Human nature, financial crises and investing in the face of uncertainty

By Quintin Rayer | July 26, 2018

While markets regularly seem to have periods of falling prices, advisers can often seem to focus on the upside, directing relatively little effort towards spotting the future crises.

Recent developments have shown that political events often affect markets and outcomes may differ from those expected by mainstream opinion. Press coverage can seem short-term, and adverse market periods are rapidly forgotten.

The fundamental causes of financial crises are often rooted deep within human nature. So how do we better manage investments in the face of this uncertainty?

Market crises

Like many investors, advisers know that stock markets are prone to periods of rising or falling prices, so-called 'bull' or 'bear' markets. These can affect individual asset classes, or else be more widespread, although generally a bull or bear market would be taken to refer to equities unless otherwise qualified. For investors, falls are a source of great concern, since a stock market crash can result in a decline of 25% or more in real equity values [1].

Sentiment often appears to drive markets as much as economic reality, and, as suggested by US Federal Reserve Board chairman Alan Greenspan during the dot-com bubble of the 1990s, markets can suffer from ‘irrational exuberance [2].

Stock market values are perceived to be linked to economic cycles, but market participants must seek to anticipate investment opportunities ahead of competitors, and so markets are forward-looking. To be forward-looking, investors must make judgments and forecasts about economic and investment outcomes with incomplete information. This results in the likelihood of error and decisions coloured by human psychological and behavioural biases. With many market participants, a wide range of views are generated; not all of these can be correct.

Secular trends

In fact, it is possible that the complexities of financial markets make them prone to fingers of instability that extend throughout the system, making them capable of amplifying small events with potentially catastrophic consequences [3]. Financial markets may be ‘chaotic’ systems, meaning that they are extraordinarily sensitive to small influences [4]. Economist Hyman Minsky also pointed out that stability leads to instability – i.e., long periods of stability can lead to debt accumulation until dangerous levels of leverage are reached [3].

Secular trends can also significantly change the investment landscape, creating new opportunities while undermining others. Market practitioners generally have a range of opinions, while some may correctly anticipate trends others will not. On top of this, the results of elections or national referendums may turn slight popular biases into clear-cut outcomes, which can come as a surprise to the consensus view.

Examples of secular trends include:
» Rising nationalism, including the UK’s 2016 Brexit vote, the election of more nationalistic political candidates, such as in the US and more recently, Italy. This has resulted in the appearance of protectionist trade policies in contrast to previous eras of increasing free trade. Examples include the tariffs imposed by the US on its trading partners with retaliation by China, the EU and others [5].

» New technologies, including, more recently, the internet dot-com stocks bubble (the 1990s)[2]. However, this is hardly a uniquely recent phenomenon, considering, for example, the 1840s railroad mania and 1793 canal mania [6].

» Demographic impacts as populations age, increasing demand for healthcare and associated support services, combined with disinvestment associated with drawdown from pensions.

What to do?

Managing portfolios in the face of these considerable uncertainties is challenging. The risks are unlikely to be captured by conventional risk measures (such as volatility, or value-at-risk); however, stress-testing portfolios may be able to help [7], [8], [9].

Working with wealth managers, advisers can identify specific issues associated with these risks and consider scenarios of possible outcomes that attempt to quantify asset movements. If test results affect portfolios to an unacceptable degree, they can be restructured to make them more robust to the scenarios considered.

Of course, anticipating market crises is not easy; their complexities may make them capable of amplifying small events with potentially catastrophic consequences. Financial professionals must overcome their inbuilt human biases, as well as political and economic systems that can leave markets prone to periodic crises. Given difficulties with anticipating such crises, advisers should always be on the alert, particularly during quiet periods when everything seems to be sound and markets are generating consistent positive returns.

How this helps Advisers

It may be difficult, but wealth managers and advisers should be attempting to form judgments about the likelihood of developing market crises. By discussing these, they should help ensure that clients have a more complete and realistic understanding of the risks their investments may entail, and facilitate a better discussion around portfolio investment allocations. It will also be clear that advisers, in conjunctions with their wealth managers are actively working to protect the value of their clients' assets.

References

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This article was written by Dr Quintin Rayer, Head of Investment research at P1 Investment Management and also published on the DISCUS website.