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The Obama Doctrine and the Greater Fool Theory

A big part of risk management is about avoiding folly. Investors who can spot folly have an edge over those who can't. Folly might even take a bit of randomness out of markets.

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Deutsche Version

The Boxing Day Tsunami of 2004 off the west coast of northern Sumatra killed approximately 230,000 people in 14 countries. All the science of Western civilization did not help to foresee the earthquake or prevent devastation and death.

One interesting aspect of this tsunami was that hardly any members of the aboriginal tribes were killed. Their «risk management» included the behaviour of their animals. From the behaviour of the animals they concluded that something bad was about to happen and they moved inland prior to the disaster. They applied wisdom rather than science.

Wisdom is a path; an ideal. It involves learning, effort and failure. Worldly wisdom, like happiness, is not a destination but a journey. The best we can hope for as investors is avoiding folly.

Folly is the opposite of wisdom. For instance, when Japan's 1980s bubble burst in the early 1990s, Japanese interest rates started to fall, from around eight percent in case of the 10-year government bond yield.

With interest rates low, the investment idea was to sell short JGBs (Japanese government bonds) and thereby benefiting from «inevitably» falling bond prices. However, the rise in yields never came in a meaningful way. Selling short Japanese government bonds has been called «the widow maker», as the trade produced losses for years. The yields just kept falling, and the bonds kept rising.

One idea in finance goes by the name «greater fool theory», which states that the value of a security or asset class doesn't matter that much as long as you can sell to a greater fool than yourself at an even more ridiculous price than you paid.

According to this «theory», it was perfectly rational to buy internet stocks in the 1990s, as it was rational to buy Japanese stocks in the 1980s, as it was rational to buy Bitcoins at $1 or $1000 or $10,000 per coin more recently. Whether financial markets resemble a random walk down Wall Street or not doesn't matter that much in this regard.

«There is no reason, only mass psychology.... It's perfectly all right to pay three times what something is worth as long as later on you can find some innocent to pay five times what it's worth.» [i]
—Burton G. Malkiel (b. 1932), author of A Random Walk Down Wall Street

As with everything else in life, risk is involved. The greater fool theory works as long as you are not the greatest of fools. This is how the «Oracle of Boston» put it:

You may find a buyer at a higher price – a greater fool – or you may not, in which case you yourself are the greater fool. [ii]

—Seth Klarman (b. 1957), American hedge fund manager

Avoiding folly is a first principle:

The first principle is that you must not fool yourself - and you are the easiest person to fool. [iii]

—Richard Feynman (1918-1988), American physicist

Buying Intel, an American technology company, at $0.5 trillion market cap in early 2000, or buying the Nikkei 225, a Japanese equities index, at 40,000 index points in late 1989, or buying Bitcoin at $19,000 in late 2017 didn't work. There's a limit to everything.

Unfortunately, the greater fool theory only works until it doesn't. Valuation eventually comes into play, and those who are holding the bag when it does have to face the music. [iv]

—Howard Marks (b. 1946), American investor

Investors who can spot folly have an edge over those who can't; and especially over those who can't and don't know, that they can't. Folly might even take a bit of randomness out of markets.

The fact that people will be full of greed, fear or folly is predictable. The sequence is not predictable. [v]

—Warren Buffett (b. 1930), American investor and chairman of Berkshire Hathaway

Foolishness is something one can count on; it's not going away. While worldly wisdom is scarce; there might be an oversupply of folly:

There are more fools than wise men; and even in the wise men more folly than wisdom. [vi]

—Sébastien Nicolas de Chamfort (1741-1794), French writer

One big part of risk management is about avoiding folly; foolishness being the opposite of applied wisdom, as mentioned. Avoiding foolishness is sometimes referred to as the *Obama Doctrine*:

Don't do stupid shit. [vii]

—Barack Obama (b. 1961), American politician and 44th President of the United States

Avoiding foolishness is easier than applying wisdom. But then, avoiding foolishness *is* applying wisdom. The *Obama Doctrine* can be traced, it's «wisdom» old:

Virtue's first rule is to avoid vice, wisdom's is to not be stupid. [viii]

—Horace (65-25BC), Roman poet

The practical relevance for today is that irrational exuberance or foolishness of the crowd can persist for a long time. Trends, therefore, can go on for a long time.

But trees do not grow to the sky, cans cannot be kicked down the road indefinitely, and chickens do eventually come home to roost. Everything ends, but trying to predict the end has widow-making potential.

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Alexander M. Ineichen is the founder of Ineichen Research and Management AG, and has been a CAIA Association member since 2003. He started his financial career in origination of risk management products at Swiss Bank Corporation in 1988. From 1991 to 2005, he had various research functions within UBS Investment Bank in Zurich and London related to equity derivatives, indices, capital flows, and alternative investments. Mr. Ineichen has written extensively on investment topics. He is the author of the two popular UBS research publications, «In Search of Alpha-Investing in Hedge Funds» (October 2000) and «The Search for Alpha Continues-Do Fund of Hedge Funds Add Value?» (September 2001), as well as two books, Absolute Returns-The Risk and Opportunities of Hedge Fund Investing (Wiley Finance, 2002) and Asymmetric Returns-The Future of Active Asset Management (Wiley Finance, 2006). He is also the author of AIMA's «Roadmap to Hedge Funds» that has been published in 2008 and updated in 2012. Mr. Ineichen holds the Chartered Financial Analyst (CFA) and the FRM designations.

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[i] Malkiel, Burton G. (1973, 1990) «A Random Walk Down Wall Street», W.W. Norton & Company, Inc., p. 31-32. First published in 1973.

[ii] Klarman, Seth A. (1991) «Margin of Safety: Risk-Averse Value Investing Strategies for the Thoughtful Investor», New York: HarperCollins.

[iii] Caltech commencement address, 1974.

[iv] Marks, Howard (2011) «The Most Important Thing – Uncommon Sense for the Thoughtful Investor», New York: Columbia University Press, p. 28.

[v] Financial Review, 1985.

[vi] Originally in Maximes et Pensées (1795) published posthumously by his friend Pierre-Louis Ginguené.On a trip to Asia in 2014, the President used a baseball analogy to explain his foreign policy as one that is more focused on "singles and doubles" than homeruns. Jeffrey Goldberg from *The Atlantic* called the quotation the «Obama Doctrine». «shit» is often softened to «stuff» when referred to the Obama Doctrine.

[vii] I use a variant of this quote. Original: «Virtus est vitium fugere et sapientia prima stultitia caruisse». Literally: «To flee vice is the beginning of virtue, and to have got rid of folly is the beginning of wisdom». Epistles (c. 20 BC and 14 BC), Book I, epistle i, line 41.