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Extinguishing fires

Fire is often used as a metaphor to help explain how a crisis or a tail event unfolds.

This got me wondering why…

I ended up with the following list:

Tail events are low probability occurrences. They start randomly.

Fires spread quickly from one area to another in an asymmetrical way. Fires behave unpredictably and, in turn, cause humans to behave unpredictably.

Fires have massive destructive power. They create smoke which can be fatal on its own.

Humans adopt policies to prevent fires but often end up increasing the probability of their occurrence.

The longer a wildfire has not happened, the greater the confidence humans have that it will not happen again.

The unpredictability and immense destructive power of a fire is what causes us to fear it.

A house fire can start from an electrical fault anywhere in the house, at any time of the day, in anyone's house.

The fire can quickly get out of control and can have disastrous consequences.

Smoke alarms in every room of every house attest to how aware we are of the danger.

Financial conflagration behaves in a very similar manner to wildfires, so it is a useful metaphor.

Volatility can be analogized as the "smoke" of financial conflagration.

The proverb "there is no smoke without fire" comes to mind.

Fire departments have high towers in forestry areas not to look for fire, but to look for smoke, thus signaling the presence of fire.

In the real world, we can obtain fire insurance to directly hedge our potential losses from a devastating "fire" event but unfortunately, in the financial world, we cannot.

What then can a portfolio manager do to avert the devastating impact of a low probability, high impact financial crisis?

They can buy contracts which pay off in a convex manner, on the volume of smoke which is generated in a certain area i.e. the amount of volatility an asset produces.

Where there is smoke, there is fire. Where there is volatility, there is crisis. There is data available to support this premise.

At the risk of torturing this metaphor further, some investors might say something like:

"In financial markets, I don't need a hedge because the "fire brigade" i.e. central banks are permanently camped outside my house, ready to break down the door and extinguish any "fire" that looks like it is getting out of control."

Whilst that may seem true, even the fire brigade is limited to the amount of water it has access to, and the amount of manpower it can put into action.

In addition, they are mandated to put the fire out and, whilst doing so, bear no responsibility for the fact that their actions i.e. dousing with water, can destroy the value of your house as effectively as the fire does.

It is misplaced complacency in portfolio management to rely on the "Central Bank Put".

The multi decade balance sheet recession in Japan is testament to this. Buy and hold Japanese equity and bond portfolios have stagnated whilst the Bank of Japan repaired the balance sheet of Japan Inc.

Do not be tricked into complacency.