

BY RICHARD "JERRY" HAWORTH

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Human beings have one ability that separates us from animals... we are self-aware. We can think thoughts about thoughts. It's our biggest blessing and our biggest curse.

We are blessed with the ability to have a mental lattice or framework upon which, to handle potential future opportunities as well as future hazards.

Unfortunately, we still have the same size brain as our stone age ancestors and we are trying to run AI programs on Intel 286 chips... this leads to a lot of psychological shortcuts which invariably lead to irrational biases.

These biases are our biggest curse, none more so than in our biases regarding stores of wealth.

This is one of my favourite irrational biases...

"Absurdity bias; events that have never happened are not recalled, and hence deemed to have probability zero. When no flooding has recently occurred (and yet the probabilities are still fairly calculable), people refuse to buy flood insurance even when it is heavily subsidized and priced far below an actuarially fair value. Kunreuther et al. suggest underreaction to threats of flooding may arise from "the inability of individuals to conceptualize floods that have never occurred . . . Men on flood plains appear to be very much prisoners of their experience . . . Recently experienced floods appear to set an upward bound to the size of loss with which managers believe they ought to be concerned."1 Burton et al. report that when dams and levees are built, they reduce the frequency of floods, and thus apparently create a false sense of security, leading to reduced precautions.

While building dams decreases the frequency of floods, damage per flood is afterward so much greater that average yearly damage increases. The wise would extrapolate from a memory of small hazards to the possibility of large hazards. Instead, past experience of small hazards seems to set a perceived upper bound on risk. A society well-protected against minor hazards takes no action against major risks, building on flood plains once the regular minor floods are eliminated. A society subject to regular minor hazards treats those minor hazards as an upper bound on the size of the risks, guarding against regular minor floods but not occasional major floods. "

Map and Territory

Rationality: From AI to Zombies Eliezer Yudkowsky

Central banks have done a great job of building financial dams and levees to reduce the frequency of financial floods creating a CORRECT sense of security regarding the frequency of flooding but a FALSE sense of security regarding the size of the damage should the now infrequent flood occur.

The number of times I have heard portfolio managers expressing an interest in hedging or risk mitigating against "left shoulders" or >5% <20% down in equity markets (minor hazards) whilst seeming uninterested in hedging against >30% (major hazards).

We have almost reached a point in this multi-decade bull market where investors deem a permanent loss of capital in equity markets as having probability zero.

"The market will always come back" is the current refrain. Even if they are right, losing even 5 years in compounding time is catastrophic for terminal net wealth.

Romans in their heyday might well have thought that heating oil for their lamps (at that time a popular store of wealth) was a permanent store of capital with a zero probability of it NOT being so in the future.

The COVID pandemic and resultant financial flood did a handy initial job of reminding us of financial risk but it was short-lived as Draghi-style central banking of “whatever it takes” rode to the rescue with north of US\$7 trillion in pandemic aid which came, as always, from the “money from the future” tree.

Money printing taken to its logical insane end point, the flood may well occur in the respective home currency or in the relative value between investment markets and the real cost of goods.

If central banks faint at the inflationary abyss they have created and, God forbid, go the other way, a deflationary flood that Noah would be proud of is heading our way.

Is it really going to matter how you became impoverished? By the equity market going down or the home currency going to hell in a handbasket, the fact will remain.

Savvy investors will cover all extreme flood risks by using yes, the same old chestnut, the panacea of extreme financial flooding ... multi asset class long volatility assets.

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