36 South Views

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I blame the central banks

Well, the equity lift is full of investors at the top and the bear has pressed 'basement'.

If it weren't for all the retirees and pensioners I wouldn't feel so sorry for the investors trapped in the elevator as it begins its descent.

What is particularly harrowing for me to watch is investors putting too much of their retirement money at risk and now watching the concomitant train wreck.

I blame central banks firstly and modern portfolio theory secondly.

By trying to 'game' the system by manipulating interest rates to zero and beyond, they have destroyed savers' ability to provide an income in their retirement, thus forcing them either out on the risk curve (with predictable consequences), or into other riskier assets in which they have no business being at that time of their life (also with predictable consequences).

And I blame modern portfolio theory and the foundation on which it is based: arithmetical averaging.

Not to bore most people, but there are two ways of analysing an investment; arithmetical and geometrical averaging. It turns out that the only difference between the two is essential variance or volatility squared. But what a difference it can make!

Financial 'scientists' in their wisdom decided that investing is 'ergodic', i.e. it doesn't matter which average you use because it is the same or put another way, time is irrelevant.

Here is an example. Imagine you are in the market for a new microwave and you get told the following by the salesman:

"This is the top-of-the-line microwave brand – we have a thousand of these in stock right now. I am offering you a 50% discount because we have discovered that there is a one in a thousand chance this particular model will have an electrical fault and may explode."

If you take the ensemble average and assume that only one microwave in that thousand is faulty, you could be forgiven for buying it and putting your family's lives in remote risk.

If in reality, every time you use the microwave, there is a thousand to one chance, well, time comes into play and you must now be thinking not arithmetically, i.e. 1000 microwaves, 1 defective, but geometrically, i.e. if I use this microwave twice a day for 3 years there is a greater than 50% chance that it will blow up in my face. Not such a great deal now?

We live geometrically and we should invest geometrically. Something bad is guaranteed to happen to us and to our investment given enough time because THE PROBABILITY OF BLACK SWAN EVENTS OCCURRING MULTIPLIES OVER TIME.

Then why is most portfolio theory based on arithmetical or ensemble or single period averaging?

The maths is elegantly simple.

The consequence is, however, anything but simple. Investors are risking much more than they should if they were to calculate the risks geometrically. Investors would hold more cash and other non-correlated assets, including assets which benefit from volatility (the very phenomenon which would otherwise be their undoing).

Most investors don't even know a vaccine is available because the disease has not been identified yet and the process of identification would turn the whole medical field on its head.

The potential destruction of capital which is seemingly imminent is beyond size description. We have delayed the inevitable adjustment so long, the remedy would be worse than the disease.

No wonder central banks are eager to apply leeches, let our blood and blow tobacco smoke up our derrieres (that was actually a supposed cure for drowning in the Victorian era, tobacco smoke blowing kits were deployed along the Embankment in London). Talk about adding insult to injury!

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