

**Portfolio Stochastic Design Scans:
A Rational and Emotional Market Paradox**

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“ In the end, how your investments behave is much less important than how you behave. ”

**Benjamin Graham
The Intelligent Investor**

Market Behavior and Simulation Models

As 2008 and early 2009 markets are demonstrating they do not always play by the rules economists create. Books by Nassim Taleb do a good job of exposing the limitations of modern portfolio theory, which assumes markets are perfectly random and efficient. They are and they are not. The behavior of markets that are both rational and emotional usually relates to different time scales and Taleb's book "Fooled by Randomness" is a good place to read about that topic. This note is about the paradox of fiscal and emotional market behavior at the same time. The essence of paradox is contradiction. In free and open markets over multi-year periods, risk behavior can be simulated well most of the time using random probability distributions and stochastic simulation methods. Black Swan market behavior is another matter. It cannot be predicted but its consequences can be anticipated and mitigated.

The Problem of Central Dogmas

Crises of confidence caused by dogmatic errors are not limited to financial behavior. I owe my life in part to the death of a central dogma in medicine that Judah Folkman spent his life proving wrong. He demonstrated that cancer tumors are angiogenesis dependent after a thirty-year war with the oncology establishment, which denied it existed. Central dogmas in medicine and other sciences also have a way of becoming celebrated in Academic circles to the point that it takes a Folkman, a Galileo or a Darwin to expose their limitations. Is that the reason for the liquidity crisis today?

The central dogma being discussed here and recently in the N.Y. Times by Joe Nocera is the wide spread use of “Value at Risk” to make virtually all banking and investment decisions in the recent past. Once again demonstrating that you cannot reduce all decisions to a calculation. Something senior management seems to have temporally forgotten. Risk models cannot predict Black Swan events but they can still be useful in predicting most probable mean value risk in my opinion and in the opinion of many others.

The current Wall Street liquidity crisis is mostly a failure of common sense in senior management over a two-year period. It was also a failure of the SEC who thought that disclosing VaR data was enough to insure that another L.T.C.M. would not happen. The value at risk was compounded by greed and incompetence and exploded in late 2008. The explosion caused a lot of collateral damage making us all victims especially those without enough cash to wait out the crisis without selling assets. That is the best way to mitigate Black Swan events.

What does the prudent investor do in the mean time? Make sure the liquidity margin of safety you had in 2007 is still intact. Take time to read the Prudent Investor Act or one of W. Scott Simon’s Morningstar essays on the subject and try to be as patient as you can, *medio stat virtus*, virtue lies in moderation. Keep in mind that Taleb is a trader not an investor and only made money three times in his life, the crash of October 1987, the dot.com crash and today. He made his fortune off investors who sold in a panic, not by investing prudently.