36 South Views

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Thoughts are free

> *Thoughts are free, who can guess them?*
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> *They flee by like nocturnal shadows.*
>
> *No man can know them, no hunter can shoot them*
>
> *with powder and lead: Thoughts are free!*
>
> Translation of German song, original lyricist and composer unknown

When I write my views I seem continually negative and troubled. I often question myself – *why* do I think like this?

It is because what I observe on the ground seems at odds with what the common gestalt is, i.e. everything is good, nothing to worry about… move along….

But troubled I remain. The main source of my disquiet is found in the cornerstone of investment theory: Modern Portfolio Theory (MPT).

MPT looks not only flawed, but positively dangerous with the current amount of leverage built into the financial system.

Zeckhauser (Warren Buffet's one time bridge partner) mentioned there are only three kinds of risk: known risks, uncertain risks and risks we are ignorant of (we can consider the latter unknowable risks). Bank this thought.

Ole Peters in his article *Optimal Leverage from Non-ergodicity*[1] makes some further astounding observations with this in mind.

Modern Portfolio Theory basically assumes that risks are 'known' i.e. cast in stone.

If this was so then, like in gambling systems, we can formulate, given the law of large numbers, precise outcomes because these risks are known. This works fantastically for games like chess where the outcomes are calculable and probabilities are known in advance. It is useless for games like poker where uncertainty plays a vital role. Real life is more like poker, where the future is a combination of known, uncertain and unknowable risks. In these kind of games, one has to be mindful that your assumptions might be wrong and ergo capital preservation becomes key i.e. avoiding risk of ruin.

For the mathematically minded, you can't assume arithmetical averages but must use geometrical averages, or: never cross a river if it is on average 5 feet deep and you are a non-swimmer.

MPT assumes the same. Given an investment universe where the risk and rewards are 'known', we can formulate an optimal portfolio.

Risk parity takes this one step further and basically leverages up low volatility investments under the assumption that this volatility will not change much.

If this is not the case, i.e. volatility can change in a New York minute, the level of risk currently taken is way too high to be remotely prudent. We have ignored uncertainty and unknowable risks.

Imagine we are only allowed to invest in riverside homes or cash. We measure the flood risk by taking the average of the last 30 day 'ebb and flow' of the river and invest accordingly.

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[1] https://www.santafe.edu/research/results/working-papers/optimal-leverage-from-non-ergodicity

This ebb and flow has been remarkably stable for 9 years. In addition, there is very little interest paid on the cash so we are biased to invest more in riverside homes to increase our yield.

In fact the government, which owns the dams upstream (central banks) have promised to only release enough water to ensure the ebb and flow stays small (suppression of volatility).

While this may be true, their agenda may change (the dam wall might be cracking) or heavy rainfall might occur in the catchment areas out of their control (Chinese trade war anyone?)

They might HAVE to release the pent up forces to protect themselves.

But the longer we go without a significant flood, the higher the probability there is one, we assume the opposite.

What we should be mindful of is the 100 year flood line. If we had kept mindful of that, we would have had a totally different composition of our portfolio, i.e. a much higher percentage in cash and flood insurance especially since long dated flood insurance (long volatility) is at multi decade lows.

Our 20 year investment in riverside homes will be totally dependent on the biggest flood over that 20 years, NOT the average 30 day ebb and flow of the current river levels.

But MPT has basically discounted the 'flood risk' and investors globally are blissfully unaware of the high risk they run of total ruin at worst or at best significant impairment of their wealth.

When higher volatility returns, normally when the traditional investment markets are going down, investors will realise they are at risk and will sell down in increasing numbers, further exacerbating volatility. They will also realise that they are highly correlated to everyone else due to the low cost passive investing fad and that what they own, is owned by everybody in similar proportion.

Not only that, what they own i.e. FANGS spring to mind, are massively overvalued and can fall precipitously, as we have had a taste of recently.

Riverside home anyone?

Failing that I have a low level bridge to sell you!

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