REAL UNDERSTANDING OF RISK

By Daryl Guppy

During the week another academic study of risk crossed my desk. As soon as it revealed that the study used university students as subjects and that the risk questions involved making or losing $5, I stopped reading.

These studies claim to explain how we perceive risk and reward but they are absolute rubbish. Traders and investors routinely put $5,000 or $10,000 or more at risk. How you react to that risk is very very different to the way you react to losing the price of a cup of coffee – even if you are a student. The biggest risk here is getting burnt by coffee that is too hot.

Drop a $5 note on the footpath and many people will simply not see it, or ignore it. Drop $5000 on the footpath and you will have a riot. Scale makes a difference, but this does not seem to be understood by PHD candidates and academics who use fellow students to study risk behaviour and reactions.

These studies are farcical, and their conclusions nonsensical. Yet they form the rigorous research basis of much of what we are told about managing risk in the market.

I apply the same reaction to any market commentary that includes a coin-toss or gambling analogy as an example of understanding risk in the market. The use of these childish and inadequate understandings of market risk is often repeated by highly paid fund managers who should know better. If what they say is true then the proprietary bank trading rooms stuffed with traders are just a waste of time and the consistent profits they generate for the bank are an illusion.

Here's an example of this ignorance from a well-known Australian fund manager who has spoken at Investfair. He was writing in an educational note for other Australian fund managers and advisors.

"Technical analysis treats the stock market “as a gambling den". It's tantamount to betting on black or red at the casino."

With this poorly constructed thinking is no wonder that your fund manager grows fat while your account balance grows slim.