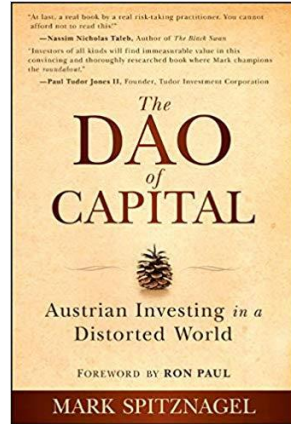


**Mark Spitznagel.** *The Dao of Capital: Austrian Investing in a Distorted World.* Hoboken: Wiley, 2013. Pp. xxix + 332. ISBN 978-1-118-34703-4. Hardcover. \$29.95.

Investing<sup>1</sup> is a favorite topic of Austro-Libertarians,<sup>2</sup> and with good reason: those who adhere to the economic framework of the Austrian School and a political ethic of individual liberty often find themselves seeking practical applications of their knowledge. In short, they want to make more money while increasing their personal freedom.

But as many have found out the hard way, understanding praxeology does not necessarily translate into profits. Entrepreneurship and investing are risky endeavors, and the unwary or overconfident may find themselves bankrupt despite their economic knowledge. Keynes is attributed as saying, “The market can remain irrational longer than you can remain solvent.” Regardless of its source, the wisdom is sound: economic knowledge can be a significant *disadvantage* in investing, insofar as it may lead the investor to predict certain (eventual) events far before their time. However, this does not mean that it is prudent to simply ride the waves of market uncertainty with the masses. Austro-Libertarian hedge fund manager Mark Spitznagel asserts that a proper understanding of economics *can* help guide investors, provided their knowledge is placed in its proper framework.




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<sup>1</sup> This essay discusses investments in the context of a book review. Nothing written here should be construed as professional investment advice or a recommendation to buy or sell any security. Readers are encouraged to consult their own legal and financial advisors prior to making any investment decisions.

<sup>2</sup> *I.e.*, libertarians sympathetic to Austrian economics.

This thesis is the subject of *The Dao of Capital*. The book was published in 2013 and is not a Christian work in any sense—some of its philosophical precepts are arguably un-Christian—but the practical relevance of the subject matter for Austro-Libertarian Christians makes it suitable to consider.

The first thing which stands out is the formidable list of endorsements from respected scholars, executives, and investors, including Ron Paul (who wrote the foreword), Steve Forbes, David Stockman, Lawrence Reed, Victor Niederhoffer, and Paul Tudor Jones. Those familiar with Spitznagel's background will recognize his own credibility due to the fact that he is a successful practitioner; he has amassed a significant fortune as an investor and entrepreneur. It is typically wise to take with a grain of salt any investment or business advice from those who are unwilling to risk their own capital, but Spitznagel is no armchair commentator.

Unfortunately, he is also not a professional author, and the language he employs is often so fanciful that the book is unnecessarily complex; the reader will at times find him or herself re-reading sentences to unravel the underlying point Spitznagel is trying to make, obscured by strange phraseology and excessive detail. This is certainly not a major defect, but it is something of which to be aware.

The book is a whirlwind of autobiography, economic history, economic theory, and practical investment advice. Spitznagel opens by quoting wisdom from his mentor, Edward Klipp: if you want to be successful in investing, you must hate to make money and love to lose money. "Klipp's Paradox," as Spitznagel calls it, is the foundation of the Austrian-based investing theory he advocates. The principle is rather simple on the surface: instead of seeking immediate gain, the investor must endure immediate loss so as to achieve greater gains later. Because this runs so contrary to human nature and the tenor of Wall Street, there remains an opening for the small minority who follow this contrarian path to generate immense profits.

The early portions of the book consist of Spitznagel's lengthy exploration of Chinese philosophy—along with copious metaphors from forestry and martial arts—mixed with his own personal history and development into the successful hedge fund manager he is today. He explains how he came to connect his experience as a trader in Chicago with what he eventually learned from the Austrian School.

The middle portions of the book begin to cover proto-Austrian and Austrian economic history, including figures such as Frédéric Bastiat, Carl Menger, Eugen Böhm von Bawerk, and Ludwig von Mises. The sequence with which Spitznagel moves between history, anecdotes, economic theory, metaphors, and practical application can at times seem dizzying, and the reader must trek through about three quarters of the book before really getting to its main point. This hodgepodge approach to the material—specifically how concepts vital to the primary thesis (like the Faustmann Ratio) are sometimes buried within it—is the book's greatest drawback.

The Faustmann Ratio is a concept drawn from the nineteenth century forestry studies of Martin Faustmann, who sought to compare the expected value of a developed parcel of land with its current bare market value (or "replacement value"). If the ratio is greater than 1 (that is, if expected value of developing the land exceeds the bare market value), then the investment is probably sound. Likewise, if the ratio is lower than 1 (if the expected value is less than the bare market value), the investment is probably unsound. This is a rather rudimentary method, but it does get to the heart of quantifying the viability of a long-term investment or capital expenditure (as is required in forestry). Contemporary investment analysis uses the same essential principles with concepts and terms like Discount Rate, Net Present Value (NPV), Return on Invested Capital (ROIC), and Opportunity Cost. Spitznagel modifies the Faustmann Ratio with these modern insights by showing that,

$$\text{Land Expected Value} / \text{Land Replacement Value} = \text{Return on Invested Capital} / \text{Opportunity Cost}$$

In other words, if we invest in something, is the return we expect to gain greater than the gains we forego in the present? The investor must consider what economists call Time Preference, and Spitznagel devotes an entire chapter to this important concept. Humans gravitate towards immediate gratification (high Time Preference), but the greatest gains often come from deferring consumption now for greater consumption later (low Time Preference). A preference for later and greater consumption is linked to higher rates of current production; this results in lower interest because people appear to be saving and more eager to lend money. In contrast, a preference for immediate consumption is linked to less resources left over for production and higher interest because there appears to be less money to lend. Those who want to reap great gains must be willing to forego present consumption with the intended goal of greater consumption later.

But Time Preference isn't always consistent, especially when extrapolated over a long timeline. Delays have a greater psychological impact in the short term than they do over the long term. Over the course of a long delay, the waiting still decreases the psychological value of the expected payoff, but the rate of decrease does lessen the longer the wait goes on, and Faustmann's calculation of expected value can be modified to account for this.

The most important concept Spitznagel discusses is what he calls the Misesian Stationarity Index (or MS Index), derived from the principles of the great Austrian economists. The MS Index is essentially an Austrian-branded version of the Equity Q Ratio devised by James Tobin in 1969, which is itself another way of looking at the Faustmann Ratio. Tobin's Equity Q Ratio is calculated as,

$$\text{Total U.S. Corporate Equity} / \text{Total U.S. Corporate Net Worth}$$

That is, the ratio has the current valuation of the total U.S. public stock market as the numerator, and the net worth (total assets – total liabilities) of the total U.S. public stock market as the denominator. Spitznagel, illustrating his point through a lengthy metaphor, shows that when the ratio of the total economy is different than 1, there has been a departure from stationarity. The MS Index is therefore a barometer for gauging the stability and rationality of the total economy. A departure from an MS Index of 1 therefore shines light on both potential profits and losses. Economically-literate readers may already recognize that this is really a corollary to the Austrian Theory of the Business Cycle, grounded in the central bank's manipulation of interest rates across the economy by expanding or contracting the money supply. But the market economy will always self-correct; it will, as Spitznagel writes, eventually return to homeostasis.

The final chapters of the book are the real payoff for the reader interested in practical application. Ironically (or intentionally?), *The Dao of Capital* exemplifies its own argument by taking the reader through the long, roundabout path towards reaping the gains of practical application in making investment decisions. Spitznagel divides his methods into two basic categories, referred to as Austrian Investing I and Austrian Investing II. When the MS Index is significantly above 1 as a result of monetary distortion, the trend is unsustainable and the market will inevitably return to homeostasis. Savers and investors will be dissatisfied with the artificially-low rates of interest pushed down by the inflation of the money supply, and will instead gravitate towards riskier investments to reap more immediate gains. As the cycle accelerates, eventually less capital is left for production, the economy is unable to progress, and investors are forced to liquidate, causing stock prices to plummet.

Comparing total excess returns of the S&P Composite Index (arguably the best gauge of the total U.S. stock market) over the so-called one year "risk free" rate of U.S. Treasury securities across historical data from 1901–

2013, Spitznagel finds statistical significance at the 95% confidence interval that when the MS Index is low, average stock returns are high, and when the MS Index is high, average stock returns are low. Across the same timeline from 1901–2013, he demonstrates that the higher the MS Index, the bigger the subsequent drop in stock price. Just as important, in periods with a low MS Index, bear markets were not much of a concern. In other words, the business cycle caused by central bank monetary distortion is fundamentally predictable (even if it can't be exactly timed). So how does this apply to investing?

The simplest Austrian-informed strategy, according to Spitznagel, is to buy when the MS Index is low (when capital is under-priced) and to sell when the MS Index is high (when capital is over-priced). After selling, the investor can stockpile cash or short-term cash equivalents (Spitznagel specifically mentions one month T-bills, though many Austro-Libertarian investors find the use of Treasury securities both financially and ethically dubious), waiting for the inevitable crash when he or she can swoop in and buy under-priced capital at a steep discount. Eventually, capital prices will rise to over-priced levels again, at which point the investor sells and repeats the process. The fundamental concept is to take the momentum from the manipulation of the market by the central bank and turn that momentum, contra the main stream, towards profit. Spitznagel's strategy, he notes, beats the general stock market by more than 2% annualized. So why doesn't all of Wall Street do this? Because the system is built around immediate gratification; most investors (and for that matter, investment professionals) won't last long enough to ride out a full cycle to its potential when they are getting beat year over year waiting around for the big payoff. Spitznagel rightly reminds the reader that while this sounds simple, it is psychologically and socially demanding.

Spitznagel discusses the so-called Black Swan problem: a philosophical probability question dating back millennia, but popularized in modern financial parlance by Nassim Taleb. A black swan (or "tail event") is an extraordinarily rare event—perhaps previously thought to be

impossible—which is so obscure and in the margins (“tails”) of a probability distribution that it never enters into the calculation of a financial model. But as Spitznagel shows, the 2008 crisis was actually no black swan; it was expected from the vantage point of the Austrians.

Beyond the aforementioned simple Misesian investment strategy, Austrian Investing I (“Tail Hedging”)<sup>3</sup> involves the use of options. An option is a derivative security<sup>4</sup> giving the holder the “option” to buy (“call option”) or sell (“put option”) a specific security at a specific price (“strike price”). For example, when the MS Index is high, an investor might purchase put options against an Exchange Traded Fund (ETF) which tracks the S&P Composite Index, giving them the right to sell the ETF at a price far below its current market price. If the market price crashes below the strike price before the option expires, the investor can exercise the option, sell their ETFs at the strike price, and pocket the difference. He or she then has additional cash to deploy, buying up under-priced assets at a steep discount during the bear market. Of course, purchasing options costs money up front, and as long as the underlying security remains artificially over-valued, the investor will appear to be losing and their options appear worthless; the strategy depends on following the long-term, roundabout path towards gain.

While Austrian Investing I is a macroeconomic strategy, Austrian Investing II is micro, focusing on specific companies with a high Return On Invested Capital. Spitznagel calculates<sup>5</sup> ROIC as,

$$\text{Earnings Before Interest and Taxes (EBIT) / Invested Capital}$$

The savvy Austrian investor/entrepreneur, expecting that there is more value to be extracted from future business growth, reinvests the business’

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<sup>3</sup> Because the business cycle is predictable, Spitznagel notes the name is somewhat of a misnomer since this strategy is not truly a “tail hedge.”

<sup>4</sup> A derivative is a security where the value is “derived” from the underlying asset to which it is pegged.

<sup>5</sup> A better-known formula is Net Operating Profit After Tax (NOPAT) / Invested Capital

profits into the business itself rather than taking a dividend in the present, thus following the roundabout path towards greater profits later. Furthermore, on a micro level, a well-managed Austrian strategy (or business) is largely immune to the worst aspects of central bank monetary distortion. By not taking on debt at unsustainable levels and growing the business more slowly—reinvesting profits rather than expanding through aggressive borrowing only made possible by central bank inflation—the investor or entrepreneur will at first appear to be losing out to faster-growing companies. However, such a company will be better-positioned to ride out market downturns while competitors find themselves unable to service their immense debt or sustain their over-scaled operations.

Not everyone has the foresight, time, or opportunity to be an entrepreneur, but Austrian Investing II is also accessible to those who buy (in whole or in part) existing companies with a high ROIC and low Faustmann Ratio (of Market Capitalization / Net Worth). The reason for preferring a low Faustmann Ratio alongside high ROIC in this scenario is because it indicates the company is very effective at deploying capital, but is not yet priced to reflect its potential (and thus is ripe for massive gains later). Of course, businesses can still fail for a variety of reasons, and so this approach is a general strategy and not a guarantee of success.

*The Dao of Capital* is far from an introductory investment book or simple how-to guide, and those with little or no prior financial experience will probably find themselves lost in its intricacies, calculations, and terminology. For those who have experience as business owners, executives, traders, investors, or serious students of the market, it provides a very valuable (if at times far too verbose) set of strategies for utilizing Austrian insights in the world of investing and business.

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