

The Nature of Risk

Stock Market Survival & the Meaning of Life

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THAT FIRST DIVE

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Foreword to the Second Edition

If there is any change or addition at all that we would make to the first edition of *The Nature of Risk*, it is that risk has become an addiction—in the sense that the addict is convinced it's entirely safe for him (or her) to take a risk, even if not for others; and then needs to keep expanding and extending and exaggerating that behavior to stay "high." One can see this clearly in young people because their recreational risk-taking has gotten ever more extreme, but even the gray-haired are more and more willing to take what they don't even think of as risks any more—in the real world as well as in the stock market. The fine line between calculated or considered risk-taking and reckless behavior has been stretched to the extent that what previous generations considered "risky" or "too risky" is now acceptable behavior, and what only crazy or daredevil people would do is now called an "extreme sport."

This spreading addiction has, as we write this, created a widespread and quite comfortable notion that the stock market bears little or no risk at all ... even while it is going down. The experience of seeing the averages go up and up and up, or watching it come back up after having dipped, has erased the sense of equity risk. Shares of stock have become what in grandpa's day was considered "money in the bank." The margin clerk used to be the boss of losses, but many traders who've borrowed on margin don't even know what a margin call is. A brokerage house recently wrote (as boiler-plate): "Trading in futures and commodities is considered highly speculative and only *true risk* capital should be committed to it." ... "true risk?" as if there is also pseudo-risk, quasi-risk, semi-risk, false risk, temporary risk—and no risk at all?

Who would have thought that risk would become non-existent. The notion of choice as determining whether one's act is risky or is fated separates accident from risky behavior, but choice, as a deciding factor, has lost its previous moorings in society's guidelines. A profligate culture is profligate about risk, too. Sexual language in the press and on TV, nudity in the movies, old fogies living together in what they once would have thought of as "in sin," have all expanded to the point of becoming so socially acceptable as to be non-issues. Risk itself, and risk-taking, has followed that same path from "Not me" to "I'll try it." The conservative investor still thinks of himself as conservative, but is more and more willing to buy what a generation before would have been considered speculative stocks (while the generations before that believed even blue chip stocks were more risky than bonds). Day-traders, trying to reduce the risk of their speculations by trading 10 or 100 times a day, are engaged in what previously would have been called sheer gambling, like pulling the handle of a slot machine quarter after quarter all day. No one believes they are gambling any more, and few if any would consider that they were speculating, or, indeed, taking any risk at all. "Over the long-term, it'll come back up," hides a multitude of risks.

It is this separation of behavior from the nature of risk that is different than—or, more accurately, is an extremist extension of—what we wrote a decade ago. Can it go to an even further extreme? probably not more than a 'steenth more; the pendulum should begin to swing back toward prudishness. Risk always gets rationalized, but we did not imagine that it could be rationalized out of existence. As bungee jumping lost its thrill, the search for something even more extreme came to glacial canyoning, and youngsters probably are pursuing other "sports" we've never heard of and perhaps never will, unless or until there is yet another front-page tragedy. Similarly, there are newcomers to the stock market now who are shocked to learn that stocks can go down. The belief that one puts one's money into the stock market and it goes up (20% a year, 30% a year, or whatever degree of avarice is desired, as if one will always have a winning lottery ticket) has become a legend in its

own time ... even as others have already lost six figures trying to trade, and have done so in an old-fashioned way—by ignoring, by defying, by not understanding the nature of the risks that were taken. Investors will cease to open the envelopes of their monthly statements in order to keep risk out of sight.

How did risk disappear? or, at the least, how did risk become so much less risky? It was always understood that adolescents had no sense of mortality for themselves, although they grasped “death” for their cat, or for an aged grandparent, or for those other kids who crashed into a telephone pole after the senior prom. One wonders if they know how final suicide is ... in the same vein that one wonders if a trader knows how much real money can be lost no matter how often they mutter “it’s only a paper loss.” And so they come to the stock market world unafraid of risk. In the old days, we used to not mind this—it was considered “good” for them to lose some money early, just as a teaching tool. But now they lack fear, as if it were an unnecessary appendix—and their parents, too, have become part of that herd mentality. To them, the “long term” solves any and all dangers, turns risk of loss into temporary-ness ... death somehow is not final any more.

**** A man sitting next to me on the airplane, watching me post my pile of daily charts, finally asked: “Wouldn’t it be easier to use a computer?” Easier, yes, we tried to explain, but not as useful. There are now many available services on the internet which provide charts in various styles, but: (a) you have to know which stocks to ask the computer to show—and thus (b) will inevitably miss some, especially those out of the mainstream or acting in a contrarily interesting manner; (c) you lack the feel of patiently watching an otherwise not-with-it stock chart gradually evolve in a useful pattern; (d) it doesn’t save time because one has to wait for each chart to come up on the screen; and (e) has to be printed out for reference if one is to do something; and most significantly (e) the scales used on computer-driven charts are infernally different, scrunched,

inconsistent, and therefore often deceptive. When posting a pile of charts by hand day after day, with only a sharpened pencil as tool—that is, posting each stock’s objective action—one is compelled to “feel” the action, to begin to sense potential changes, and to wonder, as if coming to the end of a chapter, what is going to happen next. There’s is nothing more confrontational than owning a stock that has begun to trade poorly right under your pencil point or that begins to act positively when everyone is telling you how awful its news, or the “market,” is. In the midst of posting a chart, one confronts the very nature of the risk, and the choices, involved in each stock, and one gets a sense of where the market’s life is, its dangers as well as potential.

Each helper along my path through Wall Street—Helene Meisler, Amy Goldstein, Kara Kavanagh, and now Linda Di Filippo—has started by asking the same question: “Wouldn’t it be easier...?” but has come to “feel” the same objective usefulness that I’ve long believed in. Doing charts by hand (on semi-log paper) is not the end-all and be-all, but it helps meet the market’s challenge, sort of like playing chess against a live opponent instead of a computer. I want to thank and re-thank each of them for helping me, and hope they all have similarly long careers.

The **N**ature of **R**isk

The Future Is the Risk

THE first word parents want a baby to understand and respond to is not *Mama* or *Daddy*—it's *No*. How is anyone going to learn to venture, to take a risk, when "No" resounds?

Parents and baby may exchange smiles, but as soon as the baby wants to take a risk—that is, do something venture-some—the infant hears: "Don't touch that," "Watch out," "Be careful." From infancy's earliest days, taking a risk becomes a negative concept. Parents know all about the dangers of the world. There's the hot stove, the steep stairway, the electrical outlet. Infants believe they can crawl across the entire universe, unaware of the edge of the bed. Have you ever noticed the surprised look on a mother's face when she realizes that the baby actually saw the danger ahead and paused on the edge, without her having to yell "No"? Mothers and fathers don't trust their supposedly bright baby to have any intuitive sense at all. "Watch out." "Be careful." "Don't" becomes a family motto.

Parents become consumed with anxiety about the terrifying risks their baby is taking, an anxiety absorbed in turn from their parents, from the news, from experience itself. Wanting the best for our children, we begin by trying to protect them from harm, from hurt, from loss, from risk itself.

Have you ever seen an infant, about to take a wobbly step or creep around the corner, turn back to look at his parents for

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reassurance—asking not only if it is safe to proceed, but also, is it permitted?—before he'll venture forth. "Don't" becomes, as we get older, "Look before you leap." The anxiety that breeds such phrases—however well intentioned—translates into an anxiety about every potential action. We worry about potential harm, potential hurt, potential loss, just as our parents worried on our behalf when we were too little to know any better. Taking a risk may mean divorcing, getting fired, or having to face parents', teachers', or a spouse's wrath. It also includes the way we view the stock market: an anxiety about the potential loss of money. "Don't." "Be careful." "Look before you invest."

Of course, as we toddle ahead into life, we are forced to, or are taught to, overcome certain anxieties. Our parents leave us behind to go out to dinner by themselves, we scream in terror, but they go, and they come back, and we've survived. Gradually, we scream because we don't want them to go, not because we're terrified; the lurking learned insecurity makes us want to control what happens next. The *uncertainty* of the next moment, the next hour, the next event, becomes the anxiety. What will happen? *The future is at risk*. Off we go to school, hand held, but are then compelled to go inside by ourselves where there are new "Don't"s and more "Be careful"s; one of the lessons of the school system (and later, of course, the army) is that the future is less at risk if you do what you are told.

Eventually, having been filled with all the warnings about crossing the street, we are permitted to walk home from school alone and learn to proceed so easily that it seems as if we are no longer anxious at all. Caution becomes rational, sensible. Somewhere deep inside, what is still a risk—crossing the street—has become natural. We step off the curb with scarcely a second thought because we have learned how to deal with that risk by looking both ways even when the light is on our side. *Deal with it, not eliminate it*. There are those who dart across recklessly between cars or, at the other extreme, the person, perhaps elderly, who steps off the curb, falters, gets out into the lane, takes two steps more, two steps back, finally retreats to the

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curb. That is, there are those who take risk to the extreme of trying to ignore or defy it, and those who have become so intimidated that any risk at all confuses and paralyzes.

◆◆◆◆ Everything is risky. Our childhood experiences, from the outset, are contained. What our parents have done is to have fed us, along with mother's milk, a steady strain of negative comments about how to proceed. They strapped us into walkers, they put gates on the stairways, they snatched dirt out of our mouths. Kids become scared of dogs simply because, as they come near, a voice calls shrilly: "Be careful, he may bite." No one ever suggests to a toddler: "Why don't you go see what's around that corner?" An infant knows no risk; all is ahead. Parents know all is risk, and try to protect. The child learns what the parents teach, and a world that starts out full of possibilities becomes full of limits and danger.

Nor does this sense of danger disappear as we gain experience. To the contrary, a new risk develops: ego risk. It was okay to risk taking a tentative first step, and then to fall, because, presumably, one's parents provided a safe environment. But if they laughed, or scoffed, and somehow made the toddler feel that failure—instead of renewed adventure—then the first ego-risk jolt has occurred. Why do we marvel at that folk saying that states if you fall off a horse you should get right back on? because it seems so daring, so full of risk, to try again so soon. Wouldn't you be embarrassed to fall off again? then people might say, "What a dope, didn't you know enough to walk?"

We come into adolescence with fear of failure as a new risk: the opposite sex won't like you; the teachers don't believe in you; how are you ever going to be an adult unless you do what your parents say and take no risks? Stage fright, or its equivalent, is everywhere, and everywhere understood: the less you expose yourself, the less danger of failing.

You can see this in sports very clearly. "Choking" under pressure separates the second stringer from the star. The difference between the top tennis players in the world, and the next rung down, Billie Jean King once said, is not the strokes—at that

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level, strokes are approximately the same—but in the mental attitude. The top players play to win; the others play the game so as not to lose.

When it gets to be match point, some players become tentative and hit the ball carefully. Often this kind of player is so fearful of losing that he actually double-faults at match point. The sense of ego risk does him in. In contrast, the top players continue to drive the ball from the first point to the last; when behind, they try to serve an ace. And by playing past the anxiety of the risk, they win. Even on a club level, tennis players will tell you anecdotes of how they were behind 5-0; deciding they were going to lose anyhow, they simply started to hit the ball; that ease, with nothing at risk anymore, took them to 5-5, whereupon the ego risk returned. As soon as they might win, the caution returned and produced the tentativeness that caused them to lose.

We know, of course, of the people who boast of their stock market winnings—and never say a word about the stocks they have losses in. They may believe that it is a loss on paper, and hence not a real loss, but it isn't a mirage to their ego—that's what they are protecting. (They boast about profits on paper, don't they? as if those are real.) Will you think less of them? Will their spouses refuse to go to bed with them if they have a big loss in their portfolio, if they aren't perfect? Ego risk, whether in sports, business, or the stock market, causes hesitation, faltering, and, therefore, failure.

As we get older, risk of loss becomes focused on not being able to take care of oneself. Retirement appears to be an extremely risky venture. For the sake of security, many people take, and stay in, jobs that produce pensions. In effect, they give up the best years of their lives to bureaucratic jobs so as not to face what they think of as the perils of old age. Ego risk is not as much a factor as self-risk. "Look before you leap" becomes "I can't take a chance anymore."

◆◆◆◆ Such language innately defines risk as negative. I've taken the risk of defining the word without first looking it up in

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the dictionary. Now as I open the pages (Webster's Collegiate, 5th edition), here is what I find: "Hazard; peril; exposure to loss or injury." I'm right, then. Imagine: peril! There's nothing positive about risk. "Exposure to loss or injury." No wonder parents worry. In the dictionary, the word *risk* invariably refers to danger.

We grow up in such a pervasive atmosphere of caution that it becomes astounding when we read about, or see, someone who actually does take risks willingly, skillfully, successfully. The venture capitalist, the entrepreneur, the firefighter, the batter with two strikes on him in the last of the ninth, the person who leaves a vice-presidency at age 42 to go to law school or to farm—all those who risk money, security, and the possibility of failure are so unusual nowadays that they have become folk heroes. And even more astonishing: there actually are a few people who never consider risk at all; they just do.

Were they never told "No"? Were they never limited as to where they might crawl? or what they might read? or what they might believe? Or was it the reverse? so restricted that they broke free, using defiance as a form of defense. How does one become able to venture forward without anxiety? *How does one use risk positively?*

◆◆◆◆ We are not talking here about foolhardiness, or defiance that smacks of self-destruction. Someone else can analyze the person who searches out the extreme risk of hang gliding or parachute jumping as a Sunday afternoon sport because anything less doesn't satisfy, or who, knowing the risk, believes he alone is the one who can stick a needle in his arm and not get hooked.

Children without parental "Don't's" are less likely to understand danger, as if the word is not in the language of their growing up. Such acts as holding onto the back of a bus moving up Broadway, leaping between subway cars, or a casual, even effortless, use of drugs express, it seems to us, both anger and defiance—but in part might be a language lack, too. The very notion of danger to street kids may be incomprehensible in the

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sense in which a suburban goody-goody has been brought up to understand it. When *all* is risk, as war is, or the street, or cancer, there is *no* future. "What the hell" derives from that sense, in contrast to a more standard "The future is at risk" so "Be careful." Thus it is *fear of the future* that risk magnifies.

There are degrees of risk to which that dictionary word *peril* clearly apply, risk beyond what can be measured and turned into a positive—and yet someone somewhere will take that kind of chance. Russian roulette is an extreme of risk, an "exposure to loss" that suits reality as well as the dictionary.

Foolhardiness, defiance, sheer gambling, and other extremes aside, *if there are ways to learn to evaluate what a risk is, and whether it is worth taking, and, indeed, whether it is actually less risky than not taking it—turning the notion of risk into a positive—it may be that we can translate such answers into our own too-often too scared, too anxious behavior.* If we can learn not to choke up on match point, but rather to stroke positively, then we can learn not to choke when buying and selling stocks. *Here we have a "security"—already there is a built-in semantic implication of anti-risk-taking—that needs to be challenged. What is there about risk that can be used to produce better stock market performance?*

◆◆◆◆ Let's examine one daily life situation—crossing the street—to see what the risks are: When risk is examined in terms of the moment-to-moment decisions—stepping off the curb being an assumption of risk with all the dictionary negatives of hazard, peril, exposure to danger, but also with a positive: to get successfully to the other side—*risk is at its core making a choice.* It is a form of binary Yes/No, for Maybe merely postpones choice.

Crossing the street involves an absolute danger: a car coming can hit you and knock you down, injuring or killing you. Therefore we have learned certain safety rules: Cross at the intersection, with the light in your favor, and not in the middle of the block. We also know that some drunken driver, or crazy cabbie, could go careening through the red light and clobber us.

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So we are taught to look both ways before crossing. If we follow these rules we ought never to get hit by a car while crossing the street.

But then, getting a little bolder, we come to believe that if we follow the second rule—looking both ways—we can safely cross in the middle of the block. It's a bit more of a risk, because we don't have the protection of the traffic light, but still okay. And suppose we are in a hurry. Can we simply rush across—looking as we leap? The need to get to the other side impels us. But why? to save 30 seconds we forget all we've been taught. Suddenly, going against our own best judgment, we rush out into the street even as traffic is coming—"sure" we can get across ahead of that onrushing truck. But suppose we slip, or stumble on a pothole? That moment's risk, for the sake of saving 30 seconds, does us in.

Clearly, then, we can either take what we know about proceeding safely and turn it into an assumable "safe" risk, or, in a moment of thoughtlessness, actually take an unnecessary risk. In these days of terrorists and hijackings, you frequently hear the expression "Everything's a risk—I could get hit crossing the street." But we can reduce the risk of crossing the street. It is within our control, even when trying to beat the truck, to determine the degree of risk; the timing—do we need to run?—and sense of how far away the truck is can be measured visually and through past experience. Comparing crossing the street to activities that are beyond our control is an apples versus oranges kind of comparison.

Although infinitely more complex, *the stock market is more like crossing the street*. (Those professorial types who throw up their hands and claim the market is unpredictable simply don't understand the nature of market risk.) We can learn all manner of careful things to do. The more careful, the slower we have to proceed—get to the intersection, wait for the light to change, look both ways while pausing for that last taxi to sneak through, and then proceed to a very carefully defined goal: nothing more than getting to the other side safely. We could still get clobbered by something unexpected—perhaps an angle

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we have failed to consider, a car emerging that we missed, or even, as may more often be the case, being so unsure, too tentative despite our precautions, that we move too slowly; as the light changes back, we become trapped in an untenable position.

There is no perfect, risk-free way to cross the street. There are varying degrees of risk, up to and including the foolhardy. But if we do it right under the prevailing circumstances—how heavy is the traffic? how far to the other side?—we can succeed even if we ignore the parental warning of crossing only at the light. It may not be important enough to take that added chance, but that, too, is something that must be factored in: *how important is the risk?*