IDIOSYNCRATIC RISK

Volume 1 / Issue 5 (August 2020)

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Idiosyncratic Risk is a monthly investment ideas newsletter published by Antrim Investment Research, LLC.

Study art, lest ye be doomed to repeat it

RENE GIRARD'S MIMETIC THEORY:

OUR SCAPEGOAT IS... THE DOW?

In which your author attempts to articulate the influence mid-twentieth century French literary criticism has held over modern behavioral finance and economics.

In 1947, a 23 year old French University graduate by the name of Rene Girard arrived at the University of Indiana on a one year fellowship, with the aim to pursue a doctoral degree in history and with specific intent to study the contemporary political impressions of France in America. It is, perhaps, a happy accident of history that Girard was assigned to teach a class in French literature which was distinctly outside of the scope of his research, but well aligned with his fluency in his native tongue.

Girard received his Ph.D. in 1950, and remained at Indiana until 1953. He later occupied teaching posts at Duke University and Bryn Mawr college, and earned some reknown as a French literary critic after publishing influential essays on Albert Camus and Marcel Proust. After a decade of literary criticism, Girard began to note similarities in the works of great and influential authors that he felt implied that such authors were reknowned, not for their originality, but for hewing closer than their peers to certain thinly veiled, but universally accurate aspects of the human condition.

This line of thinking led Girard to an anthropological examination of patterns in the recorded mythology of indigenous and early human societies, and a close reading of James Frazer's influential text, "*The Golden Bough*," where he continued to spy the same patterns.

In early human mythology and religious texts leading up to (in Girard's opinion) the advent of Christianity, foundational stories took the following shape: a society beset by a plague or other social crisis descends into chaos until, helpless in the throes of escalating and uncontrolled mob violence, society achieves catharsis when the king is brutally murdered, and then a new king is resurrected and deified in their place. The King, as they say, is dead. Long live the King.

To Girard, the prevalence of this plot device in the foundational mythology of, literally, every single human society, implied that contained within it is some form of universal truth. He came to believe that human beings are fundamentally in conflict with one another, because we develop from infancy by mimicking the behavior of our parents and relatives. We are, according to Girard, hard-wired to mimic our neighbors, and to covet our neighbor's possessions, or status, or abilities. This, "mimetic desire," to use Girard's parlance, results in escalating "mimetic violence," as society's membership competes for increasingly scarce and valuable resources until an act of such brazen and capricious public violence occurs that society is shocked into a cathartic state of contentedness. Frazer and Girard refer to these acts as, "Scapegoating."

Of course, it would strain credulity to draw too literal a parrallel between contemporary current events and mythological descriptions of global airborne plagues that cast a shadow over societies already gripped by elevated mimetic rivalries born out of undesirable and unsustainable inequities between socio-economic classes. But even Girard's critics typically admit that examples of "mimetic desire" and "mimetic rivalry" exist in human society.

The increasing secularization of modern society does require a more subtle interpretation of mimetic desire and rivalry, however. For Marx, (who didn't have the benefit of Girard's tutelage, which came 100 years later) the reification of the medium of exchange through "commodity fetishism" replaced the deification of the King as the mechanism that maintained order in an increasingly fractious society. It is not surprising, then, that his prescription for a utopian socialist society required the violent elimination of capitalist currencies as a medium of exchange.

Girard's insight was that the scapegoating and violent elimination of an economic rival, by definition, can only result in temporary abundance. That the solution to the gordian knot of scarcity, competition, and rivalry was to... desire less, or not at all.

From 1971 to 2017, real hourly compensation increased at an annual CAGR of approximately one half of one percent.

A long litany of economic thinkers have arrived at the doorstep of this final insight and become distracted by various schemes that purport to eliminate scarcity. For example, in 1971, facing an acute shortage of gold reserves meant to support the convertibility of the U.S. Dollar, as per the Bretton Woods international currency agreement, Nixon simply mandated that the dollar would no longer be convertible. In this way, one surmises, he hoped to eliminate scarcity.

Since that decision, the modern monetary theorists (like the Keynesian fiscal stimulators before them) have done less to repudiate Marx's mistakes and rather more to ensure that the value of an hour of one individual's labor is assassinated in full view of a public distracted by, and infatuated with, rising asset prices.

From 1971 to 2017, real hourly compensation increased at an annual CAGR of approximately one half of one percent. The average price of a houses sold in the United States has increased from roughly 18,000 hours of minimum wage labor to over 50,000 hours at the statutory minimum wage. The price of an ounce of gold has increased from just over $40 to just under $1,974. Some 31 countries in Europe, Asia, Latin America and Africa have experienced episodes of hyperinflation, after experiencing 0 comparable episodes in the years between WW2 and 1971.

Banking crises have become commonplace. The U.S. Federal deficit has rocketed to and then beyond, levels experienced before only in the context of World Wars 1 and 2. The rate of incarceration of U.S. adults has risen over 500%. The rate of incarceration for males in the United States has increased over 900% since 1971. The U.S. personal savings rate has fallen from near 15% to just over 5%.

For the visually inclined, a series of illustrative charts can be found at: http://wtfhappenedin1971.com.

Coincident with this generational destruction of the purchasing power of the U.S. Dollar and its attendant civil unrest and disobedience, the institutionalization of the worship of equity market indices has been achieved through the introduction of defined contribution retirement plans and the passive indexing revolution, a process whereby the prices of equities have been completely divorced from any relationship with quantifiable measures of the productivity and profitability of American Industry.

A politically expedient socioeconomic class of "shareholders" has been fashioned out of whole cloth to support a circular system whereby fiscal and monetary stimulus are funnelled into insolvent enterprises on the condition that payrolls be protected so that a seemingly infinite stream of dollars in the form of bi-weekly defined retirement contributions eerily reminiscent of tithing can prop up equity prices in a vain attempt to ensure that individuals' meager retirement savings can compound at a rate that outpaces the destruction in purchasing power of their dollars, which is created in the first place by the fiscal and monetary stimulus.

"Stocks only go up. It has nothing to do with the economy." – David Portnoy

That the supposed mathematical sophistication of modern economic theory hardly makes this ruse more effective at delaying the coming onslaught of inflation than the tollbooth Bart & Jim construct to delay the arrival of Hedley Lamarr's army of thugs in "Blazing Saddles," has given rise to a new cult of economic theorists: the "day traders," led by the guiding light of David Portnoy, who counsels his followers, "Stocks only go up. It has nothing to do with the economy."

And who can blame them? As the nation battles to contain the outbreak of the novel coronavirus pandemic, the cost to society of maintaining the S&P 500 at all time highs has risen exponentially. The GDP of the United States of America fell by 32.9% year over year in the second quarter, but many furloughed workers saw their first wage increases in years, as they discovered that their government unemployment benefits amounted to more than their previous paychecks.

On social media, another rather simplistic economic "take," proliferated. "They told you that we couldn't afford socialism, but they could afford to print $1,000 for every American."

Indeed, if stocks do not fall when the economy's productive output is reduced by a full third, then what is the difference between socialism and a capitalism? A society that fixes the price of capital is not capitalist, at all. And indeed, if the price of capital is fixed at an artificially elevated price to prohibit the masses from gaining access to it, we can hardly hope to argue that, as a society, we've replaced mimetic desire for material wealth and the consequent rivalry and social violence with an efficient mechanism of capital allocation designed to increase the wealth of all market participants. It's rather statistically apparent that "modern capitalism" is nothing more than a regressive wealth redistribution meant to convert hourly labor into skyrocketing prices for financial assets.

It's become fashionable to debate the relative merits of "systemic value investing," or the supposed relevancy of statistical measures of the valuation of common equity shares. But the debate is irrelevant. Whether or not valuations matter is a statistical discussion of the efficacy of the policies we've put in place to separate capital from labor. Whether or not valuations SHOULD matter is a moral question. And one that cannot be answered in the negative without willful disregard for the plight of the median American.

Take for example, the following "radical" economic policy suggestions:

(1) Hold passive index funds accountable to the same rules that govern investment managers under the investment advisers act of 1940, without exception.
(2) Make the currency of the United States convertible to gold, or bauxite, or anything, but make it convertible to an actual thing.
(3) Allow lenders and borrowers to set the prevailing rates of interest.

In the broad arc of human history, these three policy prescriptions are anything but radical. They're basically just the way things are, if only "things" could ever be let alone. And yet, any one of these policy proposals might come with the potential to cut the valuation of the Dow Jones Industrial Average in half. If we allowed borrowers and lenders to set the rates of interest, the price of bonds would assuredly be lower. If the currency of the United States were convertible to gold, the price of gold would assuredly be higher (although we're getting there, slowly, and then all of a sudden). And if index funds were forced to play by the same rules as active managers their buying capacity would've been tapped out already by 1995.

Three decades later, it's not difficult to articulate why valuations don't matter. It's difficult to understand why we prefer this system to one in which they do. That it might cause some economic pain for a class of so-called, "investors" who've spent their entire lives levering up to push the published prices of their paper profits higher hardly seems like a good reason to continue to punish the median citizen for the sin of laboring for an hourly wage.

That the DJIA would be decimated by common sense reforms in the name of fairness, equitable redistribution, and sound money says more about the quality of DJIA assets than it does about fairness, equitable redistribution and sound money. That we've come to worship the stock market as some sort of quasi-deity "savior" for an economic system that has failed for the last fifty years to generate real wealth accumulation for nearly 90% of its inhabitants is hardly a reason not to kill it.

Actually, it might be cathartic[1].

[1] "Jensen's law is a doctrine suggesting that any newsletter focused on the theory and practice of "value investing" post-1971 is destined to devolve into increasingly unhinged diatribes about gold, interest rates, and credit risk. Idiosyncratic Risk completed its descent into the ranks of "permabears" and fiat currency fanatics in its first five months in publication.

WHEN LIFE GIVES YOU LEMONS

LONG LEMONADE (NYSE:LMND), LONG THE RE-MUTUALIZATION OF INSURANCE

If ever there were a more egregious example of the excesses of a structurally fractured market mechanism for discounting risk, or perhaps of the optimism and naivety of an army of day traders furiously flipping new issues without regard to their business fundamentals, surely the IPO of Lemonade, a new-fangled underwriter of renters' insurance policies for Zoomers and Millennials that has pledged to contribute any and all of its underwriting profits to charities of its policyholders' choosing, would be it. Ever the iconoclast, your author suspects otherwise.

The insurance industry was brought to the United States in 1752 by the efforts of Benjamin Franklin, who worked to establish the Philadelphia Contributorship for the Insurance of Houses from Loss by Fire, which was structured as a "mutual" insurance company, meaning that it was mutually owned by its policyholders. This ownership structure reflected the purpose of the organization, which was, rather narrowly, to insure against the loss of local residents' houses by fire. The company inspected the homes of applicants in order to assess the risk of insuring their property, assigned a premium to the policyholder based on the relative risk of fire at their property (you could be penalized, for example, if you were in the habit of storing combustible goods in wooden structures), and established financial reserves from which it could pay claims.

The concept was not new. Insurance, in one form or another, dates back to pre-history, when public granaries were established to distribute the risk of famine resulting from poor crop yields across the entire community, or otherwise ensure that no individual farmer's family would have to go without. The operating principle is simply that the distribution of risk provides the benefits of diversification. That the odds of any one building being destroyed in a fire are much higher than the odds of all buildings being destroyed in a fire creates the pre-condition for the successful distribution of risk, after which the premiums paid by any individual policyholder need only amount to a fraction of the loss liability coverage they receive from participation in the insurance policy.

it is the enduring lesson of economics that where effort and organization are required to produce an efficient outcome, the profit motive is best at maximizing efficiency

That fire, and Philadelphia, existed before fire insurance did only goes to show that it requires concerted effort and organization to efficiently redistribute the risk of catastrophe to individuals' personal property. And it is the enduring lesson of economics that where effort and organization are required to produce an efficient outcome, the profit motive is best at maximizing efficiency. Over time, mutual insurance organizations gave way – simply – to corporations, motivated to expand the distribution of insurance by the promise of generating increasing profits for shareholders.

They did this by "integrating backwards" from distribution (which was expensive and difficult) into the underwriting of insurance, which could be priced dearly enough that its aggregate written premiums would be adequate not just to insure policyholders against risk, but also to produce economic profits for the insurance company's shareholders. In this way, the large insurance companies we are familiar with today are very similar to the large newspaper publications, which leveraged their ownership of printing presses and newspaper distribution into local monopolies on the production of news content.

With the advent of the internet, however, the publishing companies that we once knew have been all but eliminated. Simply, the internet makes the distribution of content free, which means that the producers of content need not work for any individual publisher, provided that consumers are able to find that content in an efficient or otherwise satisfactory way. In the end, all of the ad dollars that once went to publishing houses who owned the publishing and distribution of news went to the company who provided the best user interface for trawling the world wide web's troves of content, Google.

There's nothing unique about news. The internet makes the distribution of anything that is consists primarily of information, free. Including the distribution of risk, which is nothing to an actuary but the requisite information they use to assess the probability of loss.

The internet replaced paper routes and newsies with Boolean search. It will also replace brokers and agents with apps.

There is simply no way that, in the year 2020, the most efficient way to sign people up to a program of distributed risk for the liability of property and casualty loss is for thousands of agents in khakis to collect business cards from fish bowls in Chipotle and offer free burritos to whole offices full of underinsured white collar employees. And yet, the existence of thousands of agents and brokers and fishbowls implies that, somewhere along the line, the economic profits from underwriting these policies are sufficient to justify this infrastructure.

Lemonade captured a whopping 28% of the market for first time insurance buyers in New York City

To be fair, insurers who have embraced online distribution, like Progressive, who markets their "name your price tool" for online comparison shoppers, have grown at well above industry rates. But few companies have been so bold as to attempt to eliminate the human agent/broker/call center apparatus in its entirety.

Insurance industry veterans will tell you that policies like renters' insurance are sold, not sought after (like timeshares). And yet, Lemonade captured a whopping 28% of the market for first time insurance buyers in New York City, mere months after launching their chatbot-agent, "Maya." And they did it the same way Google did, by owning the most efficient and satisfactory user interface for the purchase of insurance and the submission of claims.

"Maya," doesn't bother with high pressure sales tactics, negotiations, or inspections. It just asks where you're renting and how much stuff you have and then quotes you a policy. Maya doesn't do much to dispute claims either, it basically just assumes that if you're submitting an insurance claim, you're probably already having a bad day and you'd really like that cash, and quick.

And it accomplishes those things by hearkening back to a principle that served as the guiding light for Benjamin Franklin's Contributorship, if not for the modern insurance industry. Maya exists to distribute risk, not profit from it. The company re-packages and re-sells 75% of the liability it underwrites to Lloyd's of London (who, incidentally) is satisfied that statistically, Lemonade premiums adequately compensate for the risks of the policies they underwrite. Lemonade promises its policyholders that if the company ever does accidentally make a profit on the underwriting of the actual insurance, it will donate it to a charity of the policyholder's choosing, and it organizes policyholder's into "cohorts" that support the same, or similar charities.

In this way, Lemonade operates far more like the Philadelphia Contributorship than a modern insurance company, distributing excess profits, not to its members, but to charity. For shareholders, Lemonade generates fee based income, in the form of a fixed-rate brokerage fee that the company charges for the convenience of access to the Lemonade platform. And because traditional brokerage and agent infrastructure is so expensive, that fee is substantial. It amounts to roughly 20% of Lemonade's gross written premium.

Of course, risks abound. Many are apparent at a glance. Lemonade will have to prove that it doesn't suffer from an extreme version of moral hazard stemming from the relative lack of fraud protection inherent in the company's claims management process, in order to avoid escalating re-insurance premiums over time. The company will have to prove that it can continue to grow its base of policyholders without continually increasing customer acquisition costs, which today amount to more than the company's gross profit dollars. Lemonade will have to prove that it can retain renters as they transition to homeownership, in order to keep churn manageable and generate lifetime customer values that justify the cost of customer acquisition.

But all of these are fundamentally just business challenges. In one form or another, they've been met and overcome by other successful startups in the internet era. There is no structural, insurmountable barrier to the company's success. And indeed, its rather phenomenal market share of first-time insurance buyers implies that Lemonade is not only the preferred provider of renters' insurance, but that the company is actively expanding the market. It implies that renters' insurance is fundamentally mispriced by existing market participants and that Lemonade is profitably and rapidly disrupting an entrenched and calcified industry. And it implies substantial upside for Lemonade shares.

> *It doesn't take an overactive imagination to surmise that Lemonade could translate their market share of first-time insurance buyers into a substantial market share presence in both renters and homeowners*

The renters' insurance market, "pre-Lemonade," as it were, is roughly an $8B market in the United States. Homeowners' insurance is a $90B market. It doesn't take an overactive imagination to surmise that Lemonade could translate their market share of first-time insurance buyers into a substantial market share presence in both renters and homeowners, without any additional innovations or product launches. Something like $2B in gross written premium isn't even that far away, which implies $400M in Lemonade fee income, before customer acquisition costs.

When Lemonade IPO'd, I acted rather cynically in response to a market dynamic I've observed whereby Wall Street refusesto accurately price attractive IPO's, and well-hyped issues outperform rather dramatically in the first hours of trading. While LMND "IPO'd," ostensibly, at a market capitalization of nearly $1.6B, its first public trades occurred at a valuation of just over $3 billion. Deeming that price, somehow, more reasonable than what I otherwise might have expected for such a successful disruptor operating in such a large market, Antrim purchased a small position in LMND at the open, and sold half of that position a few days later, for almost the entire amount of the initial outlay.

My readers are too astute to attempt to walk through some sort of mental gymnastics whereby I would purport to demonstrate that LMND shareholders are afforded an adequate margin of safety for the substantial execution risk inherent to an investment in the company. But as speculations go, I believe firmly that Lemonade is an attractive one. By acting quickly, if cynically, I've transformed my substantial intellectual curiosity over the company and its business model into a small financial interest in the same.

Long Lemonade.

PAST PERFORMANCE IS NOT A RELIABLE PREDICTOR OF FUTURE RESULTS

Recommendation	Date	Performance Since Recommendation
Short TSLA	July 1st, 2020	+32.5%
Short GSX	July 1st, 2020	+48.6%
Long AKRXQ	July 1st, 2020	-11.1%
S&P 500	*July 1st, 2020*	+5.5%
Long MIK	June 1st, 2020	+86.0%
Short QSR	June 1st, 2020	+4.5%
Long ZMTP	June 1st, 2020	-7.0%
S&P 500	*June 1st, 2020*	+7.5%
Long NLY	May 1st, 2020	+22.1%
Long AGNC	May 1st, 2020	+12.4%
Short SWKS	May 1st, 2020	+40.1%
S&P 500	*May 1st, 2020*	+12.3%
Long DESP	April 1st, 2020	+36.0%
Short KNSL	April 1st, 2020	+86.5%
S&P 500	*April 1st, 2020*	+26.6%

Antrim Investment Research

As proven by my "Short KNSL" recommendation, published on April 1st in this very newsletter, I already know very little about insurance.

DISCLOSURES

Antrim Investment Research is long shares of LMND, AKRXQ, MIK, ZMTP, NLY, AGNC, and DESP. Antrim is short shares of TSLA, GSX, QSR, SWKS, and KNSL. Neither does Antrim nor do I, personally, have any business relationship, banking, consulting, or otherwise with any company mentioned in this newsletter.

AS ALWAYS, LIKE, SHARE, AND SUBSCRIBE!

If you are coming across this, the fifth issue of ***Idiosyncratic Risk***, for the first time, welcome. I would always like to make new friends. If you find my views interesting or helpful, and if you'd be so kind, feel free to forward this newsletter along in your network to those who might also make use of its content.

I sincerely appreciate the friendship, support, mentorship, and camraderie I've experienced during my career in Investment Management and I would like to thank my friends and readers for supporting me, whether by forwarding this email and my contact information along in your network, or merely reading these pages and considering what I have to say.

Feel free to reach out with questions, criticisms, suggestions, and investment ideas if you've got any good ones.

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