



A Public Service Announcement: Soros on False Trends



Things are getting nutty right now... and tempers are starting to fray.

On one side of the coin, you have long-only types trumpeting thinly veiled versions of “I told you so” and “You were dumb not to be long this whole time.”

On the other side of the coin, you have macro-oriented observers tearing their hair out over the blatantly manipulative falsehoods underpinning this move. Legendary value investor Seth Klarman pegged it best as “the Hostess Twinkie Market:”

Hostess Twinkies make childhood happier with totally artificial ingredients. The market has been made happier by government manipulation.

Not to get all judgmental, but both sides (to the degree they have become highly emotional) need to take a chill pill.

Longs crowing over their favorite stocks should be more humble in respect to acknowledging the true drivers of this market, which have piss-all to do with fundamentals and are quite precarious.

Angry bears, meanwhile, should get their zen on and recognize that false trends are still trends, and fighting the big wave has been a losing proposition since time immemorial.

In other words, **you don't have to be theoretically correct in your reasoning. You just need to have the right positions on at the right time.** If you are in this game to win, then it is **not about being right, but making money.**

Yet at the same time, as a general rule **you want to be theoretically sound if at all possible...** because if your portfolio is anchored to a foundation of false beliefs, or not anchored to anything at all, that increases the likelihood of getting your head handed to you.

And thus, for traders especially, the ideal is to have the best of both worlds:

The ability to maintain general theoretical correctness, i.e. the chops to recognize a false trend for what it is, coupled with the flexibility and the means to profitably exploit false trends regardless, while keeping risk under control.

There are at least three levels to the game:

- *That which is real*
- *That which is believed*
- *The market's reaction to both*

And so we would argue that, right now, it is **more important than ever** to understand the nature of false trends, feedback loops, bubbles and the like — and the proper means of handling them all.



The originator and grand master of this particular realm is the palindrome, George Soros.

Thus, for the general edification of the public in this time of turmoil, we reproduce below a relevant excerpt from Soros' June 2010 '**Act II Of the Drama**' speech, in which the key concepts are helpfully revisited.

Read it, study it, ponder it... and while you're at it, forward to every cranky / self-righteous market participant you know!

EXCERPT FROM THE GEORGE SOROS 'Act II OF THE DRAMA' SPEECH, JUNE 2010 (emphasis added)

Let me briefly recapitulate my theory for those who are not familiar with it. It can be summed up in two propositions. First, financial markets, far from accurately reflecting all the available knowledge, always provide a distorted view of reality. This is the principle of fallibility. **The degree of distortion may vary from time to time. Sometimes it's quite insignificant, at other times it is quite pronounced.** When there is a significant divergence between market prices and the underlying reality I speak of far from equilibrium conditions. That is where we are now.

Second, **financial markets do not play a purely passive role; they can also affect the so-called fundamentals they are supposed to reflect.** These two functions that financial markets perform work in opposite directions. In the passive or cognitive function, the fundamentals are supposed to determine market prices. In the active or manipulative function market, prices find ways of influencing the fundamentals. When both functions operate at the same time, they interfere with each other. The supposedly independent variable of one function is the dependent variable of the other, so that neither function has a truly independent variable. **As a result, neither market prices nor the underlying reality is fully determined. Both suffer from an element of uncertainty that cannot be quantified.** I call the interaction between the two functions reflexivity. Frank Knight recognized and explicated this element of unquantifiable uncertainty in a book published in 1921, but the Efficient Market Hypothesis and Rational Expectation Theory have deliberately ignored it. That is what made them so misleading.

Reflexivity sets up a feedback loop between market valuations and the so-called fundamentals which are being valued. The feedback can be either positive or negative. Negative feedback brings market prices and the underlying reality closer together. In other words, negative feedback is self-correcting. It can go on forever, and if the underlying reality remains unchanged, it may eventually lead to an equilibrium in which market prices accurately reflect the fundamentals. **By contrast, a positive feedback is self-reinforcing. It cannot go on forever because eventually, market prices would become so far removed from reality that market participants would have to recognize them as unrealistic.** When that tipping point is reached, the process becomes self-reinforcing in the opposite direction. That is how financial markets produce boom-bust phenomena or bubbles. **Bubbles are not the only manifestations of reflexivity, but they are the most spectacular.**

In my interpretation equilibrium, which is the central case in economic theory, turns out to be a limiting case where negative feedback is carried to its ultimate limit. Positive feedback has been largely assumed away by the prevailing dogma, and it deserves a lot more attention.

I have developed a rudimentary theory of bubbles along these lines. Every bubble has two components: an underlying trend that prevails in reality and a misconception relating to that trend. **When a positive feedback develops between the trend and the misconception, a boom-bust process is set in motion. The process is liable to be tested by negative feedback along the way, and if it is strong enough to survive these tests, both the trend**



and the misconception will be reinforced. Eventually, market expectations become so far removed from reality that people are forced to recognize that a misconception is involved. **A twilight period ensues during which doubts grow and more and more people lose faith, but the prevailing trend is sustained by inertia.** As Chuck Prince, former head of Citigroup, said, "As long as the music is playing, you've got to get up and dance. We are still dancing." **Eventually a tipping point is reached when the trend is reversed; it then becomes self-reinforcing in the opposite direction.**

Typically bubbles have an asymmetric shape. The boom is long and slow to start. It accelerates gradually until it flattens out again during the twilight period. **The bust is short and steep because it involves the forced liquidation of unsound positions.**

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