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Hodgepodge of Issues

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This newsletter covers a number of topics but without the usual analytical detail.

Home Mortgages

One side effect of deflation (or low inflation) is that it makes it harder to relocate to a new job in another part of the country. If your mortgage is under water, in an inflationary environment the increase in nominal value of a home can bring it back above water and thus easier to sell. If rates are low this is harder and keeps the unemployment rate a bit higher than it otherwise would be.

The World According to Nassim Taleb

In Taleb's Black Swan world, he defines the regions of mediocrastan and extremistan. Mediocrastan is a world where statistical distributions reasonably reflect reality and economic fluctuations can be modeled. A good regulatory policy in that region would be to let the invisible hand work and let it evolve on its own. On the other hand, extremistan is an area where fat tails rule and deterministic stress scenarios are helpful. When times are exceptionally good or bad the regulator should step in and kick start the mean reverting process as trust in the system becomes a systemic risk in and of itself. They should prick large bubbles and provide liquidity for large crises. (unfortunately when politicians get involved the definition of large is impacted, with large bubbles left alone and small crises requiring action)

Efficient Markets (Not)

Market liquidity occurs only when there is a difference of opinion. Market values move with marginal trades. If markets were truly efficient at all times it would not matter what asset you bought.

Investing

Research shows that much, if not all, of total equity returns come from dividends. If that is the case, should companies be discouraged from retaining earnings? It seems to indicate that earnings not paid out are wasted.

Pension valuation discount rates and asset allocation should vary based on the age of the plan and life cycle of the company that backs it. The fiduciaries should overfund in the early years when the dollars are small to build up a cushion, and discourage contribution holidays. Historically these plans have been guaranteed to fail by valuing them over the plan's lifetime but increasing benefits or granting a contribution holiday when there was a temporary excess. These plans need to project out far into the future and include stress

tests where the company enters the downside of its life cycle. Can the pension plan survive on its own? Insurers with pension plans should view their support the same way they support an insurance policy.

Insider trading by governmental employees, especially those who are elected, should be a criminal offense.

Enterprise Risk Management

A practitioner's definition of ERM varies with the level of expertise they have. Beginners talk about downside risk, those gaining experience but who have not lived through a downturn look at optimization, and senior members of an ERM team define risk as the likelihood that pre-defined goals are not met. Where is your management team on this curve? Where is your regulator? Where are you? Does your definition vary between personal, career, and firm goals? (don't be surprised if the answer is yes – I find people are more experienced when dealing with personal affairs than with those of their firm since rocking the boat is discouraged)

A simple stress test ignores the benefits of diversification in a portfolio (of assets, liabilities, or a combination of both). This elegant solution is easy to explain and provides an outer limit.

China Collateral Damage

If China scales back, even if it doesn't have an especially hard landing, countries growing rich by providing commodities to it will be hit hard too. Specifically, Australia and Brazil have grown by shipping resources to China.

It is unknown what the ultimate impact will be as China opens up external markets for its investors. We are seeing signs of bubbles forming in high end markets like art and high end real estate as there is lots of cash trying to get out. Some are looking for diversification while others are looking for a safe harbor in case their own status falls.

Fracking

The Democratic embrace of fracking has led to a number of consequences and flipped traditional political stances. Since a Democrat, Obama, was in the White House when fracking became functional the Democrats will take credit for the current account deficit reduction and lower cost of energy. But there is a potential downside. Especially if ground water contamination or seismic damage occurs, voters will revolt.

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