Investing Risks: The Rethinking of Risk

Investing is risk management in many ways. If there was a perfectly safe method of handling one's money and one's portfolio, the investment markets would not exist – we would all buy government bonds paying 20% per year, and inflation would be less than 2%. However, we do not have a planned economy; we have a free market system, which is subject to violent swings and erratic price movements. Essentially, capitalism is chaos, while volatile market forces, sometimes beyond the forces of reason or logic, establish prices. We have the illusion of safety and security, because of overabundant wealth, resources, and fairly stable geopolitical era. We forgot that our grandparents suffered through the Great Depression. We assume that we will have food to eat and shelter and medical care, and our investments are more for growth and to obtain a better life and purchase more luxury consumption. While at the same time, riots have begun over the necessities such as food in many parts of the world[i], and in the U.S., food banks are at their all time low, and they are experiencing a new customer of working class people who cannot make ends meet[ii].

Most investors do not want huge returns; they want safe, steady, consistent. Nevertheless, many are not willing to risk a penny in order to achieve it, which poses a great problem. It is baffling how so many investors will build a house of cards on a beach in Florida and then are surprised when a hurricane blows it away, as we have seen with Sub-primes and related debt instruments. It just implies that investors flock to perceived security, not actual security. While history proves that the mainstream is always wrong (earth is flat, etc.), investors feel safe in a crowd, or by some other strange phenomenon they cannot behave any other way. 3 years ago, if you had said that the Real Estate market would collapse, you would have been laughed at, or worse. Yet, we are in the biggest housing decline in history[iii].

According to banking insiders, banks have recently been hiring 'sales oriented' staff vs. traditional banking and finance graduates. Bankers are being replaced with salespersons, because a banker cannot push the level of financial products on customers required to meet corporate quotas. It is bad enough to have performance based team efforts for debt-collection; having an aggressive sales force in retail banking means consumers are getting a lot of products they don't need and don't understand. And products they traditionally held conservatively, such as mortgages, are becoming larger and more sophisticated.

Is it their fault, or is it the banks fault, or the government's fault? First, if you get hit by a bus, does it really matter whose fault it is? If a foreigner comes from a village in Africa and doesn't know about the little green man in the traffic light and steps onto an Interstate highway, it's not only a risk for him, there is a risk of a major traffic accident. As such, Joe Blow homeowner has participated in, although not being directly liable for, one of Wall Street's biggest catastrophes.

What is your backup plan, in case you are wrong? It seems many went as if there was only the possibility of increase, never creating a 'what if' backup plan. NFA requires it's members, in different forms, to have backup procedures

Stocks

Are stocks 'safe' investments? It is not a difficult argument to make that stocks are risky after Enron, WorldCom, and the .com bust. However, investors sometimes think this is an anomaly, the blue chip stocks, the cornerstone of the economy, are as safe as anything is.

Yesterday, General Electric, the bluest of the blue chips, was shaken due to a 'confidence crisis' and investors watched their pensions deteriorate, in the case of GE's share price, 13% in one day.

***General Electric** underlined the depth of the global financial crisis on Friday, announcing its worst quarter in five years and slashing full-year forecasts. Liam Denning says there is more to GE's problems than the "Bear Stearns effect"*[iv]

CTAs are required to disclose risks to clients, which is without question a very prudent practice. Why didn't mortgage brokers and real estate agents then, explain the risks to their clients? Not only has housing declined, in some cases, people have lost everything. Not only did they make a bad investment, they lost their homes. Where was the NFA required disclaimer? Were they simply uninformed, unprofessional, or reckless?

What can explain the recent wanton destruction of capital? Why did so many choose to completely wipe out their life savings, some of whom saved for decades, with no tangible result or return? Thorstein Veblen described "conspicuous consumption" as a means of those with wealth displaying how easy it was for them to destroy it, by purchasing ridiculous luxury items with no functional utility, as a sign of social class. Is losing money in housing fashionable? Is peer pressure more powerful than making sound investment decisions, even in the face of utter destruction? No one wants to be a crackpot gold bug, god forbid, which has surged over 300% its pre-housing bubble levels. Not to mention that there are not 'costs' associated with owning gold. The question that the mainstream may have been asking is: "But is Gold RISKY?" 5 years later, Gold is stronger than ever and housing is suffering. So what is risky based on results? Obviously, some people have a hard time understanding what risk is. In fact, many gold bugs are risk adverse investors who are super conservative and are betting in a sense in the failure of the USD based system. While it would never be smart to put all portfolio eggs in one basket, what is wrong with spreading the risk a bit? What many boomers did, essentially, they bet 100% of their wealth on the USD system and housing boom. They do not see it like this, but it would be the equivalent of borrowing against your home to invest in .com stocks – looking back we can all say that would have been foolish. However, at the time, in the frenzy, a crashing NASDAQ was inconceivable.

Bonds

Bonds are supposedly the safest of any instruments, but you can still lose in bonds. We are entering the peak (or at least in later phases) of a bull market in bonds due to the Fed's aggressive interest rate cuts; keep in mind that bonds can decline in value. If you hold bonds to their maturity date, you will be guaranteed to at least get face value – that is if the bonds are not called or if the issuer doesn't default. There are insurance companies and ratings agencies that rate bonds from a credit risk perspective – but even those companies have come under scrutiny! That means not only is there a risk of bonds defaulting, there has been risk that the ratings agencies will cease to exist!

Cash

During the Great Depression, many kept their money hidden under a mattress. This may have been wise during an age of fixed currencies, relatively low inflation or even deflation, and a stable monetary policy. However, we do not live in 1930 or even 1950 – it is 2008 at the time of this writing, and the real interest rate when calculated for inflation is negative.

Cash is worth the paper it's printed on, in terms of intrinsic value. Commodities have use-value whereas an investment in cash is pure belief in the USD Federal Reserve System. Not only are there missed opportunities, but the value of the cash is constantly declining. Understand it or not, being in cash is a constant loser.

Risk

Average investors aren't expected to understand geopolitics and the correlation between FARC rebel movements and the price of 3 month coffee. But someone should, and that someone should protect those who understand less about risk. Over the past 5 years, very few were recommending the safe play, and to make matters worse, they branded the ultra-high risk as 'safe' with an 'element' of risk, as if using spin to sell a high risk product as low risk. That caused the entire system of risk itself, in the form of credit, credit default swaps (which measure the risk of default), rating agencies, and all those agencies involved (such as Wall Street investment banks) to collapse. Some of them still do exist, not all have met the fate of Bear Stearns. However, we still have not seen the true value of Level 3 assets of many firms, so we haven't even started the bad news. There are instruments not even the so called 'quants' understand, let alone executives, and certainly not the retail investing public. So who is really at fault? In any case, one should acknowledge the existence of these risks, develop a plan, and act accordingly. Let's assume that the DOW will be 15,000 by year end and the USDX returns to 90 and there is a new Pax Americana fueled by foreign investment: but what if there's not?

Prepare for the worst, hope for the best. There are not any plain solutions of what to invest in, with a minor exception of Ag-commodities and farms. However, there are clear signs of what NOT to invest in. The best recommendation is to wait for an opportunity to present itself, and be ready to pounce. In rural areas, some property values have increased by over 300% in the past few years.

Elite E Services develops and trades foreign exchange trading systems. Our systems' are market independent, because they are traded on price models only. In other words, our strategies may as well be trading the price of computers (if this were traded electronically) or the price of Oil. FOREX happens to be the most liquid trading market, and recently the most volatile, providing many opportunities for trading. Regarding risk in FX, FX itself is not a risky market per se, but the risks involved in trading can be risky if the FOREX manager decides to over leverage the account. Recently, EES has developed account protection modules on our systems whereby if the account value drops below 5% (can be adjusted), trading is halted and positions are closed, pending manual restart. This allows us to sleep at night, in the event of something going haywire (which has never happened by the way, but better to be safe than sorry).

EES returns last month were slightly positive but nothing too exciting. FX is not a sprint, it's a marathon; better to earn a steady 5% per month than have a 20% month and then blow up. But like any other trading market, the risk in FX needs to be dealt with. EES understands the risks involved, and they are explained to clients, and handled appropriately. Why no one in the housing market dealt with risk appropriately is a mystery. Is it safe to assume that those who lost in the last 5 years in housing are not capable of assessing risk?

However, one must assess risk, it should be appropriate for your situation. How EES manages FX risk and how a business manages it's credit risk are obviously totally different animals. But a prudent approach and a general model can serve as a foundation for developing a risk strategy. When Congress was interviewing Stan O'Neill, he was asked if Merrill Lynch had a risk model in place, and the answer was "yes, but it didn't forecast this." In Congress, that is sufficient to end the hearing and move on to the next topic.[v]

Developing a Risk Model

Establish the context: Establishing the context involves

1. **Identification** of risk in a selected domain of interest
2. **Planning** the remainder of the process.
3. **Mapping out** the following:
    - the social scope of risk management
    - the identity and objectives of stakeholders
    - the basis upon which risks will be evaluated, constraints.
4. **Defining a framework** for the activity and an agenda for identification.
5. **Developing an analysis** of risks involved in the process.
6. **Mitigation** of risks using available technological, human and organizational resources.

Identification

After establishing the context, the next step in the process of managing risk is to identify potential risks. Risks are about events that, when triggered, cause problems. Hence, risk identification can start with the source of problems, or with the problem itself.

- **Source analysis** Risk sources may be internal or external to the system that is the target of risk management. Examples of risk sources are: stakeholders of a project, employees of a company or the weather over an airport.
- **Problem analysis** Risks are related to identified threats. For example: the threat of losing money, the threat of abuse of privacy information or the threat of accidents and casualties. The threats may exist with various entities, most important with shareholders, customers and legislative bodies such as the government.

When either source or problem is known, the events that a source may trigger or the events that can lead to a problem can be investigated. For example: stakeholders withdrawing during a project may endanger funding of the project; privacy information may be stolen by employees even within a closed network; lightning striking a Boeing 747 during takeoff may make all people onboard immediate casualties.
The chosen method of identifying risks may depend on culture, industry practice and compliance. The identification methods are formed by templates or the development of templates for identifying source, problem or event. Common risk identification methods are:

- **Objectives-based risk identification** Organizations and project teams have objectives. Any event that may endanger achieving an objective partly or completely is identified as risk. Objective-based risk identification is at the basis of COSO's Enterprise Risk Management - Integrated Framework
- **Scenario-based risk identification** In scenario analysis different scenarios are created. The scenarios may be the alternative ways to achieve an objective, or an analysis of the interaction of forces in, for example, a market or battle. Any event that triggers an undesired scenario alternative is identified as risk - see Futures Studies for methodology used by Futurists.
- **Taxonomy-based risk identification** The taxonomy in taxonomy-based risk identification is a breakdown of possible risk sources. Based on the taxonomy and knowledge of best practices, a questionnaire is compiled. The answers to the questions reveal risks. Taxonomy-based risk identification in software industry can be found in CMU/SEI-93-TR-6.
- **Common-risk Checking** In several industries lists with known risks are available. Each risk in the list can be checked for application to a particular situation. An example of known risks

in the software industry is the Common Vulnerability and Exposures list found at http://cve.mitre.org.

- **Risk Charting** This method combines the above approaches by listing Resources at risk, Threats to those resources Modifying Factors which may increase or reduce the risk and Consequences it is wished to avoid. Creating a matrix under these headings enables a variety of approaches. One can begin with resources and consider the threats they are exposed to and the consequences of each. Alternatively one can start with the threats and examine which resources they would affect, or one can begin with the consequences and determine which combination of threats and resources would be involved to bring them about.

http://en.wikipedia.org/wiki/Risk_management

"Victory is reserved for those who are willing to pay it's price." - Sun Tzu

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[i] See google news Food Riots http://news.google.com/news?q=food+riots&ie=UTF-8&oe=utf-8&rls=org.mozilla:en-US:official&client=firefox-a&um=1&sa=N&tab=wn Food Riots Bangledesh, Army called in http://www.hindu.com/thehindu/holnus/001200804122173.htm Food Riots Haiti http://africa.reuters.com/world/news/usnN12264858.html

[ii] http://www.usatoday.com/news/topstories/2007-11-19-2045876918_x.htm Operators of free food banks say they are seeing more working people needing assistance. The increased demand is outstripping supplies and forcing many pantries and food banks to cut portions. Demand is being driven up by rising costs of food, housing, utilities, health care and gasoline, while food manufacturers, wholesalers and retailers are finding they have less surplus food to donate and government help has decreased, according to Lisa Hamler-Fugitt, executive director of the Ohio Association of Second Harvest Foodbanks.

[iii] http://www.bloomberg.com/apps/news?pid=20601103&sid=aonDdgoWQ.pg&refer=patrick.net ``It will be the biggest housing-price decline since the Great Depression,'' Heebner, 66, said today in an interview in Boston. Prices may fall by a fifth in some markets, he said.

[iv] http://www.ft.com/cms/s/0/3e3dc394-07be-11dd-a922-0000779fd2ac.html?nclick_check=1

[v] http://en.wikipedia.org/wiki/Stanley_O%27Neal About Stanley O'Neal http://money.cnn.com/2008/03/07/news/newsmakers/ceo_pay/ CEO Pay Congressional Hearings