Q & A

The roundabout path to profits: Mark Spitznagel on the Dao of Capital

INTERVIEWED BY **DANIEL P. COLLINS**

Mark Spitznagel is an accomplished trader and hedge fund manager who has learned to take advantage of market distortions he blames on an overly involved Federal Reserve and government, while preparing for the consequences of those distortions. Instead of fighting what he knows is an illogical distorted market he has learned to ride those irrational markets while preparing for the inevitable snap back, where he then can profit in an exponential fashion through the perfecting of tail hedging strategies.

However, his book "The Dao of Capital: Austrian Investing in a Distorted World" is not an explanation of his trading strategy but an in-depth study of economics and human nature, the inevitable result of which is the philosophy of building a successful enterprise through the understanding of the roundabout, and learning to delay gratification to gain an advantage down the road. He does it through the study of Austrian economics and the application of the roundabout method of investing.

Spitznagel could have simply written that investors need patience and must avoid the temptation of the quick profit; that building a successful strategy, and life, involves a longer-term approach foregoing instant gratification; that establishing a solid foundation while appearing not to create progress puts you in position for much greater success later on. He did not do that. Instead, he takes you on a tour of history and even nature that illuminates these long-held truths. Just as the technical trader delves into cycle analysis and Fibonacci numbers, Spitznagel illustrates how these truths are imbedded in history and nature and are not just platitudes to throw around. In the end his message is simple, but by providing the historical underpinnings he brings them to life in a much more vibrant way.

He travels a long way to come to a pretty simple message but it is in his vast research and study that he shows this message, though simple, is essential. He has documented how it has been so throughout history.

FUTURES MAGAZINE: Your book cites some of the most accomplished economists, military and historical figures as inspiration, but at the top of your list is an old grain trader and family friend, Everett Klipp. Why?

MARK SPITZNAGEL: He was a close family friend, very close to my dad. I caught the [trading] bug from him early on and he said simply 'to be successful you have to love to lose.'

FM: It is no huge revelation that a lot of our recent economic problems can be blamed on short-term thinking; never looking beyond the next quarter. You take a circuitous route in your book to describe this. Is that on purpose?

Successful trading is a process and the quickest, most direct route is not always the best. Here we discuss the roundabout method with "The Dao of Capital" author Mark Spitznagel. Dao is a Chinese word that means "The Way."

MS: It is on purpose. The whole point is there is a lot you have to build up along the way. There is a path you have to follow to get somewhere and it is not the direct path. For instance, it is not enough to give someone an investment strategy, the key is what is underlying that investment strategy, why these things should work, what is the thinking behind it. It is very easy to say this is a strategy that works and it will continue to work.

FM: It seems that we intuitively know some of these things but often don't act on them.

MS: People say it is a long-term thing. It is almost a cliché to say that. They use it as an excuse for what is not working at the moment. What I am talking about is not just about waiting, it is about working in the present to gain an advantage in the future as opposed to just putting something on and twiddling your thumbs and watching it work. Yes, we are all very short-term minded. Corporate managers are thinking about the next quarter. This is all very rational for them to do. There is the [Stanford professor Walter] Mischel study (an experiment to determine whether kids would be willing to wait to get more marshmallows or take one immediately). It turns out that the reason they don't wait is not because of impatience, it is that they don't believe you are going to come back with more. Any investment manager is right to think that if I don't get my marshmallow now, do well now, you are not going to give me an opportunity to do better later.

FM: You successfully called the market turns of 2000 and 2008. Was your tail hedging strategy perfected or was it just forming?

MS: I was on the floor from 1993-97. In '98 I was a swaption trader at a Credit bank primary dealer arm. In 1999 I started a hedge fund with Nassim Taleb, who was at the [Chicago Mercantile Exchange] when I was at the CBOT; 2000 was our big play there. In 2005 I went to Morgan Stanley within its stat arb group. In 2007 I left to start Universa [Investments] and we all know what happened in 2008.

FM: A lot of people saw the 2000 crash coming as the market appeared overbought throughout the late 1990s but lost money by being wrong on the timing. Is your strategy a fix for that problem?

MS: Absolutely. You can't short markets that are running like that. You are going to blow yourself up. It goes back to Everett. The whole reason I approach the market this way—the idea of taking a one-tick loss. If you want to trade that market with S&Ps you would short it but when you are wrong you will have a tight stop. And throughout the '90s you would have taken a lot of losses. Eventually you would have been right, whether you would make up all your losses, I can't say.

FM: Isn't it different now. In the '90s we had a booming economy. No one would confuse the last six years with a booming economy.

MS: Agreed. But I would argue in both situations ultimately there were delusions. The booming economy of the '90s was happening but it was not based on anything real. At some point monetary distortion can easily lift asset prices but it could also make it look like there is activity in the economy that is artificial. They both had similar sources. The late '90s look very different than today and for that reason it will probably be very difficult for us to go too much higher.

FM: What was the misallocation in the '90s? It seems that they were constantly raising interest rates anytime growth went beyond 3.5%.

MS: It was the Fed keeping interest rates too low. Rates were too low in the '90s. We don't understand why Greenspan kept rates as low as he did in 1996. The general argument was rates were too low for too long. I know by today's standards it seems benign. They were artificially low in the '90s.

FM: Your philosophy is based on non-intervention but 2008 was a pretty extreme crisis. Do you think the Fed needed to do anything?

MS: People who are Libertarian are always put in this unenviable position where we look like people who don't care because we are saying you shouldn't do anything; you should let the forest burn; let people suffer. It is unfair to start with the tragedy, you have to start with the build-up.

FM: Was QE not necessary?

MS: It depends on what you are trying to do. If you are trying to prop up the stock market, if you are trying to save people who own risk assets like banks, it was absolutely necessary, in the short term. There is no doubt that the Fed is capable of pushing risk assets. We shouldn't be surprised that the market has gone up and continues to go up but it can't go on forever. It is an artificial world we are living in. If we were able to manipulate it like this permanently then obviously this would be a formula that would work everywhere.

Go to **futuresmag.com/spitznagel** for an unabridged version of this interview.

FM: I don't think anyone believes that this is good policy in general just that it was necessary to avoid a disaster. We kick the can down the road to a point that growth improves and we can better handle the excess. Can it work?

MS: You are looking for a precise, perfect scenario. I am not necessarily calling for hyperinflation but with the money being printed it is [possible]. Be careful what you wish for, if you start getting growth I recognize how we could get very high inflation. But first you have to have growth, you have to have people investing capital.

FM: But these misallocations have been going on for long time. Is there a way to do this gradually or does it have to happen all at once?

MS: I would be perfectly happy with a taper that ends over a period of time with a free market in interest rates.

FM: Discuss your trading philosophy and how it can be used.

MS: You simply step aside when markets get distorted. What does that mean? You have to watch all your friends making money when you are sitting aside making nothing. You are no longer focusing on your returns today but the return opportunities you will have later when markets reset. I am thinking about the advantage that you will have with dry powder when the markets crash and not about returns today. By doing nothing I am doing something real big. I am allowing myself opportunities later.

FM: In your strategy do you constantly have the same hedge on or do you increase and decrease it based on the MS Index?

MS: You can increase it or decrease it. I showed an example in the book that it is the most effective when there is a high MS index (see "The Mises Index," above), when it is low there is not a lot of room for a systemic crash. When that is low a tail hedge is not critical. The great thing about what I do is that the more distorted the market gets, the cheaper my trade is and the better the risk/reward looks. It is a very convenient property. For instance the VIX tends to go down when the S&P rallies.

FM: How much do you underperform the market when things go well?

MS: It is complicated because I do some complex hedges and spreads. What I talk about in the book is a very simplistic naïve representation where you are just buying out of the money puts. But it costs you a low single digit percentage a year—in that naïve case. I could be short premium, meaning if the market shuts down I am earning premium; but if the market crashes, I am long gamma.

FM: How will the current distorted market be resolved?

MS: At some point whether it is quickly or not [there is so much leverage a system can take] markets will crash. In classical economic perspective they say that when interest rates get lower we have higher liquidity preferences, people don't want to lend anymore, they don't want to borrow anymore. That is why balance sheets at banks get so bloated. It will probably happen quickly when it happens, but at the end of the day when markets are this distorted you will find your way back.

FM: What are you trying to get out of the book?

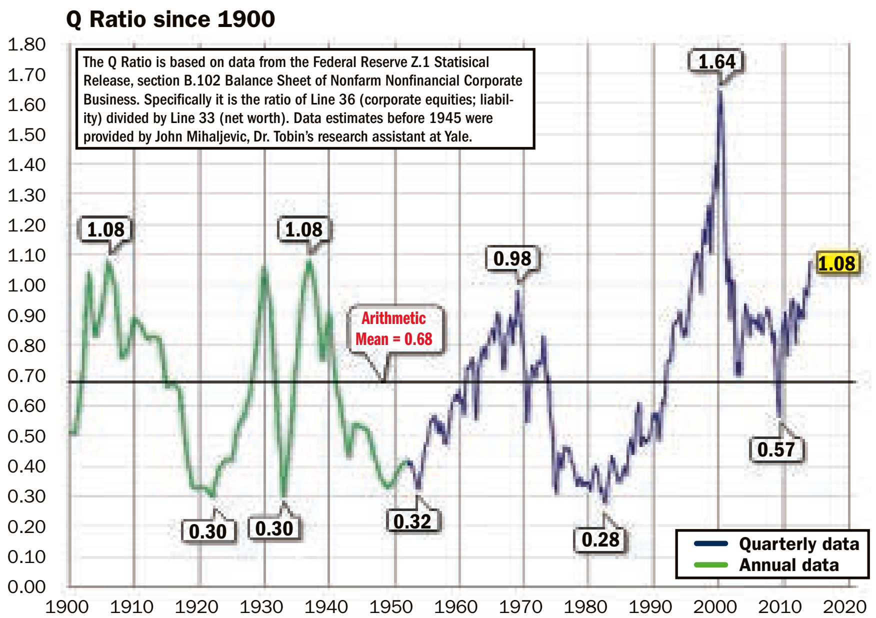
MS: These are the tools of what got us here in the first place. The idea of a roundabout. Focusing on the means and not the ends. It is so obvious but it helps to understand the role it has played. You can't just focus on outcomes.

FM: For people to adopt this is it just going to take pain? Another crash or event to reorganize ourselves?

MS: I think it will. And capitalism will be blamed again when it happens. All the scary stories that we heard when they jammed through TARP, a lot of it was overstated. I can't prove it and I don't think others can prove the other side of it. But this idea of the end of the world scenario is entirely wrong. We should look at this as a healthy process, as a cleansing process. We would be on the road to very healthy real growth today if we just let it cleanse itself. My ultimate message is one of great optimism. Seeing optimism in a crisis or a tragedy. It is a means to a much greater end. We need to recognize that. Politicians can't because politicians will not get reelected during a crisis. They are rational to try and stop all pain. ...We should have had more banks fail. F

THE MISES INDEX

Spitznagel's simple investing advice is to go long equity markets when the MS Index (or Q-ratio) is low and stay out when it is high. However, this would have left you on the sidelines for the past two decades.



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