Deconstructing Risk

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"I am always doing that which I cannot do, in order that I may learn how to do it."
Pablo Picasso (1881 -1973), Spanish painter and sculptor

Forecasting the future is so devilishly difficult not only because it requires modelling the complex interactions between a multitude of variables, necessitating processing capabilities that just don't exist yet, but also because even in those instances where predicting an outcome may appear to be relatively straightforward, we tend to get it wrong more often than not. Part of this stems from an overconfidence in our cognitive abilities: we think we know in advance how we are going to react to something, we don't realize that our thought is occurring in a "vacuum", thus failing to consider a multitude of other factors that may influence our decision making. The difference between anticipating our reaction to something and actually experiencing it is more than subtle.

Now imagine being asked about how you think you will react to opening a box containing a tarantula. Your response will most likely differ from how you actually do react if it were to really happen. This is because when being asked about a hypothetical event, you are leaving out a whole bunch of cognition influencing factors[1] such as being caught by surprise from the equation. Knowledge, past experience and our senses can guide us only to a certain extent. The rest of the path, according to a fascinating study using data from the Swedish Twin Registry[2], appears to be a combination of "nature and nurture": our genetic profile, our personal experiences and the environment and culture in which we were imbued and raised[3]. So, predicting the future boils down to understanding our risk profiles which, in turn, depend on these three key building blocks.

Our genetic profile appears to play a significant role in determining the way in which we are likely to handle risk, especially in our "formative" years[4] where it appears to contribute a substantial degree to explaining the variation in the "riskiness" of our investment portfolios. It goes to say that if you come from a family of police officers or the military, chances are that risk-taking flows naturally through your veins in contrast to if your family is made up of civil servants or teachers, in which case you are more likely to be risk averse. Although the influence of genetics does subside over time, its importance lingers on. The environment in which we grow up also appears to play a role in shaping our risk profiles and is determined on the degree to which a country's societal safety nets and welfare programs are established. Those growing up in cultures with robust safety nets and more developed welfare programs tend to be less risk-averse than those with weaker ones.

[1] It likely goes a long way into explaining why questionnaires designed to determine an investor's risk profile invariably fail to be of any use at all.
[2] https://ki.se/en/research/the-swedish-twin-registry
[3] https://www.sciencedirect.com/science/article/abs/pii/S0304405X10001777
[4] Formative in this instance is defined as between 16 and 25 years of age.

According to the same study, the most significant contributor to risk appears to be derived from our personal experiences, which is likewise shaped mainly over our formative years but that, contrarily to genetics, becomes more substantial as we get older. You can be sure that growing up in an environment of economic turmoil such as during the great depression of the 1930s, or in a war-torn country like present-day Syria is going to influence our general tolerance for risk very differently to say living in Geneva[5], especially over the last 10 years, where markets have been breaking records and inflation is conspicuously absent from the picture. Just when you thought that this list was exhaustive, recently published research[6] by behavioral finance guru Daniel Kahneman has brought to light the added importance of such matters as the time of the day or the weather, not to mention our emotional state at the precise moment in which we take a decision.

So, if the complexities are such and we lack the computing power to process even a fraction of what is needed to do the job, is all this just an exercise in futility? I guess it depends on what it is we are trying to achieve. If it is to predict how the markets are likely to perform even in the near future, we may indeed be wasting our time, the challenges do appear unsurmountable, at least for now. If, on the other hand, we are trying to determine what our “true” risk profile is, so that we can maybe avoid or at the least lessen the mistakes of the past, there appears to be sufficient value in this approach to warrant dwelling deeper.

That would require considering the professions of our parents and maybe even grandparents on the one hand, and combining that with superimposing a time series chart of the stock market and the interest rate performances with “key” moments in our lives (formative years, when we first began investing, when we launched our own business, etc.). This cognitive behavioral therapy type of approach should help us gain a better understanding of where our strengths and weaknesses lie, in essence our risk tolerances, and, by doing so, help us position ourselves in such a way that we are less likely getting caught “off guard” next time around. Now if only we had the necessary computing power to take it all to the next level…

Where Do We Go From Here?

Markets have been moving in all directions over the past few weeks, reflecting shifting sentiment on the way in which the economic outlook is likely to unfold. We’ve had brief bouts of optimism, led by the combined effects of economic resilience to a multitude of headwinds, and those fleeting moments of respite, where Trump appears to be backtracking on his conflictual dealings with other leaders. They become quickly overshadowed, however, by the rising geopolitical tensions and his inconsistent policy approaches. It is because these sentiment shifts have been occurring in the context of a global recovery that is showing clear signs of a slowdown, and thus in need for more accommodative policies, that concern is rising.

The main worry at this stage stems from the growing risk that a political or economic crisis of some sort could trigger contagion, spreading rapidly into the broader markets. The very significant quantities of corporate and public debt levels that have been accumulating over a decade or so of unusually low interest rates is appearing increasingly like a ticking bomb. A sudden sharp rise in interest rates would cause significant financial strain on businesses, triggering a wave of bankruptcies that could precipitate a more protracted global recession. With fewer stimulus firepower at their disposal, central banks across the world would be at pains to counter such an event with effectiveness. This is likely why the Fed’s most recent quarter point cut, and the ECB’s broader accommodative measures should be perceived more as targeted “preemptive strikes” designed to limit greater damage in the future, rather than just efforts in fine tuning.

[5] https://www.swissinfo.ch/eng/living-the-good-life_zurich-and-geneva-among-top-five-european-cities/44319586
[6] https://hbr.org/2016/10/noise?mod=article_inline

As the effects of a trade war begin to trickle into the economy at large, the stakes for the global recovery are greater than ever. A combination of rising tariffs and the poorer outlook visibility (further reinforced by the Brexit debacle) are prompting firms to pair back on large project investments which is, in turn, dragging growth to a slower pace. The globally integrated supply chains act as conduits in spreading the effects of manufacturing sector contractions in China and Germany to other countries, prompting central banks such as the ECB to take more aggressive accommodative actions to counter it[7]. The prevailing challenges facing Europe in coming months will be to prevent a continent-wide recession from materializing on the one hand, and in resolving the Brexit drama in a manner that doesn't threaten its integrity on the other. These are tall orders considering the significant proportion of headwinds emanating from external sources: the ongoing trade spats and dwindling export demands show signs of spreading to other sectors such as services in Germany, a worrying development given the critical juncture we are in.

There are a couple of significant developments to keep a close eye on in coming months. The emerging impeachment drive against Trump is noteworthy for the uncertainty in its outcome. As with previous attempts to challenge the president on a broad range of disputes, deep partisan divisions remain, which means that it will be difficult to achieve enough of a critical mass for impeachment to proceed. An unsuccessful impeachment carries risks of its own, especially in the way it could embolden Trump to act even more forcefully in his future dealings. In the UK, the recent high court ruling regarding the prime minister's suspension of parliament is putting the whole Brexit process in limbo and making a "hard" Brexit less likely from materializing. It will more likely weaken Boris Johnson's resolve which may pave the way for a negotiated exit which would be positive for both the UK and Europe.

Arguably the most significant wildcard is with regard to the way in which the trade dispute between China and the U.S. is resolved. It is more likely that the dispute drags on indefinitely, as neither side appears willing to concede anything of significance, which means that the tariff and the uncertainties of what happens next will continue to act as headwinds on the recovery. The longer-term effects of this are even less clear, Trump's hostile and mercantilist tactics are creating bad will and distrust with trading partners that could have significant repercussions as the world order continues to rebalance. Unless these processes are reversed before it is too late, the dismantling of treaties, reneging on past accords and a more populist/protectionist stance will usher us back into a cold war era, fueled by deep suspicion. Just as with an infection or disease, there usually is an incubation period during which you might not feel anything, and by the time you do, it may be too late to do anything about it.

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[7] Major central banks including the Federal Reserve have been cutting interest rates in recent months, seeking to insulate their economies against foreign headwinds that range from international tensions over trade to weaknesses in emerging markets such as China. The ECB rolled out a large stimulus package more recently that included interest-rate cuts and an open-ended bond-buying program.