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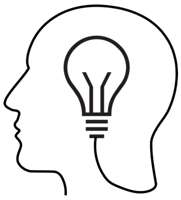
WEALTH MANAGEMENT

The Many Dangers Of Dissonance



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"A government or a party gets the people it deserves and sooner or later a people gets the government it deserves."
Frantz Fanon (1925-1961), French West Indian psychiatrist and political philosopher

There is little consolation in the thought that what has been unravelling over the last couple of months couldn't have been anticipated, let alone prevented, given that the last time anything remotely comparable to it occurred sufficiently long ago to have been erased from our collective memories of "life altering events". This is what happens when exposed to thousands of years of natural selection: we have been conditioned to believe that we can handle whatever the "environment" throws at us when the truth is otherwise. Nature endowed us with generous quantities of gray matter, so much so that it helped propel us to the very top of the food chain. And it happened in such record time that it made us overconfident in our abilities. That may be why we tend to cringe when faced with uncertainties: we are unable to accept the truth, that we may not always be masters of our destinies.

This perpetual state of cognitive dissonance[1] pushes us to unwittingly commit all sorts of costly and occasionally fatal mistakes. We understand the concept of probabilities; the entire portfolio management construct lies on a notion of needing to tame underlying risks so that we can steer outcomes within a "controlled" range. It is when there is a massive breach on either end of the range that cognitive dissonance tends to kick in and distort our ability to explain the reasons why. As a rule of thumb, when performance ends up being way better than expected, we tend to attribute it to manager skill and when it falls well short of expectations, we seek an outside culprit, like that once in a lifetime pandemic shock on the system that was totally unexpected to begin with.

That is why complacency happens during protracted bull markets: risk management takes a back seat; the selection process flies out the window and only when the "bubble" bursts do we realize we've been swimming naked. Cognitive dissonance can be dangerous when it leads us to stand our ground and stick to our original cognitive decisions despite the conflicting information. We all know that smoking is poison that can lead to severe health problems down the road, and yet, there are plenty of smokers out there. When faced with such dissonance, you could put an end to it by just quitting, or you can come up with arguments in favor of smoking that make sense in your mind to atone the dissonance. For example, studies show that smoking reduces the risk of attaining morbid levels of obesity or developing Parkinson's disease[2].

[1] https://en.wikipedia.org/wiki/Cognitive_dissonance
[2] https://n.neurology.org/content/94/20/e2132

The current, populism-driven and increasingly discordant world we live in is turning out to be a good breeding ground for the emergence of more extreme forms of cognitive dissonance. With pandemic restrictions gradually being eased across regions, many people seem to be disregarding social distancing or mask wearing, reverting to the pre-COVID-19 ways of life. You might be tempted to flout the rules and risk your life because of your deep inner convictions, whether they be religious, political or scientifically driven. Chances are, in a world of rising polarities, you are even less likely to budge from those convictions, rationalizing them with arguments that may sound increasingly absurd. The hostile reactions towards 5G technologies or childhood vaccinations are just some examples of dissonance with scientific evidence[3].

The same goes with our approach to the markets. We tend to ignore the large, market roiling events that happen roughly once every decade. In our minds they appear to be too few and far apart to matter when in reality they should, if only because their impact on the bottom line tends to be significant. Whether it be bubble-triggered recessions or ones caused by more "exotic" and thus less probable events (solar flares, alien invasions, God particles[4] to name a few), it is not in trying to time them that we are going to make a difference, even if our cognition would lead us to think otherwise. By arming ourselves with the knowledge that such events will continue to occur and accepting the impossibility in getting the timing right (this is where luck does play a disproportionate role) means that investment portfolios should always be prepared to face such events[5].

Changing our minds on something that we have invested time and effort on is certainly not easy, but achievable. The challenge is to find better ways to cope with the multitude of uncertainties we face. That requires an awareness that biases can and do endanger our well-being. It also requires self-reflection to make the most informed decisions we can with the information we have at the time and change them accordingly, when new information suggests that we do. Admitting we were wrong requires humility and courage, no one likes being ridiculed, but it also puts us on a much stronger footing, by helping us avoid the type of biases that will harm us in the long run.

Where Do We Go From Here?

Noticing that stock markets are hovering within striking range of pre-pandemic levels, despite the numerous headwind formations on the horizon, makes one wonder if the observed market "decoupling" with economic realities on the ground has taken on a more permanent stature. After an almost uninterrupted decade of liquidity driven asset class inflation, amidst a backdrop of growing populism-driven political and societal tensions, you would expect the recent pandemic crisis, with all the uncertainties that come with it, to instill fear into sentiment long enough to affect markets in the opposite direction. Instead, sentiment appears to be surfing exclusively on the "good" news, filtering out the more worrisome elements from the information flow, which makes one wonder whether participants are suffering from some form of collective cognitive dissonance.

Governments have been injecting massive quantities of liquidity since the onset of the pandemic to counter its damaging effects on the economy. As with previous protracted interventions, these concerted efforts of cash injections and bailouts will be helping to dampen the economic contraction, but it is also causing longer term damage to capitalism itself, mainly through the diminishment of productivity, as less efficient firms that would normally fold in such conditions continue to survive. Extended intervention has also created an environment of unusually low interest rates, conditions that benefit mainly the big technology firms, allowing them to further reinforce and consolidate their already dominant positions. The combined effects of the rescue efforts (survival of inefficient firms, greater market dominance of large ones) is the crowding out of investment capital and talent that startups should normally have access to, impeding the process of creative destruction needed for capitalism to strive.

[3] https://www.theguardian.com/technology/2020/mar/12/5g-safe-radiation-watchdog-health
[4] https://www.livescience.com/47737-stephen-hawking-higgs-boson-universe-doomsday.html
[5] If nothing about the universe we inhabit in is ever static, shouldn't that amplify the chances of experiencing an improbable event? And just because we have never experienced a particular event shouldn't really diminish its chances of occurrence.

Central bank interventions have also been contributing to propelling stock market levels higher, as investors are forced up the risk ladder given the environment of permanently lower yields. This is causing another form of social strife, widening the wealth gap through the rich who have disproportionate exposure to stocks. There is also the massive debt buildup over the last decade to consider. It is bound to be such a burden on future generations that even its financing through lower interest rates are unlikely to alleviate its negative economic effects. As a result of the increasingly significant central bank rescue efforts each time there was a crisis in the last couple of decades, markets have become accustomed to the belief that such actions will continue into the future. These efforts have undoubtedly been contributing to sustaining a form of market dissonance. The fact that stock multiples have reached such high levels even beyond where they were at the start of the year, is a clear indication that central banks have dangerously distorted risk perceptions.

The current economic recovery is marked by its extreme fragility. It risks being derailed by a number of potentially disrupting factors that are likely to become clearer over the coming weeks and months. If massive central bank interventions have staved off a complete economic collapse from materializing, it has done little to alleviate the two major fears held by households right now: risk of getting infected by the virus and unemployment. Liquidity injections have helped buy time[6], but with recent signs of a reemergence of infection rates across many regions, those efforts will have to be maintained in order to prevent an even greater crisis from taking hold. There is already significant disparity in the strength of the rebound between countries where the handling of the pandemic has been more orderly (Europe) and others (mainly US).

The post-lockdown complacency that is being observed amongst various populations across the globe is raising the specter of a second, possibly deadlier wave inflicting far greater structural damage on the economy[7]. The U.S. is in a very vulnerable position right now, especially if infection rates continue at their current pace in what is an election year, just when the political stakes are at their highest. The recent spat between the U.S. leadership and China is a warning shot that gives plenty of reasons to worry. There is a clear and present danger that it may lead to a permanent cold-war like rift that would propel us to a past that not too long ago we thought we had gotten permanently rid of.

Altug Ulkumen, CFA

Independent Contributor
aulkumen@gmail.com

[6] Consumption has remained steady in the US mainly because significant government outlays have temporarily shielded households from the more dire effects of unemployment. It is crucial that these programs be maintained in order to prevent even greater economic contraction from occuring.
[7] https://www.nytimes.com/2020/07/24/world/coronavirus-covid-19.html?action=click&module=Top%20Stories&pgtype=Homepage