because you can make more than $1 million in present-value terms. In this case, the seat is a proxy for monopoly value, like a taxi cab medallion in NYC, something with a quota, that prevents entry that would drive profits to zero, and within organizations, there are often seats like this, positions that many earnest and smart people could do, but alas only one is chosen and makes the big bucks. But such value need not be an explicit monopoly. Many big organizations are profitable because of their brand name and their existing network of buyers and suppliers, or their government-approved monopoly.

I once reviewed a currency trading desk early in my career as a risk manager, when I had little clout or any real understanding of the alpha, the essence of the net revenue of various groups within a bank. I proudly printed out a sheet with my preliminary estimate of the Value-at-Risk for the desk, about $50K per day for a 95 percent event, based on all of their day-to-day positions. The manager of the desk then tore into me, getting very upset about my abuse of protocol, in that he supposed he should have been involved in this estimate from the very beginning, as I was potentially spreading misinformation on his group within the company.

I was dumbfounded, because I merely took their end-of-day positions, aggregated the exposures to the various currencies and yield curves, and applied the newfangled RiskMetrics algorithm to the desk. As part of risk management, I was privy to their end-of-day positions. I figured he would be very happy I estimated his risk to be so low. What I did not realize was that for a desk making $10 million a year, this made it quite obvious that they were not alpha magicians, because this would imply a Sharpe ratio of about 25, so outside the range of plausible it screams, "Market maker."

Thus, you had a case where a desk head presents his group’s function as deft speculators, not market makers, because this inflates their alpha, and justifies their bonuses as a percentage of profits. There are many similar desks on the trading floor, and all of them tell the same story. This basically allows insiders to exploit their information advantage to keep proportionately more of the revenue. I once sat in a meeting where our head of trading noted
Alpha Games

proudly to the bank CEO that his group made money on a day the stock market fell precipitously. This was really misleading, because they didn't have any significant net positions per course of regular business—they were market makers, and they didn't even trade equities. The CEO nodded in approval. This is really bad because keeping the CEO ignorant of the genesis of alpha in various business lines clearly disserves the shareholders, but it also disserves the public, because the CEO cannot meet his customers' needs better with a solution than might actually not protect the fiefdom of the "Head of Global Default Swaps."

In another case, I witnessed a group that was creating an automated version of a trader. That is, using the electronic feeds, you have a book of limit orders just like the specialists on the floor of the NYSE have. You can adjust your bid and ask, just as a human can. Being a specialist—posting offers to buy and sell at modest quantities—is highly amenable to an algorithm. But to really make money off this within the company, it helps to sell one's algorithm as not merely as something so straightforward, but crucially integrating a proprietary factor model that layered in a directional bet on the equities being traded. While theoretically, there is a case for adding a 1-ish Sharpe factor model to a 5-ish Sharpe market-making algorithm applied to retail flow, I also knew the specifics of how the algorithm worked. The marginal effect of a long-term drift factor was negligible on actual transaction criteria. But the boss did not know this, and so this guy was able to arrogate more of the profits for himself, through his insinuation that much of the profit was not from a straightforward market-making model—and certainly not from the retail trade flow—but a "market-making cum algorithmic-trading model" that suggests the touch of a Buffett or a Lynch.

The costs are more than how much someone is being overpaid. The cost is the senior management does not understand the essence of the profits being generated. They might reallocate their capital, or adjust their product offering, if they understood exactly what their clients were paying for. The alpha deception of the traders means those with the capital are not optimizing its use, because they do not understand where alpha is being generated.

INVESTOR MEETS ALPHA

In theory, equity earns all the profits. Labor and debt earn fixed payments that basically cover their opportunity costs—no abnormal returns there (this was the theme of Frank Knight's Risk, Uncertainty, and Profit, published in 1921). Equity is defined as the residual claimant, and he receives the residual revenue, which includes the alpha. Practice is quite different. For example,
in Lowenstein’s book *While America Aged*, General Motors poured $55 billion into its workers’ pension plan over a 15-year stretch ending in 2006, compared to only $13 billion that it paid out in dividends. As retired union workers voted, one could say that GM was not run by shareholders, not by its current union members, but by its ex-union members.

The key is that any written agreement is not worth merely as much as the implicit power of the agents in real time, because most contracts are not renegotiation proof. For example, if A and B write a contract, where B gets 10 percent of the profit, A receives 90 percent, and both are necessary, it is easy for B to renegotiate. He can threaten to walk away, or not try as hard as he could for the duration of the contract. To the extent B is able and willing to withhold his effort, he can negotiate a higher percentage, because A’s 90 percent of nothing is worse than 50 percent of something. Profits of all sorts are a function of power and negotiating, because the law and contracts are merely one of many tools used by all claimants to reconcile a power differential.

Looking at alpha, we should see that the investor also does not receive anywhere near the entire alpha in the investment. Look at employee expense as a percent of profits to shareholders at investment banks. Goldman Sachs earned $14.6 billion and $17.6 billion in 2006 and 2007, respectively. They paid out $16.4 billion and $20.2 billion in bonuses in those two years, suggesting that those on the ground, making the deals, are able to get about half of the profit. Note that Goldman has a lot of insider ownership, so I do not think this is a simple capital-management agency problem, where the employees have outnegotiated the shareholders. Alternatively, look at hedge funds. If one assumes that hedge funds make only 2 percent of assets and 20 percent of profits, then over the glory years of convertible bonds from 1994 through 2003, when they returned 10 percent to investors, this implies hedge funds raked in about 5.5 percent of assets in profits for themselves, while investors received about 4.5 percent in annual returns above the LIBOR. As one might expect when you have two inputs, equally necessary, the split seems to be near 50–50.

The one with the idea has to get capital, or partners. If his strategy is a variation on a theme well-known to investors, this is usually quite straightforward. Indeed, the best pitch for an investment strategy is to note a highly successful, comparable strategy, just as for almost any new product. But then, to the extent it is obviously attractive, one then must retain some secrets so that the capital provider does not merely take it the idea, say, “No thanks” to the alpha pitch, and implement it himself. The listeners usually think they *completely* understand the idea, and they can make it even better by adding some personal touches—making it easy in their mind to think it is really their idea—and cut out the potential middleman. Good ideas that
are easy to understand will be misrepresented more because to do otherwise is foolish.

Another reason to misrepresent ideas is that people tend to distrust simplicity. It is a fact that more data gives people the illusion that something works better. Barber and Odean claim that when people are given more information on which to base a decision, their confidence increases. This is true even when the information is actually meaningless, but related.\(^{24}\) Basically, our minds are like naïve statisticians that try to maximize the \(R^2\) by mindless data mining, confusing explanation with predictive ability, hurting out-of-sample performance. In other words, a model of arbitrage based on one factor will generally appear inferior to one based on several, a key point if you are selling a strategy, because you can often accomplish two necessary goals in one swoop, by adding irrelevant factors: It both disguises the strategy and serves to make it look better to the average investor.

Unconventional strategies that are not so obvious, no matter how simple and true, take a lot more work. As John Bogle showed, it was not until he was the CEO of a fund complex that he could implement his idea for a retail index fund, and even then he dealt with a skeptical board, and relied heavily on authority figures like Paul Samuelson. Imagine if he were a bright-eyed young kid with merely a PowerPoint presentation and his own data.

Capital providers need to understand the essence of alpha, and generally all they really understand are two things: a track record and pedigree. Thus, a good degree from a good school is good, especially the Ivy league. A couple years of audited financials is good. A recommendation from someone the investor trusts, be it his uncle or George Soros, is good. Whether the idea makes sense, based on the logic and empirical evidence, has a tertiary effect on its actual probability of being implemented. Most look at arguments for your pet alpha project as advocacy, suspect because of the obvious self-interest involved. People have preconceptions, and if something cleverly articulates or extends their preconceptions, they think it is genius. If it is something outside their preconceptions, they find it uninteresting. If it is contrary to their preconceptions, it is wrong. People are generally not very good at evaluating alpha of the sort that is unconventional, unfamiliar by definition. You can sleep well knowing the logic of your unconventional idea, if true, will be obvious to posterity because the truth does, eventually, get out (though validation from the wild success of those who were fortunate enough to have wealthy relatives, has its downside). But truth is still important to the inventor, because getting started is only a part of the battle, your idea does have to work, and the idea generator will lose the most in terms of opportunity cost if the venture is a dead end.

The more you know, the more efficient you can be in structuring incentives so that your alpha is successful. An investor seeking alpha needs to
understand the incentives facing the alpha producer. She needs to get her hands dirty with unconventional, idiosyncratic pitches. To the extent she has some knowledge of the market, she can assess these claims not merely on their track record, or the college of the manager, but on the logic and data in the proposal. For example, if an equity portfolio manager promises you a 10 percent return above the S&P500 investing in equities, you have reason to be very skeptical, indeed, dismissive. This is because the historical data of the S&P500 and mutual fund managers suggests this to be implausible. If you knew nothing about the market, or other data, however, you might believe it is true, based on her anecdotes and testimonials, and irrelevant signaling such as having a nice resume and a pleasant demeanor. This same kind of approach is useful in other domains, although involves a much more detailed level of product knowledge. If you know what the average default rates for B-rated bonds, and the average power of models that predict defaults, how they relate to state-of-the-art alternatives, you know that a manager predicting 4 percent annualized excess returns by going long the correct subset of B-rated bonds is a fraud or a fool. But if the manager shows how one can make money, and actually uses a set of assumptions that are consistent with broader data, and reflects a deep knowledge of the product space, that can be very compelling. The effort, and wisdom, required of an investor looking for alpha is very hands on, and quite contrary to the view of sitting down, looking at means and covariances, and generating portfolio weights.

The fact that alpha is private information makes the search for alpha much different from if we assume that alpha can be assumed. Knowing that as an investor, you are joining forces with someone who needs you, and whom you need in return. The information transfer is fraught with danger for both sides. This is where the rubber hits the road, in terms of benefiting from being smart, educated, hardworking, having integrity, but also not being too trusting. Investing wisely is a lot more about negotiating and understanding a product space than optimizing. That is, to the extent you are passively accepting information on returns and volatilities, your odds of actually finding alpha are about the same as those from investing with a mutual fund manager.