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"Confusing uncertainty with volatility or VaR is like mistaking a tiger for a pussycat. It's irresponsible and dangerous"

Ronald Reagan once made a contribution to the English language by defining its ten most dangerous words: "Hi, I'm from the government, and I'm here to help."

Today, 'Reaganomics', rightly or wrongly, stands for smaller government, less government spending, lower taxes, controlled money supply, and reduced regulation. Repressionomics is the antithesis of Reaganomics and describes the current political, economic, and financial landscape of bigger and growing government, more government spending, higher taxes, uncontrolled money supply, more regulation, and financial repression.

Attempts to improve the financial system by making it less prone to accidents and failure is laudable. However, the effort to eliminate failure entirely is not. Failure is an elementary part of learning and, therefore, progress. Many frogs fell flat on their noses and many died before the frog's strong legs evolved and allowed it to jump about as they do today. This trial and error – the process of natural selection – worked very well for the system 'frog' even if it didn't work out for every single frog that ever lived. The same is true for the financial markets. Single market participants, certain ideas, and certain products need to be able to fail. It's part of trial and error, or evolution, or the 'learning-by-doing' dictum.

Currently, the 'learning-by-doing' process is disturbed and capital misallocated as a result.
The societal costs of failure are perceived as too high. But abandoning single entity failure through government intervention not only rewards failure but also disturbs the system's ability to improve and progress and to allocate capital smoothly and efficiently. It's a perverted form of Robin Hood's code – essentially taking from the frugal, diligent and successful and reallocating to the profligate, reckless and failed. By artificially trying to eliminate small failures, the system's collapse becomes inevitable. Herbert Stein's Law applies: "If something cannot go on forever, it will stop."

Applying financial orthodoxy is dangerous for the system and investors alike. Imagine two hypothetical artists taming white tigers and making a show out of it in Las Vegas. Such a venture can go well for a long time. Risk in this instance is obviously not measured by volatility or VaR (value-at-risk). Risk is system-inherent and is 'measured' by the probability of an 'accident' of the system. Tigers are beasts and even if one builds up a high degree of conviction that the system is safe, it isn't.

Accidents lurk in all man-made systems. There is uncertainty. Markets can erase investors' wealth overnight (for example if communists orchestrate a successful coup), asset classes can compound negatively for decades, sovereigns can default on their obligations, monetary authorities can inflate one's wealth away (together with someone else's debt), currency unions can fail – you get the picture. It is, therefore, uncertainty that is the proper way to think about risk and risk management. However, this is not in the mindset of the bureaucrats and technocrats drafting legislation and regulation for financial institutions. Confusing uncertainty with volatility or VaR is like mistaking a white tiger for a pussycat. It's irresponsible and dangerous.

The absolute returns revolution
Throughout the 1990s, institutional investors increased their allocations to equities. Equities were perceived as a long-duration asset class and long-term investors could stomach any drawdowns. Many institutional mandates were indexed or benchmarked to an equity index. The fund managers were managing 'tracking risk', that is, risk was perceived not as losing money but as a deviation from the benchmark. Traditional and established aspects of portfolio management, such as diversification, position sizing and hedging, were secondary considerations. Absolute returns weren't even a thought among many long-only asset managers and their clientele. The doctrine worked well until it stopped.

The benchmarking idea changed as share prices started to fall. The assumed indifference to absolute losses slowly but steadily turned out to be ill-advised. It was like Ayn Rand speaking to investors: "You can avoid reality, but you cannot avoid the consequences of avoiding reality."

It is felt that history does not repeat itself, but does indeed rhyme. This time it is bonds that have risen strongly, not equities. Furthermore, the doctrine of managing relative instead of absolute returns is not referred to as 'closet

indexing' but as 'asset-liability management' (ALM). The communality between the benchmarking of equities to an asset benchmark and the benchmarking of bonds to a liability benchmark is that one is implicitly indifferent to absolute losses.

Many investors believe that they are indifferent to rising yields and falling bonds because their liabilities will fall, too, in the case of rising interest rates. There is the perception that there is no need for diversification or capital preservation; both being reasonable applicable tools for investors thinking in absolute return terms. However, the perception of being indifferent to losses is a bull market phenomenon that will not last.

An additional aspect is related to committee-based investment decision-making. Most institutional investment committees are comprised of individuals with different backgrounds. Not all are familiar with finance and economics in general, and the history of stock and bond markets in particular. Those with knowledge dominate the investment process, especially when all goes well. Those with less knowledge have nothing much to add other than nod approvingly.

Criticism is easily silenced by referring to favourable past performance. However, when equities started to fall, the investment committee dynamics started to change. Suddenly the equities-outperform-bonds-in-the-long-term mantra had a different feel to it. The trustees started to voice solvency concerns while lay people in the committee started to question the logic of having such a high allocation to equities. Losses were the game changer.

The practical relevance is that history rhymes. The investment experience of the past 12-15 years has taught us that a fool with a tool is still a fool. This time it is not an infatuation with equities but a repressively induced high bond allocation. The authorities, via bond-worshipping regulators and equity-averse accounting rules-setting boards, are to blame. The ALM phenomenon is essentially a function of the political, legal and regulatory framework; hence the perception of rationality on the part of the institutional investor conducting the ALM.

The bottom line is this: bond markets can compound negatively in real terms for decades. This has not occurred during the lifetime of most contemporary investors. When bonds start to fall in earnest, it is likely that some of the current institutional doctrines will be questioned. Ideas such as 'we can hold bonds to maturity', or, 'our (liability) benchmark is falling too' will sound as hollow as some of the ideas when equities were falling and investors moved from a relative return to an absolute returns approach. The positive feedback loop that propelled bonds and bond allocations to high levels will eventually reverse. A negative feedback loop will then – again – change the game.

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