

Financial Control Limited

THE INVESTOR December 2002

[Thought of the Month - Rule 9 of the "Major Rules of Thumb" by Nassim Taleb¹](#)

In previous correspondence I have encouraged our readers to take a look at some of the writings by Mr. Nassim Taleb, a hedge fund manager that has been trading derivatives for many years. Having worked with derivatives from a pricing, risk management, and accounting standpoint, I can appreciate Mr. Taleb's "Major Rules of Thumb" as well as anyone. But for some reason I find the most meaning in Rule 9, which goes like this: "Read every book by traders to study where they lost money. You will learn nothing relevant from their profits (the markets adjust). You will learn from their losses." I would add that it's worth substituting the word "investor" for "trader" when reading Rule 9 in case one considers himself to be more of an investor than a trader. But the power of this rule remains the same: by learning from mistakes of others, we can add to our wisdom by avoiding pitfalls that we might have made ourselves had we not been made aware of them. Of course, when we place bets on the table (i.e., invest our hard-earned money) and make mistakes, our memories tend to be much clearer! Nonetheless, supported by Mr. Taleb, I hope we investors will study not only our own mistakes, but those of others and protect our capital as best we can.

[Why is the Sky Blue? – Why are there so many opportunities for hedge funds to make money?](#)

Some studies conclude that investors favor downside protection more than they should even though there is no statistical basis for their decisions. For example, one study² showed that 80% of survey respondents (including those highly educated in statistics and business) would prefer a 100% chance to earn \$3,000 instead of an 80% chance to earn \$4,000 combined with a 20% chance to earn nothing. Separately, a Nobel prize winning professor who was responsible for much of modern portfolio theory was once asked the following question: "Within your retirement plan, how have you allocated your investments across stocks and bonds?" His answer was something like this: "I should have determined expected returns, volatilities, and correlations for these two asset classes. I should have then used an optimizer to determine the appropriate allocations based on my risk tolerance and investment time horizon. Instead, I simply allocated 50% to bonds, and 50% to stocks."³ And finally, I once heard about a professor who became quite famous for his early attention to the area of rare event risk and how mathematical models such as Value at Risk often fail to adequately address such risks. This same professor went on to run a hedge fund that later blew up on account of some rare, extreme market event that took the professor by complete surprise. When asked how this could happen to one of the earliest proponents of understanding rare events, his reply was understood to be something like this: "Well I never thought it could happen to me."

¹ See Mr. Nassim Taleb's website at <http://pw1.netcom.com/~ntaleb/jorion.html> for a list of the nine rules including Rule 9 which is reproduced in the first section of this newsletter.

² Daniel Kahneman and Amos Tversky, "Prospect Theory: An Analysis of Decision Under Risk," *Econometrica* (March 1979), p.266.

³ From a speech given by Professor Richard Thaler, University of Chicago, at the Family Office Exchange Fall Forum, October 2002.

The above studies and anecdotes all point to one thing: there is substantial money to be made in the financial markets by those with the diligence to root out areas where investors put emotion ahead of reason. Unfortunately, as LTCM and others often learn, waiting for markets to "behave" as they should can sometimes exhaust the resources of even the most well funded investors. But a discussion of highly leveraged bets on expected market behavior is beyond the scope of this article.

Nourishment - Volatility is important when trading listed options

Some option investors perhaps think to themselves "...but it's listed on an exchange, therefore the option price must represent fair value right?" In other words, because an option is listed on an exchange some investors can be lulled into a false sense of security that a small bid ask spread indicates fair value. However, listed options are no different from unlisted options in that prior to investing, investors should meticulously analyse both implied and historical option volatility. By observing historical and implied volatility over a range of time periods, investors can get a better feel for where markets are actually trading in comparison to the recent and distant past. As in any market, sometimes emotions run roughshod over rational behavior and the recent levels of the VIX volatility index⁴ indicate that investors must be in some kind of emotional funk at least in the US. Further analysis of volatility levels might indicate that it is not a good time to buy options whereas simply relying on the fact that an option is listed on an exchange offers no analytical basis to support an option trading strategy other than perhaps enhanced liquidity. If volatility levels are high, should one sell options? That is once again beyond the scope of this article.⁵

Feedback

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. As always, we greatly appreciate your comments and feedback. 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.

⁴ Bloomberg ticker for S&P 100 implied option volatility. For more information on VIX go to: http://www.stockcharts.com/education/What/IndicatorAnalysis/indic_VIX.html.

⁵ Nassim Taleb takes issue with shorting volatility. See <http://pw1.netcom.com/~ntaleb/> for his internet home page where this issue among others is discussed.