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| **Uncertainty and Risk in the Suicide Pool****By John Mauldin | September 29, 2012****New Publishing Schedule for *Thoughts from the Frontline*****Jumping into the Suicide PoolProbability Theory and Retirement PortfoliosObsessing on Risk, Ignoring Uncertainty****An Uncertain SpainOrlando, Portland, Atlanta, and South America** “By ‘uncertain’ knowledge, let me explain, I do not mean merely to distinguish what is known for certain from what is only probable. The game of roulette is not subject, in this sense, to uncertainty; nor is the prospect of a Victory bond being drawn. Or, again, the expectation of life is only slightly uncertain. Even the weather is only moderately uncertain. The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence, or the obsolescence of a new invention, or the position of private wealth owners in the social system in 1970. About these matters there is no scientific basis on which to form any calculable probability whatever.”* John Maynard Keynes, *The General Theory of Employment,* 1937

“… there are known knowns; there are things we know that we know. There are known unknowns; that is to say there are things that, we now know we don't know. But there are also unknown unknowns – there are things we do not know we don't know.”* Donald Rumsfeld, Secretary of Defense, 2002

“There are four types of men: 1. One who knows and knows that he knows... His horse of wisdom will reach the skies.
2. One who knows, but doesn't know that he knows... He is fast asleep, so you should wake him up!
3. One who doesn't know, but knows that he doesn't know... His limping mule will eventually get him home.
4. One who doesn't know and doesn't know that he doesn't know... He will be eternally lost in his hopeless oblivion!”
* Ibn Yami, 13th-century [Persian](http://en.wikipedia.org/wiki/Persian_people)-[Tajik](http://en.wikipedia.org/wiki/Tajik_people) poet

For the past 80 years, we have created ever more sophisticated models of risk in the economic and investment worlds. With each new tool we create to measure risk, we seem to think we have somehow gained more control over our future. Paradoxically, we appear to believe that the more we understand risk, the more we can somehow control our exposure to it. The more we build elaborate models and see correlations between events and the performance of our investments and the economy, the more confident we become. And if by some ill fortune we encounter a period of lengthy stability in our models and portfolio performance, we are likely to imbibe a cocktail of collective hubris: we actually think we understand some things in a quantifiable way. We thereupon seek to take on more risk at precisely the time when additional risk is the most disastrous. This week we explore the difference between risk and uncertainty. Perhaps we can even tie all this into our understanding of secular bull and bear markets.**New Publishing Schedule for *Thoughts from the Frontline*** But first, for those who missed this week’s announcements about new activities at Mauldin Economics, let me very briefly summarize. Beginning next week, *Thoughts from the Frontline* will be written on Sunday afternoon/evening and hopefully arrive in your inbox early Monday morning. *Outside the Box* will now come to you on Friday for your weekend reading pleasure.The reason for this change is, frankly, that it is taking me longer and longer to write *TFTF.* I jokingly suggest to friends it may be because I have quit drinking and lost the inspiration of wine and scotch. But for the most part, it’s the sheer amount of material I consult while writing, coupled with the complexity of our world. As a consequence, I find myself walking and thinking about what I write more than ever.Plus, the alcohol *might* have been a way of self-medicating my ADD. Or maybe I'm just getting older, and the policemen who stop me at night on my walks around the neighborhood are right to think I am somewhat confused.Whatever the reason, Friday afternoons in the early years became Friday evenings and then morphed into Saturday mornings. Which means my weekend was shot, taking away some of the pleasure I get from writing. Regardless, I think the new schedule will improve the letter, as well as give me some more time to think about the events of the week just past, and the week ahead. Finally, regular readers of *Outside the Box* are familiar with Grant Williams, who writes the wickedly brilliant *Things That Make You Go Hmmm….* Grant has very graciously agreed to allow Mauldin Economics to become the publisher of his letter, and it will become a regular part of our offerings to you. Grant is an addictive essayist, and I think you will soon agree with me that he is the best “new” writer to come along in a very long time.  We have also announced a new publication, called *Bull’s Eye Investor,* a monthly newsletter that Grant will also write. Grant manages $250 million in a hedge fund in Singapore, with a total global mandate. We are philosophically very close in how we approach investing and the markets, and I’m excited that he will be writing what will become our flagship publication, bringing the same global perspective to his specific recommendations. [You can click here to learn more](http://www.mauldineconomics.com/bulls-eye/learn-more). Now, since the above amounted to mostly known knowns, let’s embark on a trek into the world of uncertainty.**Jumping into the Suicide Pool** My oldest son Henry and my son-in-law Allen Porter are both in their late 20s, perfect gentleman, appropriately humble, engaging, and thoughtful young men. Unless you are talking about sports, when they become opinionated, overly self-confident, and quite willing to share their intimate knowledge of the subtleties and nuances of sports in general but football in particular. For the last few seasons, my friend Barry Habib has enticed the three of us to participate in what is known as a Suicide Pool.A Suicide Pool is a betting pool – with a twist. Starting with the second game of the season, participants simply have to pick one winner out of all the games that are played that week. There are no point spreads involved and no handicaps. All you have to do is predict just one team that will win that week. Every week, if you like, you can pick the team that is the most heavily favored to win. There are no restrictions on your choices.At the beginning of the season you “invest” $100 into the pool. And you stay in the pool as long as the team you pick wins. If more than one person survives to the end of the season, the winner is decided by cumulative point spreads. If you go out the first week, you are allowed to buy back in for $50 plus a point-spread penalty.Notice the word *if.* Having done this for a few years, I have noted that the survival rate is actually quite small. The trick is not to pick close games but just to survive. But even if you are trying to choose the safest picks, every now and then there is a secular bear market among the top teams. So, I bought spots for Henry, Allen, and myself. Since I know absolutely nothing about what teams to pick, Henry and Allen chose them for me. My only instructions were to choose the safest pick and never to choose the Cowboys. It is bad enough to have the home team lose without losing your money as well. After 50 years, I’ve had too many heartbreaks watching the Cowboys to want to bet on them.I figured the Suicide Pool would give us guys something to talk about and share a few laughs over, at least for a few months. But as US football fans know, in the past few weeks there has been the equivalent of a market crash rivaled only by the NASDAQ in 2000-2001.This year has been a disaster for us Suicide Poolers. We started with 148 in the pool. We lost 78 football “experts” (!) in the first week, but 57 of those (including your humble analyst) had enough hubris to buy back in to the pool. (The winner would get $17,600 – enough to keep you fully invested.) After a second straight week of major upsets, there were only 21 people still standing, or about 14% of the original 148. Even worse, only eight (about 5%) were able to pick two winning teams in a row.Note that my brain trust picked two prohibitive favorites, the least risky choices available. They agreed with my plan to avoid risk and also agreed on the teams we should all choose, rather than diversifying our risk. I went with my experts. We chose the New England Patriots the first week and the Pittsburgh Steelers the next. And we were not part of the elite 5%. No family-time discussions and debates, just commiseration and licking our wounds. I was hoping that at least one if not more of our chances would carry us a few months into the season, providing us with some good times, making game time a little more interesting – the whole thing seemed like a good investment at the time.(Clearly, my choice of investment advisers this year has not been optimal. Wait till next year. Only, next year I’m going with the real sports authority in the family, my daughter Abbi.) **Probability Theory and Retirement Portfolios** While this is a cute story, there is, sadly, an investment implication. While no one would call betting on football an investment (except a bookie, and he is really investing in human frailty and probabilities and not, strictly speaking, football), all too often investors approach the markets in a fashion distressingly similar to my approach to betting on football. You either think you are an expert on the stock market, or you hire someone whom you think is. And while we are a great deal more serious about our investments, here too we try to pick safe investments that will last us for the long run. We use models to outline the probability of success or failure, and all too often we ignore the low probabilities that would be absolutely disastrous if they came about. In most places and in most times, withdrawing 5% a year from a retirement portfolio is a reasonable approach. But not in all places and certainly not at all times. Your retirement plan should not be the investment equivalent of the Suicide Pool. Many investors are told that it is safe to take 5% of their savings each year to spend on retirement. And the history of the last 110 years suggests that on average this is true. But every now and then people retire at the beginning of a secular bear market. Taking out 5% at such times is about as safe as betting on football.  My friend Ed Easterling at Crestmont Research did some very basic research which shows that if you retire and decide to keep your retirement savings 100% in stocks, then if you begin to invest your savings at a 5% withdrawal rate during a period when stocks are in the highest 25% of the historical average of valuation (P/E ratios), about 5% of the time you will be out of money within 23 years. And this outcome has a probability that we can model. Of course, we can’t tell you what your actual experience will be, but we can demonstrate that you are involved in risky behavior! Typically, investors are comfortable taking such a risk, because at the end of a secular bull market stocks have been performing well for a very long time. All the models show the bull will continue – or at least the ones you get to see. (You can read Ed’s full report at <http://www.crestmontresearch.com/docs/Stock-Retirement-SWR.pdf>.) **Obsessing on Risk, Ignoring Uncertainty** Investors in the stock market, especially professionals, are obsessed with risk, your humble analyst included. We try to measure risk in any number of ways, looking for an edge to improve our returns. Not only do we try to determine probable outcomes, we also look for the “fat tail” events, those things that can happen which are low in probability but will have a large impact on our returns. I have found that it was the surprises that were not in my model that were the true drivers of portfolio performance. We like it when surprises produce a positive result, and we often find a way to congratulate ourselves for our wise choices. No one in 1982 thought that price-to-earnings ratios would rise by five times in the next 18 years. Yet that simple driver accounted for 60% of the last bull market (20% was inflation and only 20% was actual increased earnings). And while a few people began to invest in technology in the early ’80s, many of those early technology stocks ended up being disasters. (Remember Wang? Osborne? Sorry, I know, you were trying to forget.)“In 1910 the British journalist Norman Angell published a book called ‘The Great Illusion’. Its thesis was that the integration of the European economy, and by implication the global economy too, had become so all-embracing and irreversible that future wars were all but impossible. The book perfectly captured the zeitgeist of its time and fast became a best seller. “In some respects, the early 20th century was a period much like our own – one of previously unparalleled global trade and exchange between nations. Human beings appeared largely to have outgrown their propensity to mass slaughter, and everyone could look forward to to a world of ever increasing prosperity. War, Angell compellingly argued, was economically harmful to all, victors and defeated alike. Self interest alone could be expected to prevent it happening again.” (Jeremy Warner writing in *The London Telegraph)*On the eve of World War I, bond markets throughout Europe were not pricing in a conflict. Everyone “knew” there would not be a war. It was all bluff and bluster. And then the world got a surprise. Archduke Ferdinand was assassinated and armies began to march. And while no one expects a war today in Europe, there are certainly plenty of tensions.**An Uncertain Spain** The Spanish government announced this week a rather severe austerity budget. They promise they will hold their budget deficits to 6.3% while slashing spending almost 9% and raising taxes. And of course there will be no wage increases for government workers. They also assume that growth will only fall to -0.5% in the face of that austerity, which most observers think is woefully optimistic. Even though the ECB has committed to buying Spanish bonds, they have made it clear that they will do so only as long as Spain is committed to bringing its deficit under control. “European Central Bank Executive Board member Joerg Asmussen said on Friday that he would only support purchasing the bonds of struggling [euro zone](http://www.reuters.com/subjects/euro-zone) countries if pressure on them to reform their economies remained high. ‘Only under strict conditionality and only if there is continued pressure to reform,’ Asmussen said of the bond purchase plan announced by ECB President Mario Draghi earlier this month.” (Reuters) And if things were not already difficult enough for Spanish Prime Minister Rajoy, one of my favorite regions of Spain, Catalonia, which includes the beautiful city of Barcelona, is seriously talking about seceding from Spain. As much as 20% of the population (1.5 million) turned out for a march supporting independence last week.  Prime Minister Rajoy met with Catalonia’s president and flatly rejected any autonomy or more money. Catalonians are not happy that they send a great deal of money to Madrid, which goes to other regions as they deal with their own crises. So much for “all for one and one for all.” The situation is complicated by the fact that the Basque region of Spain has been given a great deal of autonomy in its budget. If Spain were to compromise and give Catalonia the same deal, it would cost the Spanish government a great deal of money and enlarge the already gaping hole in their budget.“Separately, the parliament of Spain’s most economically important region, [Catalonia](http://www.ft.com/cms/s/0/cfec73de-07dd-11e2-9df2-00144feabdc0.html), approved holding a referendum on independence. Ms Saenz de Santamaria threw down the gauntlet to Spain’s most economically important region, arguing that Madrid could use a constitutional measure to block any attempt at a separatist vote. ‘Not only do instruments exist to prevent [a referendum], there is a government here that is willing to use them,’ she said.” *(The Financial Times)*Casually browsing news on the Catalonian crisis, I came across an article on previous referenda concerning independence, held on a city-by-city basis in Catalonia. Independence was favored in nearly all cities by margins of 90% or more. This was rather surprising to me, as I am not certain I could get 90% of my neighbors to agree on the time of day.In addition to the Basque and Catalonian regions, there are two other northern Spanish regions that send net revenues further south. If you give Catalonia budgetary autonomy, let alone political autonomy, then what do you do for the other two?Which brings up the uncertainty in the entire euro project. It is one thing to create a common market in which goods and services can freely trade. It is another to impose monetary and fiscal authority on a sovereign nation. If economic tensions within the regions of Spain begin to move voters to push for independence from central control, how much more inclined will voters in the various eurozone nations be to do so?Germany is just now entering a recession that has the real potential to get much worse. If Germany is asked to write checks and send them to other countries when they are in the midst of their own financial crisis, how will that play in Bavaria?The only thing I can be certain about regarding Europe is that Europe is an uncertain mess. But the markets go on treating all these pressures as if they were not real. And, indeed, perhaps the mess will all get sorted out. It is my belief that we focus on risk because it is something that we can model. The economics profession has physics envy. Economists like to think of themselves as scientists, but I must say that I am not convinced. Economics has a great deal to teach us, but it cannot tell us much about certainty. It can’t even help us all that much to avoid risk.I fear we don’t pay enough attention to uncertainty because we cannot reduce it to an equation. How did you price in the risk of Catalonia succeeding from Spain, even two months ago? The answer is that no one did.The US market seems to be focused on the “fiscal cliff” that will inevitably create a recession unless Congress does something. The fact that doing nothing will clearly create a recession gives me some confidence that even Congress will figure out a way to avoid doing nothing. What has not been priced in is what Congress will do about the deficit. Depending on what they do, what we get will be hugely positive or negative. But we remain totally uncertain as to what they will actually do. And so for years we have ignored the looming train wreck that is unfunded liabilities. It is the fact that the results of inaction on the deficit are uncertain that allows Congress to keep postponing the inevitable. “About these matters there is no scientific basis on which to form any calculable probability whatever.”We live in most uncertain times.**Orlando, Portland, Atlanta, and South America** I am in New York tonight, writing as I look down on Times Square. Starting Sunday afternoon I’m booked solid with meetings until I get on a plane to Orlando on Tuesday afternoon. Monday night Tom Romero and I will host a dinner for a few friends. What started out as a small dinner has grown into a small crowd. There will be between 20 and 25 of us seated around a square table so that we can see and talk with each other. I have decided to give everybody a yellow flag they can throw at any time to comment on another participant’s musings. Only one flag per night per person, but that should make it interesting. Too many names to mention, so let’s just say, the usual suspects. Okay, two names. My Dr. Richard Roizen is coming, and he is bringing someone called Mehmet Oz.I will be at the UBS conference with my partners from Altegris and will also spend an evening with my good friend Pat Cox, who writes *Breakthrough Technology Alert.* I am sure we will talk about the latest technologies and especially those that may help both of us fight off the ravages of growing older. Pat has the prototype of a new “toy” that he is raving about. I have been able to procure a prototype as well, and if it works even half as well as the study results out of Stanford suggest, I will let you know. Just think of me as your friendly neighborhood guinea pig. I will go to Portland the following week to speak for Common Sense Investments, and they have invited me to stay the next day and go pheasant hunting. I have never been pheasant hunting, let alone hunting at all. These are brave people who will hand me a shotgun and walk with me into the field. I will try not to do a Dick Cheney. And for all of you animal lovers, let me note that any bird I shoot at has a high probability of being missed. And that means I’ll also be taking them out of range from anyone else who could actually shoot them.Care to join me election night, November 6 … in Argentina?  From October 28 to November 8 I'll be in Brazil, Uruguay, and Argentina, speaking to regional chapters of the CFA Society. As part of the trip, I'm stopping by for the season-opening celebration, November 5-10, of friend and partner Doug Casey's lifestyle and sporting estate, [La Estancia de Cafayate](http://www.laestanciadecafayate.com/?Adv=7e8ac), where I'll host the group at a café on the scenic town plaza and watch the election results roll in.  If you'd like to join me and a group of interesting folks from around the world in what promises to be a unique experience, drop Dave Norden a note at LiveMore@LaEst.com. David Galland has promised nonalcoholic beers for me for the evening. The recent polls suggest I might want something stronger, but I think I can hold out. My oldest son, Henry, was having some problems as I left on this trip to Atlanta. Sitting on the plane, I got a message that they were testing his appendix, and that evening as I landed I learned they were taking it out. Oddly, I was relieved, as the symptoms he was having were making Dad nervous, given that he has early-onset diabetes. He is doing fine. But an event like this does bring the health-care debate up close and personal. On October 17 I am in Atlanta once again for Hedge Funds Care.I fly back home on Wednesday, where I will watch the first Presidential debate with my youngest son, whose teacher has assigned him that task. The next morning I turn 63. I hope my new toy helps – I need all the help I can get. I’ve also added a few new supplements that are just appearing on the radar screen. As I said, I am just a living guinea pig. If I notice anything, I will let you know.It is time to hit the send button on what will be our last Friday night/Saturday morning newsletter. I stop here knowing that I will get to write next Sunday, rather than all night Friday, and I really believe I’ll be more efficient. We’ll see! Have a great week, and you might check out early voting – I already have.Your going to sleep till the crack of noon analyst,John Mauldin |
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