

Understanding Risk

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The global economy is often described as a machine. The problem with this analogy is that machines operate in the physical world where there is a strong link between cause and effect. Outcomes in the physical world are often deterministic. This is why we can accurately predict the motion of distant planets or the precise time of a solar eclipse down to the minute.

The same cannot be said of the economy. A recent [study by the IMF](#) showed that economic forecasters all had one thing in common – an almost unblemished record of failure to predict recessions. This does not come as a surprise because outcomes in the economy are complicated and probabilistic. Outcomes are affected by a multitude of variables that are often difficult to measure. The economy behaves more like an ecosystem than a machine.

Some of the best lessons about risks in the financial markets can be understood by studying the natural ecosystem. 'The beast in the garden' by David Baron tells an intricately woven story about hidden risks in an ecosystem. The lessons in this book transcend the confines of the natural world and investors stand a lot to learn from it.

Mountain lions in North America were notoriously elusive and tended to avoid contact with humans. In the 1960s, farmers slaughtered the lions in large quantities to protect their livestock and hunters also killed the big cat for sport. The environmental movement in the '70s made this killing rather unfashionable and over time, the population of mountain lions started to grow again.

Wolves were also a victim of the killing spree in the '60s and were the mountain lion's biggest natural enemy. Without wolves around to pester them, the mountain lions grew bolder. Lower wolf populations increased the population of deer, a favourite dish of the mountain lion. Now the deer are very [loyal to their territory](#) and as humans started to encroach on their land, they were not so willing to relocate.

You can already guess what happens next. Bold mountain lions which never experienced aggression from humans hunted deer that lived near humans. In total, 14 mountain lion attacks on humans have been verified in California since 1890 and the clear majority of these have occurred after 1992.

What does this story have to say about risks in the financial markets? Risks are dynamic and often go undetected for a long time before they become apparent. If we look at the global financial crisis of 2008, no one could precisely predict the timing or the magnitude of the crisis. However, some good investors were aware of the risks building up in the mortgage market.

Warren Buffett for example was [aghast](#) when Alice Schroeder, his biographer, told him she had bought a house in 2004. Michael Burry (from the Big Short) understood the risks better than anyone else. He understood that the ecosystem of the housing market had changed and mortgage defaults were artificially low because of low teaser rates. Once the adjustable rates kicked in, many homeowners realised they could not afford the houses they bought. This was the start of the crisis.

Housing was traditionally viewed as a safe asset however, a mixture of bad incentives and greed transformed it into a very risky asset. This is the true nature of risk in the economy. Its effects cannot be precisely measured and often take years to build up.

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