# Monthly Depth Report – August 2022

## Signal Interpretation – Signal vs Noise

A few years ago, I was invited to be a guest lecturer at the United States Military Academy at West Point. It was a fantastic experience, and a day spent with the Cadets would cure even the most hardened cynic claiming that the current generation of young Americans are spoiled and lack a strong work ethic. These young men and women were smart, focused, polite, and engaged (even the funny exchange student from the Naval Academy). I chose to speak to the Cadets about Signal Interpretation to help them better understand how to separate valuable signal from distracting noise. The idea is that if you can identify pockets of groupthink where large numbers of people reassure themselves about an issue where no one has done the work, you can make profitable investment decisions. There are also implications for evaluating military intelligence as well.

In 2008, I was able to make a huge return shorting the stock of a bank that was making mortgage loans where not paying the mortgage was an option and didn't trigger a default. The bank would simply add the amount of the missed payment to the mortgage balance. The bank traded at what would have then been a normal multiple of earnings and book value, and other investors reassured themselves that the company's SEC filings indicated there was no problem with asset quality. I realized that if everyone could stop paying their mortgage and not be considered delinquent, then it was IMPOSSIBLE for the bank to have any indication that there was a problem with asset quality. In late 2008, a huge percentage of the bank's customers stopped paying entirely, and the whole situation imploded providing a great return on our short position.

In 2012, most large hedge funds owned television networks like Viacom and CBS. At Silver Arrow, we took a closer look at the industry and had some concerns. I called a friend at a multi-billion-dollar fund who had a huge position in Viacom and asked him if he was concerned about piracy, YouTube, Netflix, DVR, commercial avoidance, Hulu, and other advances in streaming television. His response was "I haven't thought about it". We realized that these asset managers hadn't done proper research; but rather, had reassured themselves by talking to each other. This was groupthink on a huge scale. We produced a white paper predicting that streaming television would cause huge problems for the entire television broadcast industry and called it TV is Next. Ten years later, our conclusions are obvious, but at the time, the work was groundbreaking and even resulted in unhappy emails from the management suite at CBS. My dad was worried I'd get sued. I thought getting sued for correctly predicting the future of a changing business would be incredible publicity. The television networks were hoping that an old business model in decline would continue as it always had.

We've used the same independent lens to create outsized returns here at Deep Knowledge Investing. Subscribers were able to more than double their money in HCA Healthcare, Inc. (ticker: HCA) and more than quadruple their money in Houghton Mifflin Harcourt (ticker: HMHC) in about a year. In both cases, the companies went though a difficult period due to Covid. People have a tendency to project the most recent thing that happened into the future. We correctly determined that all high-end medical capability was not going to be dedicated to treating Covid in perpetuity, and that the United States was going to continue to purchase educational materials for children. It seems obvious, but the market was focused on Covid and the available returns were huge.

We've done the same thing on the topic of inflation and higher interest rates. Our calls to buy gold and oil last November and to short the market in January were correct. Still, it took the large investment banks 4-7 months to recognize what we were seeing. The number one reason for that is groupthink. It's both easier and safer to hide in a crowd, particularly when you're at a big firm. At DKI, we prefer to keep an independent point of view which has allowed us to lead the research community by months instead of following.

If you're wondering why I'm focused on this right now, it's because I've seen three things in the last month that made me think about our "obvious" filters and how they can be wrong. Many of us have heard the story about the US government paying $8 for a bolt and have assumed it was some combination of stupidity, waste, and theft. That little piece of common knowledge might be completely incorrect. One of the things I love about my job is it allows me to read widely which is ideal for someone who's curious (a common trait among hedge fund managers). I'm not sure how I found it, but I'm on the mailing list for a blog called Construction Physics, and last month, I was reading a piece on the costs of building a nuclear power plant.

It turns out that during the construction of the Apollo spacecraft which took our astronauts off the planet and more importantly, back home, in order to ensure that no component failed, every single part had to be traceable back to its point of origin. That $8 bolt came with paperwork that indicated the steel rod it came from, which ingot the rod was made from, and so on all the way back to the shaft the where metal was mined. Based on that kind of excruciating record keeping, the bolt should have actually cost more than $30. The government wasn't overpaying. It was exercising extreme caution when we needed to get our people back safely in an environment where even a small problem would likely be fatal.

There was an article in the Wall Street Journal last month that salesmen with beards were considered to be more trustworthy and knowledgeable. The article also had some comments on women's makeup which we'll allow you to read and evaluate yourself. Around 20 years ago, there was a general sense among hedge fund managers that CEOs with beards were not to be trusted with Bernie Ebbers, the CEO of WorldCom as the prime example. Absent some sort of ZZ Top style beard which I wouldn't want to see on a CEO, I don't think neatly trimmed facial hair or a close shave is indicative of knowledge or trustworthiness. With that said, knowing which the market overvalues and undervalues could be useful.

Finally, Peggy Noonan wrote an editorial predicting that people working from home would break down our national culture and lead to loneliness, emptiness, and the loss of workplace romance. Jamie Dimon of JP Morgan and other executives and commentators are chiming in in similar ways. While many people many agree with the sentiment, we're highly skeptical. First, the HR department put an end to workplace romances years ago, and given some related behavior, they did so with good reason. We think Noonan and the "work from the office" crew are making two errors.

There are huge advantages to working from home. It's common for commuting to take up 10-20 hours a week for some people. That's now time that they can spend working, exercising, or connecting with friends and family. Workplaces can be distracting and constant meetings chew up huge parts of an otherwise productive day. And everyone who reads these letters knows I spend plenty of time working from other continents and am energized by the changing cultures and environments.

It's also false to think that online or Zoom relationships aren't real. Last month, I threw a party at my home where two DKI interns came. We barely realized that we had never met in person before. I'm a Strategic Advisor to Terra Group, and Terra CEO, Tony Saxton is a member of the DKI Board of Advisors. At a recent dinner with the Terra team, it took hours before several of us realized we had never been in the same room. DKI Board member, John Krubski, has argued convincingly that meeting over Zoom can at times, be more focused and intimate than getting together in person. Noonan can argue that we'll lose our culture if we don't return to an office, but the big workplace environment is a relatively new development in human history, not an indication of the way we're "meant" to interact.

Our final word on the matter is that while conventional wisdom is often correct and the group is often heading in the right direction, it pays to look at everything with fresh eyes and a different perspective. That's the part of the job I enjoy the most.

We'd like to welcome new member of the DKI Board, Dr. John Lenczowski. He's the Founder of the Institute of World Politics, and was President Reagan's National Security Advisor on the Soviet Union. In a webinar on August 10th, we'll be featuring him, Lt. Colonel (Ret.) Jason Galui, a combat veteran who was an advisor to Presidents Obama and Trump, and is the Founder of 4 Liberty Consulting, and Heather Heldman who worked at the US State Department and runs Luminae Group, a geopolitical risk forecasting firm. We'll be discussing Russia/Ukraine and the implications for our relationships with our adversaries.

By putting Lenczowski, Galui, and Heldman on the panel at the same time, we're going to let you experience first-hand the interactions between these three uniquely informed experts. It's not just the ideas and analysis they bring to the table; but rather, the way they evaluate and respond to each other's ideas that will make this webinar one you'll want to see live.

We believe that DKI is better positioned to help you understand the shifting geopolitical landscape than any other firm in finance. We've been right and early on inflation, interest rate hikes, stagflation, the oil market, and the real estate market all year. I'll be available to help translate the insights provided by our geopolitical and military strategists into actionable market analysis. You can get more details and sign up here.

Finally, we're excited to announce a new partnership with AlphaSense. They'll be distributing DKI research to 1,500 buy-side financial firms and 1,500 corporate clients including most of the S&P 500. Their AI-driven research product is fantastic, and their reach is enormous. We're looking forward to partnering with them.

If any of you have questions, concerns, or thoughts regarding issues we should address in a future depth report, please feel free to reach out to me at IR@DeepKnowledgeInvesting.com. If you think a friend, RIA, family office, or portfolio manager would be interested in this monthly commentary, please feel free to pass it on to them.

Thanks for being part of Deep Knowledge Investing,

Gary Brode