

Irrational Exuberance

Panic rooms and flutters in financial markets.

By Vijay Fafat

It's been more than a decade since Nietzsche's Abyss stared right back at us. The pebbles of financial crisis dislodged in mid-2007 led to an avalanche that peaked in December 2008. But for many, the surrealism of that fourth quarter has faded. The sentiment Irving Fisher expressed two weeks before the 1929 stock market crash appears to be back in vogue: "Stock prices have reached what looks like a permanently high plateau." The new bulls have thundered on with a Midas touch to their hooves, swatting aside every obstacle that would have seemed momentous and perilous in any other age—including Brexit and the subsequent fumbblings of the British government; the Great Trade War between the U.S. and China; North Korean missile launches over Japan; the Chinese foreign exchange reserve crisis and the fear of another Asian contagion; the structural weaknesses in emerging markets; and the multiple incidents of terrorism.

There have been warning dips along the way, but in retrospect, they look more like the pauses of drink breaks in a marathon run. So the questions arise: Is the stock market overvalued? Are there clouds heralding a crash just over our short-sighted horizon?

"Hypothesis non fingo," Sir Issac Newton had said when he didn't know better. I frame no hypotheses either, for that directional view is not the purpose of this article. I only offer a few cautionary thoughts here on why we overshoot in our optimism and why even genius comes to grief in the face of capricious, mercurial capital markets. There are aspects here that investors can evaluate, and facets that they can control, most notably with the flow of their money and their proxy votes. Institutions, on

the other hand, certainly have more power to manage these risks as part of their cultural fabric if they look beyond their next earnings quarter, and their independent directors remain truly independent.

The factors mentioned below apply against the juggernaut today just as much as they did a decade ago. How we deal with them collectively will determine whether we land softly in the next trough or face a hard landing with rippling effects.

Greed

‘Anything in excess is poison’—these are words of great knowledge. Greed is good—it drives capitalism in part. But unbridled avarice saddled with power and ambition has brought many an empire to ruin. ‘If it is good with a grain, it is better with a bushel’ is a thought that may work in some instances of economies of scale, with pooled mutual funds and good-sized nations—but beyond a limit, there are negative returns. Size matters, but recall that even Soviet Russia and the British Empire collapsed when they became too big to govern.

Leveraged portfolios, like leveraged homes, must be within your wherewithal. Ask if a 30-50 percent wipe-out of your portfolio will give you a heart attack. Reach only as far as your purse strings will safely allow. A very telling statistic comes from the 1929 crash. At one point, the stock market was down 50 percent from its highs. It must have seemed like a dream opportunity to buy on the large dip. Those who went in at that point lost 80 percent of their investment subsequently.

Of course, this by no means implies that you shouldn’t buy when opportunity presents itself. It does caution, though, that no matter how

good an opportunity looks, the greed in grasping at it must stay tempered. A falling knife is still a knife when you’re trying to catch it mid-flight.

Hubris

We all suffer to varying degrees from what is known as ‘illusory superiority’. This is the phenomenon where we significantly overestimate our own abilities while magnifying the perceived shortcomings in others to create our own version of reality: an enlarged feeling of infallibility. This is particularly true for investments in more esoteric or illiquid securities. After a while, an AA tranche of a collateralised debt obligation (CDO) looks the same as an AA corporate bond, not because portfolio managers do not understand the difference, but because they think they understand their own CDO better. They rely on their own correlation analysis based on selective research that reinforces their positive bias and remain convinced that any downturn or spike in credit defaults is a short-term course correction that will be shrugged off by the market bulls.

One week before Bear Stearns went down, TV pundits were proudly proclaiming it to be a “strong buy”, completely disregarding its liquidity problems.¹ Mortgage-backed securities could not be snapped up fast enough in early 2007, regardless of composition and tranching, because of the firm conviction that housing prices could never fall. Leveraged and synthetic CDOs were touted as the newest financial technology to transform the financing world, with no regard to the terrible risks involved. These are just a few specific paths along which the investment managers were misguided right before the 2008 crisis. We don’t have to go back to the Long-Term

Capital Management episode of the 1990s to highlight what hubris can do to an investment strategy.

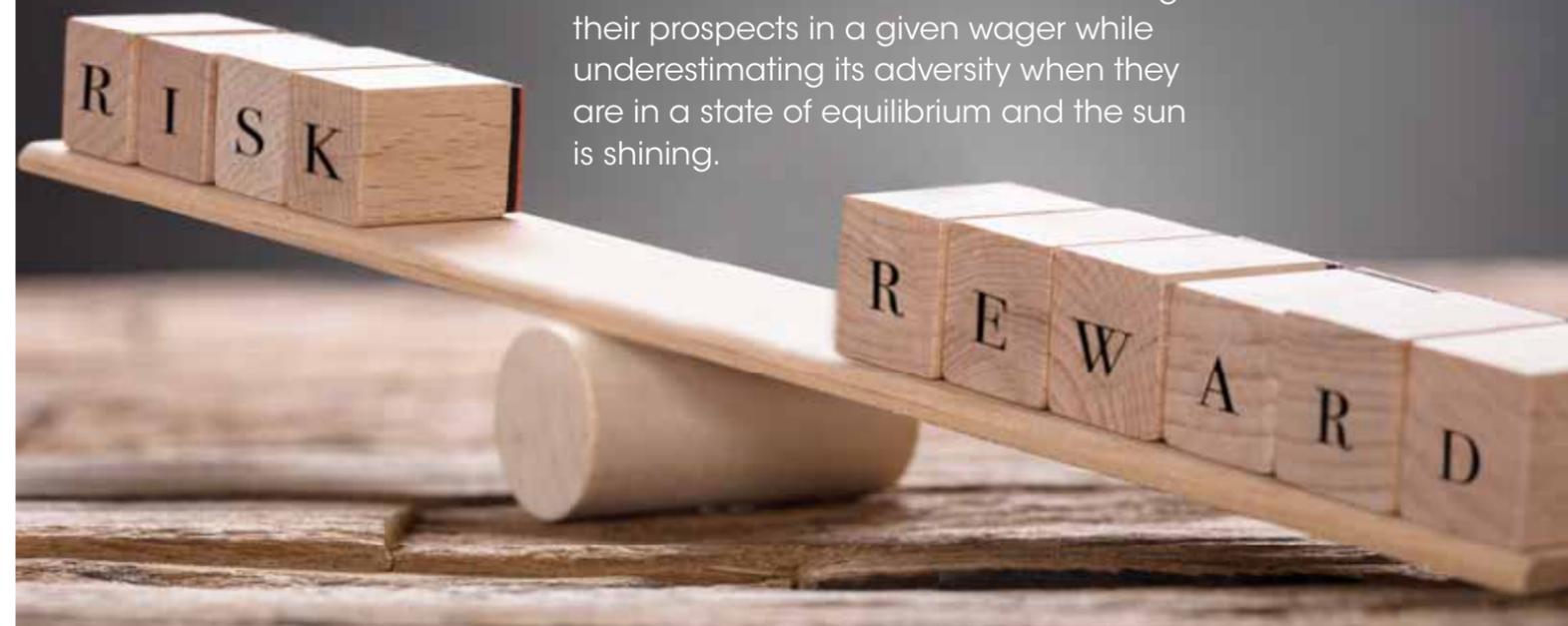
To be sure, many portfolio managers do succeed in obtaining spectacular returns. Then again, there will always be the one lucky or unscrupulous risk-taker who will come out ahead in a barrel of a hundred playing at the gambling table. Hubris may pay off for a few, but many will fall on their faces.

Moral hazard

There are often vices in our affairs because people feel a need to negotiate with what may have once been sacrosanct principles. The degree of compromise is determined by circumstances such as incentive schemes, opportunities, personal ethics and credo, role models, delegated authority, and the implicit and explicit controls in place. Where there is much money and power, the temptation of moral hazard can be hard to resist.

While some may merely cut corners, others will saw off the entire bend to achieve their objectives. These include acts of self-interest—insider trading, outright fraud and cooking the books. When the piper stops playing the tune, we all pay with our coins for the show through government bailouts. Recall the uncritical, nonsensical ratings the supposedly independent and analytical rating agencies handed out to exotic

No matter how good an opportunity looks, the greed in grasping at it must stay tempered. A falling knife is still a knife when you’re trying to catch it mid-flight.



Humans have a habit of overestimating their prospects in a given wager while underestimating its adversity when they are in a state of equilibrium and the sun is shining.

instruments simply to maintain market share and ill-gotten rating fees—Madoff’s fraudulent funds and Enron were just two of thousands of capital markets scams which had brought investors chasing easy returns to grief. Even a prestigious firm like Arthur Andersen was brought down due to its complicity in such fraudulent activity.

Confidence and subjective probabilities

Humans have a habit of overestimating their prospects in a given wager while underestimating its adversity when they are in a state of equilibrium and the sun is shining. The illusory rainbow extends over the horizon and the potential tiger behind the bush is forgotten. This should be a little surprising because our risk-averse utility functions are actually poised in the opposite direction. Normally, we apply a significantly stronger negative factor to adverse outcomes compared

to the positive premium we attach to happy occurrences.

These contradictory directives are conveniently ensconced in our worldview, even though we are quite aware of their opposing natures. They colour our approach to opportunities and pitfalls. Likely, this happens not because we set aside our risk aversion but because we end up significantly misestimating the probabilities involved, giving easier reins to our natural fears. Such unseen mistakes become dogma in decision-making, for it is in our nature to fortify our errors against informed correction. Can a mountain of circumstantial evidence of dubious reliability be ignored in one’s gut, when hope and greed lurk?

Myopic exuberance

We may remember the pain of the Asian and Russian crises, the tech bubble, the liquidity crisis of 2007-08, but we have this remarkable

ability to convince ourselves that *this time* will be different. *This time*, the markets are rising rationally. *This time*, the investors are more prudent. *This time*, the pull of the lever really is the one favouring the brave.

This is not hubris. It is the persistent, short-sighted, irrational belief that the world of dice is non-Markovian, that a string of bad throws will be followed by that of good ones, and good fortune will persistently follow good fortune. In the long run, risk is rewarded, but we forget that this does not apply to individual outcomes and indeed, a downturn can outlast one’s solvency.

Circular rumour and resonance

The herd effect of instinctive sheep following the shepherd remains a large factor in market bubbles. We feel ebullient when others display a confident charge into the raging

waters. Once a small herd follows a leader on little more than rumour or reputation, this ‘second- and third-party confidence’ provides a reassuring validation to the original perpetrators, fuelling further leaps of daring. By their own petards are such castles sometimes hauled upward, with little capital in their foundation. And that works in reverse as well. In today’s hyper-connected environment where social media can fan a spark into a forest fire, and where fake news from malicious bots can catch on as gospel truth, the risk of a snowballing market crash is all too real.

We all like to think that we can analyse markets well and not fall victim to the temporary momentum effects. But repeatedly, we buy into our own hype—a case of falling for circular rumour. Before the 2008 crisis, how many stalwart banks with their armies of Ph.D. quants loaded up their own balance sheets with garbage securities (which do have a place in the world—but for high-yield speculators, not staid banks) or non-performing assets? Take a look at any large bank’s balance sheet from 2006 for proof. It has taken many of these banks a decade to offload those toxic assets they had built up on their balance sheets. For example, Deutsche Bank has made not one, but two separate attempts at hiving off

those toxic assets in its ‘bad bank’, with book value exceeding US\$100 billion.

Is this happening currently? Perhaps we should look at all the non-performing loans loaded up on the balance sheets of Chinese and Indian banks...

Simulacra or experience

We forget that models are mere representations and approximations of what are incredibly complex processes. In the process, we forget simple aphorisms. We get enamoured by models, and models are high maintenance, especially when they misbehave.

In the utopian world where we have convinced one another that the Gaussian distribution rules, black swans never come back to their lake to roost, and home prices never fall (as the U.S. rating agencies assumed prior to the 2008 crisis). Fat-tail events have again faded from view. Do our models really represent the world in which we live or are we just inventing Ptolemaic models of epicycles within epicycles instead of creating fundamental value?

One cannot become a pundit by proxy. Knowledge obtained cheaply is not respected. On a similar note, practical knowledge never obtained also matters! Take securitisation



We all like to think that we can analyse markets well and not fall victim to the temporary momentum effects. But repeatedly, we buy into our own hype.

as an example. There are tranches, and then there are tranches. You cannot expect to have a third party label them AA or BB and rest complacently. But we did, and we do. The error is in the act of losing sight of the fact that such instruments remain radioactive even when locked up and forgotten inside wooden drawers. For people who have not been burnt before, and even for many who have been, such lessons are hard to understand before the fact.

Panic rooms and flutters

When the compass points South, the ones who get out first escape and set off the avalanche. When panic rooms are activated, the pendulum of our subjective probabilities swings to the other side, utility functions curve significantly, and we create our own self-fulfilling prophecies. That is just the nature of all chaotic systems—there is a critical threshold beyond which the system breaks out of a stable attractor and escapes the basin uncontrollably. A butterfly flutters in Florida’s housing market and the resulting hurricane savages the Pacific Rim.

A Ponzi scheme, or a financial system dissociated from real economy, survives only as long as there is a steady supply of gullibility. Bitcoin and tulip bulbs come to mind.

In the end, we must look back at ourselves before we look at others. We all have visions of control in our lives. There is nothing wrong in strong convictions and beliefs, but temper them with a modest amount of doubt and caution. Today may seem very different from a decade or two ago, and it is. It is much riskier. We have newer instruments to play with, like cryptocurrencies and tokens, and better technologies, like Artificial Intelligence and Blockchain, whose implications we do not fully comprehend. The increase in financial inclusiveness from a myriad of Fintechs is also enabling more people to be able to play with fire—fire with which they have not been singed directly in the past.

The myopia of control replays itself at all levels, in every aspect of our lives. As Dr Ian Malcolm reflected ruefully in the movie *Jurassic Park*, “You never had control, that’s the illusion! I was overwhelmed by the power of this place. But I made a mistake, too, I didn’t have enough respect for that power and it’s out now.”²

While investing, discount everything you think you understand, and keep your fear of missing out in check.

Even Aristotle was felled. Taste your hemlock with care.

Vijay Fafat

is the Head of Global Markets Transformation, APAC at BNP Paribas

References

- ¹ Hedgeye, “Dear Jim Cramer, Remember this Beauty?”, September 12, 2018.
- ² Jurassic Park, Film directed by Steven Spielberg, 1993.