Making Money through Paradigm Violations

When Nordic or cross-country skiing consisted of only the classic stride, an innovator won the American Birkebeiner by skating on her skis. At that time, there were no rules against this since the innovation came out of the blue. Now the Birke has a classic race and a skate race.

In the 1970's a local firm then known as the Metropolitan Clinic of Counseling made a lot of money by selling behavioral health insurance plans that offered liberal benefits but strictly curtailed claims and services. The plans were sold to benefits managers concerned more with limiting costs than with any outcomes, since that is the insurance perspective. These were sold into a cost-plus environment of traditional self-insurance where all claims were paid and even encouraged, since the administrator collected a percentage of all claims dollars paid. The scheme was so profitable because most behavioral health services do not conform to the prerequisites of insurance. Services are goal oriented, not loss oriented. There is considerable moral hazard, meaning that the individual has considerable control over the management of needing services and the amount of services. The claims criteria are not objective and reliable, meaning that the same individual presenting to ten different providers will obtain very different opinions as to what services and how much are needed. And, often such as with chemical dependency, the individual needing services denies the need. If less than 5% of actual incidence results in a claim submission, the insurer can make lots of money by setting premiums closer to incidence than to actual claims.

Rob Arnott has designed a new ETF product sold by ProShares (RALS) which is not only based on a fundamentals index (cash flow, price-to-book, price-to-sales, dividends) rather than the traditional cap-weighted index, but then takes only the tail differences between the two indexes and goes long the one tail and short the other. The result is an ETF which is expected to outperform the market by 2-5% and is not correlated to the market. In addition, might divergence between the SP-500 and the RALS be a signal of an overbought or oversold market running on momentum up or down rather than on fundamentals and be about to turn around?

In gambling, the house uses the laws of large numbers for the purpose of predictable gains. My use of statistical means to identify stocks that predictably outperform is use of a gambling paradigm for investment purposes. It works to the extent of the predictability of such patterns, which is in part a function of the tools involved, the skills and methodology employed, and the fact that not everyone is deploying the same methodology.

All of these innovations violate the original and presumed paradigm. The innovative part violates a presumed but non-formalized or non-legalized set of rules or common practice not yet prohibited. There is an adage that he who makes the rules, wins. Sometimes economic innovations are advantageous to all parties in a transaction; usually at least one party is disadvantaged.

For example, if our educational delivery system decided to model the way it is financed based upon how medical services are financed, educators could violate the current paradigm by introducing ignorance insurance. If you or your child thought you might be ignorant in a certain matter, you could then go to an assessment clinic where professional assessors could give tests to determine if you are indeed ignorant and to what degree. The professional could then refer you to institutions where they have staffing privileges (schools rather than hospitals), and submit claims for educational interventions. If a hospital can charge for an aspirin, think about a school submitting claims for each five-minute intervention for each student throughout the day. Look at the new business for Third Party Administrators! The beauty for the schools would be that they could escape the concern with

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outcomes, since insurance is not based on outcomes but merely whether the "loss" exists and the contractually required services are delivered. Teachers could have compensation comparable to surgeons! Of course, there would be concerns about cost, but such concerns could be dealt with (or ignored) in the same way as in the medical services delivery system. The paradigm rules.

Credit default swaps are an economic innovation that mixes the paradigms of insurance and investing. The swaps made a lot of money for a number of players until the scale mushroomed and it all collapsed, with tragic consequences.

From a business or investment perspective, understanding paradigm violations can be useful in at least two ways. One is to innovate by violating the implicit rules in order to achieve a competitive advantage. Another useful and important function is to be aware of how such rule changes may unfairly disadvantage parties to a transaction, such as those with a vested interest in positive outcomes from behavioral health services in the example above, and expose the dynamics so that the losing parties do not enter such transactions, or perhaps legislate rules to prohibit destructive innovations. In either case, it is helpful to understand the dynamics and source of these economic innovations.

The elemental building block for all economics is the exchange of goods and services, or the transaction. I give you something and you give me something back. The somethings may be tangible or intangible. All economic transactions are based on one of eight paradigms or sets of rules. A series of transactions may form sets comprised of different paradigms, such as when one buys insurance and then the insurance company contracts with a provider to deliver claim obligations.

Just as the number three may not exist anywhere in reality and is merely a concept of relationship that we impose on things, that does not mean that one can arbitrarily change the essence of three. In the same way, while each of the eight paradigms for economic transactions do not exist anywhere in reality, one cannot arbitrarily change their respective essential natures.

So what are the economic paradigms? I would suggest:

1. **Procurement**: money is exchanged for some thing or service.
2. **Purchased outcome**: money is exchanged not for a thing or service, but an end result. I don't buy the shingles and labor, I buy the roofing job with a twenty-year guarantee.
3. **Insurance**: the laws of large numbers are applied to charging a premium calculated to more than cover assuming a definable risk of loss.
4. **Entitlements**: the costs (premiums) are not directly related to the risks or benefits. Think families, associations, library cards, subscriptions, government transfer payments.
5. **Gambling**: the laws of large numbers are applied towards a potential gain.
6. **Gifts**: usually thought of as a tangible benefit exchanged for an intangible benefit, such as enriching a relationship, social justice or promoting the common welfare.
7. **Theft**: similar to gifts, except control is with the recipient rather than the donor and it tends to diminish relationships and the common welfare. Bad debts are one example.
8. **Investments**: money or something of value is exchanged not for the purpose of immediate use as with procurement or purchased outcomes, but for potential later gain, advantage or increased value. There are two kinds of investments: something for **resale** at a later date (stocks, bonds, real estate, commodities, jewelry, etc.) or a **promise** of future payments (bonds, loans, annuities, etc.)

Do you concur that each of these modes of finance are distinct paradigms, each with their own set of purposes, rules, dynamics, language, legal embodiments, and contexts? Can you think of additional economic paradigms that are not included in the above list? Can you think of innovations that would advantageously apply one paradigm to a set of goods or services usually acquired through another paradigm?