

Financial Control Limited

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Thought of the Month - How Long Will It Take To Restore Market Trust?

It is interesting to note that psychology is perceived to drive markets as much as any fundamental or technical market theory. In other words, investors and traders often invest and trade based on raw emotion, regardless of the soundness of a business plan, or the projected earnings of a business. How much of a role does psychology play? If it is a large role (which I think it is), then how much effort is necessary to calm the emotions of the average investor? Does the average investor have feelings about the market, and if so, how deep are those feelings? If an investor is burned by the tech bubble, the Enron and Worldcom fiascos, and then hears that the supposed gatekeeper of the current restructuring of market oversight is in fact biased and prone to selective disclosure, how does this effect his or her psyche? Although I am no expert on psychology, I do believe in several fundamental ideas: i) the financial markets, like any other markets, rely significantly on the trust of the average investor ii) in the absence of market turmoil or large scale dishonesty, trust will be relegated to a lesser role in the investment thought process iii) if trust is broken, the impact on financial markets is immeasurable.

Anecdotally, I believe we will all save newspaper clippings or other evidence of how each of us has been personally hurt by this crises (economically and emotionally). Just like increasing the money supply has a multiplier effect on the benefits, a breakdown in trust also has a multiplier effect: all of us will be passing down our own personal anecdotes and criticism for generations to come! This negative multiplier effect could dampen enthusiasm for any quick fix to restore trust in the financial markets for many years. So how long will it take to restore trust? Perhaps the explosion in the hedge fund market provides insight into the answer: it will be a long, long time before the average investor is comfortable sticking his toes back into the pool of long-only equity and fixed income markets without a significant allocation to hedge funds and other asset classes that have relatively low correlations to such markets. In fact, the days of long-only investing as a complete investment program might be numbered even for the least sophisticated of investors.

Why is the Sky Blue? – Why Is Common Sense So Difficult To Employ In A Sound Risk Management Operation?

Few can deny that most of the major blow-ups in financial markets and firms occur as a result of the most basic of reasons. Yet why is it so difficult to employ controls based solely on common sense that will minimize the chances for a blow up? I believe the reasons are few and simple: i) history - it's always been done that way ii) perception of risk - the risks of a blow up are perceived to be lower than they really are iii) boredom - it's not exciting to think about the controls necessary to protect the franchise iv) complacency - lack of initiative to do something, and v) "it's not my job" - everyone believes someone else is responsible for a control procedure. With respect to the first reason, most of us take on a role at a firm that was designed before our arrival. Accordingly, we do our best to fill that role and if we deviate too much, our colleagues may become suspicious of our agenda - are we ambitious are just stupid?! Plowing ahead with our personal goals therefore becomes more and more difficult over time as colleagues realize

that either we are ambitious and therefore should be watched carefully to ensure that we do not upset the hierarchy, or feel that we are completely missing the boat and therefore should be contained as much as possible. In either case, implementing sound internal controls might be impossible or ineffective due to political ramifications.

With respect to the second and third reasons, countless academics and professionals alike have repeatedly demonstrated that market returns for almost every conceivable financial asset are not normally distributed. Therefore, one should rely on financial models very cautiously and understand that losses can be much higher than what most models predict. Entertainingly, many of us spend considerable time thinking about how to build the latest cutting edge financial models believing they will solve many of our problems while we should spend more time thinking about other more basic aspects of operational risk such as i) are our daily data feeds appropriate? ii) are all derivative confirmations reviewed for reasonableness by a back office person who understands the implications of every term therein? iii) are our trades and investments marked to the appropriate fair value based on an independent thought process, and most importantly iv) do the figures reported by each business line make sense on a daily basis given changes in the markets and our risk appetite and goals as an organisation?

Regarding a lack of initiative, there is often some justification for not taking any action such as: "the markets are down and budgets are tight", "markets are booming so where is the risk?", "we don't take much risk so such a disaster can never happen to us", "what benefits do I get after spending the money and how can I show these benefits to my boss or my investors?", "we will consider it next year", etc. Yet, few people complain when buying insurance. How can anyone claim that everything is under control and understand all of the significant risks when nothing has been done? The time to assess all significant risks, reduce them where appropriate, and implement on-going risk controls is when you are still in business and not after something goes terribly wrong!

Often, basic controls and procedures fall through the cracks because everyone in an organisation thinks another person is responsible for a particular procedure thereby neglecting it completely. I cannot over-emphasize how every organisation from the smallest hedge fund manager to the most complex investment bank should evaluate at least on an annual basis every aspect of its sales, trading, and investment banking operation to first determine what could go wrong, then determine what procedures could prevent things from going wrong, and finally determine whether such procedures are actually in place and functioning effectively. This simple three step path is not to be taken lightly - it comes from years of experience working with virtually every type of financial institution and is not based on some high-brow idea that simply repeats the obvious.

Nourishment - What Is An Asset Class?

Ask a hedge fund manager, and he or she may tell you that hedge funds "are not a new asset class". Is he or she telling you this because you are a pension fund that is considering investing in hedge funds and if your board of directors believes that hedge funds are a separate asset class, the approval process will be significantly more difficult than if hedge funds are treated as the combination of existing asset classes such as equities and bonds?

Ask a US-based endowment manager, and he or she may tell you that there are five asset classes: "US equities, foreign equities, bonds, private equity, and real estate". Considering the global village that we live and work in, the idea that US and foreign equities could be separate

asset classes must be particularly appealing to those who live without televisions and other modern conveniences.

Ask a commodities or renewable resources (e.g., timber partnerships) fund manager and they may tell you that "no asset allocation framework is complete without an allocation to asset classes such as metals, timber, oil and gas, etc."

Ask a consultant, and they may say that an asset class is any investment type "that is highly uncorrelated with any other investment type thereby providing diversification benefits."

So what exactly is an asset class? And where do short positions fit in? After all, short positions are liabilities, not assets. And where do derivatives fit in? After all, derivatives might actually alter the payoff of an asset class beyond recognition. And where does investor intent fit in? After all, an investor who employs stop-loss limits and other risk management tools might skew the returns from an asset class to look like something else. And where do optimisation models fit in? Do they help define or structure asset classes in some way? And finally, where do rare events fit in, considering that many investments seem to exhibit high correlations in times of market stress thereby nullifying traditionally accepted definitions of an asset class?

After one has considered each of the above questions and comments, one should be able to determine for himself or herself the basic meaning of an asset class. And predictably, every manager and investor's answer will be different!

[Feedback](#)

As always, we greatly appreciate your comments and feedback. We realize that our ideas and information might be cutting edge, futuristic kind of stuff or mysterious in some ways. E-mail us anytime at help@financialcontrollimited.com if you would like a) for us to clarify anything, b) to recommend improvements to us, or c) to just debate with us – we like philosophy especially as it relates to financial services! Or visit our site at www.financialcontrollimited.com

This issue of the newsletter was written by Robert Jones and edited by Ben Vella.

These newsletters are designed to provoke thought and stimulate debate based on real world challenges that we face in our daily lives as we manage investments for ourselves and for others.