

Investment & Risk Management – A view from off the beaten track

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Views

- Being able to come up with a view and to communicate it is a valued commodity in Financial markets
 - Why?
 - Does it matter if these views are correct?
- Intention of this talk
- I will come back to this later...



Importance of the Big Picture

- **Enterprise Risk Management – a Health Warning!**
- This course is not intended to provide the definitive recipe for risk management, and indeed has no intention of suggesting that risk can be reduced without cost. In the real world, the material in this course has to be applied in the appropriate context. Just going through the motions of implementing ERM, without truly embracing its ethos, can increase the bureaucracy of an organisation and could even damage it.
- Risk management needs to complement whatever existing commercial competitive advantage that an organisation has. The consequences of any additional workload added to the commercial side of the business must be considered, and consideration should always be given as to the most efficient way that any extra workload can be added.
- Individuals need to behave professionally, recognising that other people may have different views to their own and that these people may be correct. Much of the material presented in this course is subjective, and the consensus as to what is best practice may change over time.
- Individuals need to have an existing base of wisdom and understanding of an organisation, both from the risk and commercial side before applying the material in this course to that organisation. **A lack of appreciation of this “bigger picture” (or perhaps even worse, a belief by the individual that they do have this appreciation when in fact they do not) will likely sabotage any attempts to improve risk efficiency in an organisation.** Indeed, this is the essential idea of the ST9 course: that Enterprise Risk Management of an entire organisation is superior to individual



Dynamics of a Capitalist Economy

- The Big Picture
- Increased Volatility
 - Aim of a capitalist system
 - Technological Improvements
 - More risk can be taken
 - Market autocorrelations not zero
 - Wider involvement
 - Average smartness and mental health
 - Greater risk of manias
 - Financial economics
 - The next boom could be huge!!
 - The next fall would be more scary than the last one



Getting involved in Financial Markets

- Three ways to make money in Financial Markets
 - Luck – but!
 - Working harder and having better judgement than others – tough!
 - Knowing things that others don't know.
- Only sensible option for most people is #2
 - But! What is your Risk Intelligence? (www.projectionpoint.com)
- Fallacy about 50% winners and 50% losers in Financial Markets
 - Reality is 1 in 7 win, about 3 in 7 lose a little, and 3 in 7 lose big.
 - Survival rates in the CME. - Evolution of markets



Getting involved in Financial Markets

- A psychological prerequisite to be successful in financial market investment and trading.
- Having a specific competitive advantage is also a prerequisite
- You must have an edge!
 - Inside the box, outside the box, on the edge of the box
- An important characteristic for an actuary is persistence. For a trader or fund manager, the important characteristic is vitality.



Risk Intelligence

- Definition:
 - Risk Intelligence (RQ) is a measure of how well a person can assess their self knowledge in order to accurately estimate probabilities.
- Actuaries are traditionally seen as highly skilled in relation to the logical and rational sides to managing risk. Risk Intelligence is related to the emotional, irrational and psychological sides to managing risk.
- Broader Definition: How well does somebody know yourself!
 - *He who knows others is wise; He who knows himself is enlightened.* Lao-tzu



Risk Intelligence

- A new area:
 - Should Actuaries try to enter this space ?
- Opportunities for the profession to both improve its RQ levels and become established in the use of RQ testing and the implementation of remedial actions to improve RQ levels.
 - Unlike IQ and EQ, RQ can increase with training.
- Why are actuaries not using these techniques in Investment Manager Research?



Freud

- An appropriate balance between the ID, the Ego and the Super Ego.
- Example.....
- The function of the Ego is to protect our conscious from emotional shock.
- Working in as a fund manager/trader is hazardous to the Ego and mental health.
- Mental strength and good mental health are prerequisites



Fashion & Finance

- Comparison between Financial Markets Industry and the Fashion Industry
 - Both have a huge attraction to a lot of young people
 - The majority ‘want’ or ‘desire’ to be a ‘trader’ or a ‘fashion designer’
 - But albeit most of these do not have what it takes (the competitive advantage) for one reason or another, whether that’s related to their attitude, their psychology, or their acumen.
 - However, most of these people do enter these industries and indeed make up the majority in the industries. A proportion of them are helped by relatives.



The Irish

- Ethic composition of the 'risk takers' on Wall Street
 - Approx half being Jewish or Jewish decent
 - Approx half Irish or Irish decent
 - Only about 10% WASPs
 - » Craig Donohue, CEO CME Group
- Unfortunately for Ireland, most of its traders, FMs leave the country!
 - Good for London, Wall Street!
 - Emigration as a selective decrement



Risk Astuteness

- Pessimism of the Intellect, Optimism of the Will
 - Positive people,
 - Negative people.
 - People who look at everything that can go wrong and when they are comfortable with what can go wrong, they are willing to go ahead.
- F.R.O.G.
 - Avoiding ‘fear based thinking’
 - Minimising regret risk
 - Not getting carried away
 - Not being Greedy



Financial Economics / How Financial Markets Work

- 100 year old – compare to other sciences.
 - Rationality Assumption – nonsense!
 - Why learn about it?
- Financial markets are about astute people taking money from un-astute people
- Kant:
 - Three things grow stronger in me the further I make my way through my life: the starry skies above me, the moral law within me, and the law of the jungle around me.



How Financial Markets Work

- The most complicated thing in the world
- The market price is determined more by the combined folly of the market than by the combined wisdom of the market.
- Each participant is operating at a different level of ignorance
- Models of the market generated from aggregations of these participants - and allowing for interactions.
 - Inefficient Market Models
 - Logical thought needs to better encapsulate illogical thought



Summary

- The Big Picture
- The Dynamics of a Capitalist Economy
 - Implications for Solvency II
- Having a Competitive Advantage / an Edge is essential
- Risk Intelligence
 - Measuring the Emotional, Psychological & Irrational sides to Managing Risk
- Characteristics of Market Participants
- How Financial Markets work



Q&A

- Thank you for your attention this afternoon
- Comments/questions to colm.fitzgerald@dcu.ie
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