Facing a year of decisions

1. Yet another conundrum

When representatives of the central banks are puzzled, they don't admit it, or at least not directly. Rather, because they feel they ought not to find themselves in such a situation, they conceal their lack of insight behind impressive phrases, or, better still, puzzles. There is indeed some sort of intellectual appeal to discussing puzzlement in terms of puzzles, and a master of the art was undoubtedly the previous head of the Fed, Alan Greenspan. Almost till the end of his long term of office, he was renowned for the way his speeches, which mostly lasted for hours, avoided saying anything really tangible. He even spoke in riddles when there was nothing puzzling about the topic. So, when in 2005 he found himself confronted by an apparently unanswerable question, he took refuge behind a similarly incomprehensible answer, as if he were a doctor obliged to communicate a terminal diagnosis. The magic word was "conundrum". "A logically deduced contradiction that is not susceptible to a simple resolution" undoubtedly sounds better than "perplexity" or "helplessness", for there is a notion that perplexity or helplessness is not an option for the head of an institution whose only value resides in the confidence that a global public places in it.

That particular conundrum concerned a peculiar situation with regard to interest rates and the US dollar. It was also, if we're right about this, the first sign of the subsequent catastrophe in the financial system. For it was in 2005 that the degree of momentum that was being generated by the global players in the system – the big banking and insurance conglomerates, the investment banks, the non-banks operating in their orbit, such as hedge funds and "Special Purpose Vehicles" – began to become apparent. They were all speculating on one and the same scenario: the continuation of the (so far) extremely successful monetary policy of "gradualism", combined with the Fed's guarantee of liquidity, which washed all the real problems away. This mass speculation in one and the same direction resulted in distortions in supply and demand for money at various terms, and this was the source of Greenspan's conundrum. The voices of those who thought that there was really no conundrum at all were too few and too weak – or the message too unwelcome – and so the party was allowed to carry on. Two more years of boom – nice.

We might feel that conundrums should be relatively infrequent, for, firstly, today's highly scientific approach to economic theory should leave little unclarified. Secondly, in purely morphological terms, "conundrum" is linked with "Cassandra" – an unwelcome state of affairs when it concerns the future intrinsic value of one's own assets. Thirdly, there is a vague feeling that the existence of irresolvable contradictions might be not unrelated to the far too frequent occurrence of catastrophic events in the financial system.

The fact is, however, that we are again confronted with a puzzle, or rather, several puzzles. As we are not central bankers, we prefer to talk of perplexity or helplessness, not least in the belief that those who admit honestly to their current lack of knowledge may acquire and enjoy trust and confidence. Our problem is a constellation of developments that should theoretically not be simultaneously possible:

- Firstly, we have this year all observed, and to some extent benefitted from, a significant global boom on the stock markets. This can be equated with more or less positive expectations concerning companies' future revenue situations. The (mostly successful) cost reduction programmes launched by many companies by no means justify the rise in their stock prices. Rather, the rise anticipates strong growth in future cash flows, which implies a significant improvement in the economic situation. Put another way: the stock markets are reflecting the expectation of an end to the recession, followed by a sharp upturn.
- However, the bond markets seem to be sending a contradictory message. Over the year, returns have fallen again, to the benefit of creditors; the interest rate curve would be relatively flat, were it not for the disproportionately low short-term interest rates resulting from an extremely accommodating monetary policy. The

bond markets offer no signs of an imminent upturn, and certainly no indication of inflation. The credit markets too indicate stagnation, or even a further decline in economic activity on the part of the Western industrial nations. The central banks' exceedingly generous monetary policy seems to be having absolutely no impact; bank lending is at a historical low. This is not what either an upturn or imminent inflation look like.

- The price of gold, however, seems to suggest something different again. Gold races from peak to peak. What, if not the expectation of imminent depreciation, would motivate market players to buy and hoard a precious metal that generates no revenue and has little direct application in the economy?
- Lastly, we also encounter contradictory signals from surveys of the prevailing mood, and in particular sectors of the economic system. While almost all manufacturing surveys indicate an improvement in the situation, the facts look a good deal more sobering. In the USA, sales for private consumption, building permits, construction expenditure and corporate investments are at best stabilizing at a low level. Unemployment has reached 10 percent; were this to include the unregistered illegals, those whose entitlement to benefits is exhausted, invalids and those working involuntarily on a part-time basis, reliable estimates indicate a figure of over 15 percent. Where in the world do the companies surveyed find their optimism? And who will be the consumers of all the products that will flood the markets after investment picks up again?

Look at it how you like: a combination of rising stock prices with lower returns on bonds, coupled with record prices for gold and the discrepancy between the prevailing mood and the facts, must raise serious questions. What we would of course like to do is to arrive at clear conclusions based on consistent analysis. Let's be clear: this is not going to be possible. But we'll do the analysis anyway.

2. What is truth?

Analysis! Analysis? What does it actually mean? Normally, the gathering of some facts, to the extent that they are indisputable, and the application of a model that seems appropriate to the case in question. "Appropriate" in the sense of its ability to explain and to forecast. This is what we all do, day in, day out, and the result is somewhere between sobering and shattering. For even those who, for instance, had in some way anticipated the technology bubble of 2001 and the subsequent recession; even those who warned of excesses in the run-up to the financial crisis of 2007, must admit that their whole choice of language and their behaviour patterns remained almost completely oriented on their experience of normality, and this normality did not include the cumulation of extremely extreme events.

The model that underlies our thinking, explicitly or implicitly, is based on the assumption of a normal distribution of events; that is, a continuous distribution of the probability that events will occur. It is continuity alone that enables statements (and thus forecasts) that things appear to be "highly improbable" or "highly probable". This model enables calculations to be made and potential future stress situations to be modelled. Thus, for example, according to a paper by Mark Rubinstein, professor of applied investment analysis at Berkeley, a day on the stock exchange on which stock prices drop by 29 percent has a probability of 10^{-160} with a (normally observed) volatility of 20 percent. Such an event should not have occurred during the entire existence of the universe (probably around 20 billion years). So, we might regard ourselves as lucky to have experienced such an event just once. The probability that we might experience it (or something even worse) is extremely low. But in fact it happened extremely recently in terms of billions of years: in the legendary crash of 1987.

Of course, the real problem lies not in the occurrence of this unique event in 1987 – that might happen, even if the probability is extremely low. It lies in the objectively ascertainable cumulation of similarly disastrous events in the subsequent decades. 1998, 2001, 2007: this is a good deal too much. Put differently, the explanatory power of models based on normal distribution is low. For our purposes, they are useless, devoid of explanatory power, pointless.

The only serious critics of the received wisdom that we see are the mathematician Benoît Mandelbrot (*The (Mis)behavior of markets*, 2004) and the economist Nassim Taleb (*The Black Swan*, 2007). Mandelbrot, who recently spoke at an event in Zurich organized by our bank, had already pointed to the discontinuities in probability distribution in cotton prices in the 1960s. After co-founding "chaos theory", he then returned to the financial markets at the beginning of the century. His warning was clear enough: risks occur in clusters, and much more frequently than we think, but are impossible to forecast specifically. Mandelbrot's risk distribution has been described as "wild randomness". The accusation has been

made that his theory is useless, because it cannot be used for forecasting. As if the insight that things can go wrong much more frequently than generally expected were not in itself a forecast to be taken seriously!

In *The Black Swan*, Nassim Taleb not only reiterates Mandelbrot's insights, but also provides them with theory and application. His key insight is that while *"black swans"* are relatively infrequent, they are not as improbable as generally assumed. On the contrary, they actually *dominate history*. Models based on normal distribution, such as Markowitz Optimization, CAPM, the Black-Scholes Formula, the Sharpe Ratio, and so on, are all unusable. Volatility without reference to differing time periods is not suitable for the measurement of risk. Betting against so-called improbable extreme events can end in disaster. In a new working paper (*Errors, Robustness, and the Fourth Quadrant*, 2008), Taleb advocates the development of a risk landscape containing four categories:

- A category of simple, proven structures, where the occurrence of events can be calculated easily. The purchase of a sunshade for the garden in the winter sales would belong to this category of risk, which Taleb describes as "extremely robust".
- A category where the events appear complex, but the probability of occurrence is clear. Structured products of the type we avoid, with pay-out structures dependent on various factors (such as the "worst of" products, which ultimately deliver either a fixed amount or possibly the worst performing stock), but which are guaranteed tradable at any time on a secondary market, belong in this category. According to Taleb it is "quite robust".
- The third category, also "quite robust", contains easily comprehensible structures that may easily fall victim to extreme events. Those who build holiday chalets at the edge of a slope down which no avalanche has thundered "in living memory" are operating in this category.
- The fourth, and most dangerous, category ("not robust") contains risks where the occurrence of events is dependent on many factors, and where it is virtually impossible to calculate probability. A large number of political processes, whose outcomes are well outside economic (and thus forecastable) efficiency belong in this category, and with them, sadly, the rights to life, liberty and property defined by these political processes. But it now also seems that the constellations on the financial markets have become far less "robust"; not least, perhaps, on account of the ultimately politically motivated implicit state guarantee for very big players in the system, and the resulting distortions, which are way beyond any idea of economic efficiency.

The big question now, however, is how to think about the risks in the fourth category – by far the most crucial ones. If the current models are unusable, what can replace them? If linear extrapolation produces excessively optimistic results, what alternatives are there? If we cannot avoid the black swans – risks of the fourth kind – in life and in business, but we wish to limit their impact as much as possible, how can we have any idea of them? For without some idea of what one is trying to contain, it will be impossible to contain it.

Deduction and logic alone are unlikely to suffice. It's more likely that we need to do something that people have always done, but have done less and less since Descartes and the Enlightenment: we need to tell tales and stories. The many myths and sagas, the Holy Scriptures, Grimms' fairy tales, and the Thousand and One Nights: it is here, and not just in logical deduction, that we will find the stuff with which we can turn the future, with its opportunities and risks, into a time that is imaginable for us.

That may sound dangerously esoteric, but it isn't. For when rigorous, rational methodologies fail as blatantly as they have been seen to do in the financial crisis, any kind of arrogant superiority with regard to apparently less scientific methods would be quite out of order. The philosopher Paul Feyerabend (1924–1994), wrongly dismissed as the anarchist of economic theory, has pointed to the inadequacy of pure logical deduction, and tried to give more prominence to empirical methods. With his "Anything goes!" he provoked his colleagues in order to open the way for theoretical pluralism. Feyerabend was convinced that more help is often to be found in popular stories than in scholarly papers. He also provided, if we're right about this, a recipe for dealing with Taleb's fourth category of risks, for "black swans" in one's own personal environment: "What matters is having a few friends around – that's all". A piece of advice, as attractive as it is simple, for protection against risk. The consequences of the absence of genuine friendships, often to be observed among wealthy rational optimizers, are all too obvious when extreme events occur, whether of a medical, family or monetary nature.

Very good then: let's make up some stories! Let us try to turn the currently highly contradictory conditions into scenarios that make sense for our

purposes, or at least have some entertainment value as stories.

3. Scenario I: the comfortable "lazy L"

It is evident that not only has the financial crisis seen the implosion of a banking system based on excessive debt and hyperactivism, but the lengthy period of entirely unproblematic financing has also created distortions in the real economy, which will now be corrected in the global recession.

This phenomenon of distortions with real consequences and the necessity for real corrections is most obvious in the case of Dubai. The results of an excessively low threshold for project finance are plain to see. In a place in which it is only possible to be outside for six months of the year at most, and in which everything is literally artificial, who in the world was supposed to fill the thousands of offices, hotel suites and penthouses, and pay vast sums of money for the privilege? Vacant properties were a foregone conclusion. It is said that credit buys time. But too much credit generates too many ill-considered projects in too short a time. That is the problem with excessive debt. It was the case in the American real estate sector, it was the case in Dubai, and it is also the case in the balance sheets of various, mainly European, banks, that have been happily stuffed with Dubai risk. (According to an estimate by Morgan Stanley, of the current 113 billion dollars of Dubai risk, 87 billion is held by European institutions, 50 billion of which by British ones. What was that about lightning never striking in the same place twice?)

The financial hype was – and still is, in some parts of the world – reflected in the exuberance of the real economy. This perspective also explains the partial paralysis of the global economy, made manifest in the collapse in cargo rates towards the end of 2008. The financial crisis provided an occasion for releasing the excessive pressure in the global economy, and because this happened abruptly, a significant amount of collateral damage was unavoidable. Overall however, apart from this tectonic shift downwards, *little has changed in the basic structures of the global economy*, which means that from about 2010, business can continue unhindered, if at a lower level. The development of the economy would thus resemble a slanted, "lazy L": sharp drop, gentle recovery.

The roles of the individual economic blocks have also changed little, and without any additional signs of real crisis. American consumers will tendentially become less important, but they will remain the dominant source of demand for goods from the Far East. This is reflected in the still significant balance-of-trade surpluses that the Asiatic countries have vis-à-vis the USA. Europe will be able to resume its lucrative export of capital goods. Any company in this sector that has improved its productivity through cost reductions will be able to continue to exist with this lower level of sales; greater demand will improve margins in due course. To this extent, the profit improvements already anticipated in stock prices seem not unrealistic.

Economic development at this lower level will not, though, be sufficient to generate inflationary pressure, given the productivity improvements. On the contrary, there is still enormous global overcapacity, which will put a sharp stop to any upward pressure on prices. As in this moderate scenario there is little room for political pressure for protectionist moves, regional and sector rigidities will play only a secondary role. This also means that the central banks will be able to keep interest rates low for a long time. An end to "quantitative easing", the radical provision of liquidity by means of a zero-interest policy and the inflation of the central banks' balance sheets, remains some way off. And as all the important central banks in the system – the Fed, the ECB and the Bank of England – are following more or less the same policy, there will be no abrupt shifts in currency relationships.

The banking system benefits greatly from this monetary policy of the central banks. Essentially, the financial conglomerates can take on debt at no cost and, at minimal risk (!), deploy a quantity-based strategy to earn generous revenues effortlessly. Those who still have some clearing up to do can get on with it calmly, and everyone else can return to the habitual frivolities of excessive bonuses and political arrogance.

And what of Dubai? And the further billions of write-offs that Dominique Strauss-Kahn, the Director of the IMF, recently said would be required in the global banking system? We'll muddle through, see-sawing between hope and fear; from time to time some institution with deep pockets, such as the Abu Dhabi Investment Authority, will step in to prevent a return to the acute phase of the financial crisis. The Western nations, heavily burdened by the consequences of the financial crisis, will begin to come to terms with their new levels of debt. As nominal interest rates will continue to be low, debt servicing will remain feasible. The continued inflation of the central banks' balance sheets will mean that the necessary

treasury auctions will be able to be held relatively unproblematically.

No doubt about it: this "normal scenario" represents a *continuation of the developments* in 2009, in the direction of a *somewhat better future*. It does not seriously contradict the current development of stock market prices, and nor are the low returns on bonds unjustified with an "L" that is not heading upwards too sharply.

4. Scenario II: the blood-red abyss

The rising price of gold and the rapid increase in credit risk premiums for national finances in the wake of the Dubai crisis are the first signs of an inexorable spiral that will end in the downfall of the Western industrial nations, in the abandonment of their function of ensuring order internally and externally, in a chaos of increasingly illusionary promises made to the various social groups without the capital to honour them, in greater protectionism and an inclination towards expropriation, and ultimately in violence. *Abyssus ruber*, a blood-red abyss brought about by the radical increase in the already almost hopelessly excessive level of debt in the USA, Japan, the United Kingdom, Germany and other European countries, in the wake of the financial crisis.

The additional debt turns out to be essentially unproductive, as it only serves to maintain the notoriously inefficient structures in the financial system, to cement in place the sinecures provided for the big financial conglomerates by the implicit state guarantee, and to perpetuate the distortions in the real estate sector and the short-term saving of face in industrial policy (car manufacturers!).

Political errors, particularly on the part of the USA, aggravate the situation in that, on top of the already existing reservations about America's debt situation, measures are taken that increasingly deter foreign capital from financing US debt. The Foreign Account Tax Compliance Act of 2009, on top of the already extremely off-putting plans to reform the Qualified Intermediary system, and together with the inclusion under American inheritance law of tax liability for foreign holders of American securities, with high rates of progression, begin, slowly but surely, to erode the basis on which America is financed. The US dollar comes under increasing pressure, not least as powerful voices in the country, such as the bond expert Bill Gross and the stocks guru Warren Buffett recommend greater diversification. At a certain point in the erosion of the currency, and under the impact of a crash on the bond markets – the creditworthiness of state debtors is no longer accepted globally – the Americans are obliged to raise interest rates at the worst possible moment.

Meanwhile, the world as a whole is seriously *disappointed* by the way the *economy develops*. What had been described as stabilization at a low level turns out to be merely a plateau on the edge of the next abyss. The stimulation packages for car manufacturers and home owners turn out to be expensive flashes in the pan – in fact, mistaken investments. The US real estate market falls by a further 20 percent, and General Motors finally ceases production. In Europe, the medium-sized companies, which had managed so well during the first phase of the crisis, are seriously wrong-footed, as they had just started to ramp up production. Given their already stretched financial situation, bankruptcies are inevitable. Politicians behave erratically, pressure from the street on business grows, and results in many cases in outbreaks of violence.

The guiding light of 2009, the Peoples' Republic of China, experiences in 2010 one of its most dangerous internal crises. As American imports dry up, large, labour-intensive enterprises have to be shut down; it proves impossible to absorb the hordes of unemployed workers elsewhere in China. The result is social unrest, which increasingly threatens the tender shoots of an emerging middle class. Uncertainty settles like a leaden cloud over the Chinese colossus.

And so on. There's not much fun in outlining the future Armageddon in the style of a pulp novelist. But seriously: can all this, and even worse, really be dismissed out of hand? A Russian futurologist recently forecast the collapse of the USA and the possibility that Russia might get Alaska back. Apart from the notion that Sarah Palin might then one day become President of Russia, such scenarios often appear to be little more than irrational fantasies. The thing is, the history of the world is full of such irrational courses of events. So, in our view, it would be unwise to devote too little attention to the consequences of such "blood-red abysses". They do exist; indeed, historically speaking, there is little else. And there is this: *Abyssus abyssum invocat* – one mistake leads to another. Proverbs, too, belong to the treasury of mankind, along with myths and legends.

5. Scenario III: the East is golden

This story too starts with the rising price of gold. This rise is due to continuous, secret purchases of gold by the central banks of India and China. In part, the banks are interested in diversifying the excessive currency reserves held in dollars, but this is not all; they are also preparing for the

launch of an Asian alternative to the US dollar as the monopolistic reserve currency. Backing such a currency with as much gold as possible is one aspect; another is the preparation of a market for Chinese treasury bills issued via the financial centre of Hong Kong. For the Chinese, crassly underestimated in the West as mere copyists, have, as accurate observers and excellent economists, realized why the euro has never been able to win a position as a serious reserve currency: because it lacks a liquid market for risk-free paper. In Hong Kong, they have a versatile platform, oriented both inwards, in the interest of investments in mainland China, and also outwards, towards the global financial universe, which is well known to be thirsting after diversification possibilities – for zero-interest Treasury bills have only a limited appeal.

The key *eastern countries* are currently enjoying a robust *upturn*. India, always characterized by a strong domestic economy, is successfully dismantling significant internal trade barriers. With its Anglo-Saxon legacy, it is increasingly coming to represent a significantly more youthful clone of Europe. The low level of debt enables Indian companies not only to keep pace with the current wave of innovation, but at times to play a leading role in it.

After many years as the last bastion of real socialism, bleeding its labour force dry and flooding the world, and the USA in particular, with the cheap goods they produced, China began in 2005 to distribute the national assets that had accumulated at the highest level of the state, by means of enormously ambitious and extremely rapidly executed infrastructure projects. The millions of engineers, craftsmen and other workers are achieving a degree of private prosperity, and moving upwards to form a sort of middle class. This middle class corresponds in size roughly to the population of the USA or Europe. At the same time, the Chinese are cautiously beginning to spin the strands of a social security network. The Chinese savings rate falls in parallel with these developments: the Chinese have become consumers. Growth, the only determinant of political stability in China, enables the regime, nominally communist, but de facto an oligarchy with monarchical characteristics, to retain control without significant problems.

Both neighbouring countries (Hong Kong, Taiwan, South Korea) and those further away (Indonesia, the Philippines, Australia, New Zealand) benefit greatly from the Chinese upturn and stability in the east. The whole region orients itself on the new reality of the shift in the global balance of power. To what extent changes in security policy occur, to reduce the dominance of America in this part of the world, remains, however, uncertain.

Europe and the USA are battling with an economic “double dip”. The economy collapses for a second time in 2010, as the disadvantages to the western industrial nations of excessive state debt and overindebted social security systems become manifest. The forces of reform have not yet managed to regroup, however. Thus the new coalition in Germany completely drops the ball played them by the electorate, and tries to force through tax increases, instead of freeing the country and its citizens at last from the burden of excessive solidarity. The President of America’s halo has long faded; the hoped-for leader has become a mere cheerleader, no longer taken seriously by his weary and shrinking public. The only companies benefitting from the Asian boom are those that still had sufficient financial room for manoeuvre after the first phase of the recession, and that were able to get sufficient finance for their investments from the banks.

For one thing has become clear. Not only has the economic geography of the world changed; the recession of 2008/2009 has also unleashed a further *technological revolution*. There is no sector and no market in which the same products can still be manufactured or distributed with the same structures. From car manufacture to energy generation, the media and financial services; it is the flexible, quick-acting market players that have gained ground, while the old dinosaurs at best suffer and decline.

6. Undecided

Which story do you find most appealing? The third, because it oozes optimism and belief in progress? Hang on a minute – have you given any thought to your own personal situation in such a scenario? Have your children already learnt Mandarin? Have you come to terms with the relative – and indeed, absolute – reduction in Western economic activity? And already said farewell to the prospect of benefitting from a social insurance system based on growth? Have you adjusted your lifestyle to the foreseeable reduction in your assets? And what about your financial investment portfolio? Is the new world adequately represented in it? Has your advisor taken account of the need for greater financial power in his stock selection? How do you intend to deal with the end of the US dollar as the only reserve currency?

Abyssus ruber, the blood-red abyss – we none of us want that! But, because it is conceivable,

should we not at least take some precautions, so as not to be entirely unprotected should the worst happen? Not easy, for it might develop into either a deep depression or inflation – hyperinflation, even. The responses in terms of investments are contradictory: in the one case, liquidity is the best remedy; in the other absolutely not. Furthermore, the blood-red abyss scenario almost inevitably involves expropriation and possibly physical danger; the possibilities for individual precautions are seriously limited. Where to live will be a question of the utmost importance. Switzerland, with its citizen-based society (and the resulting limitations on politicians' ability to take extreme actions) has been able to get through comparable historical abysses. But would it be able to do so this time? Would Dubai or Singapore be alternatives? Or rather, New Zealand?

Almost inevitably, we come back to the "normal scenario"; the continuation of what we know, although we also know that this is not what will happen. It takes a great deal – too much, perhaps – till one reaches the point at which one is ready to give up the comforting warmth of the familiar. This is understandable, particularly when it concerns real issues such as where to live, or where to locate a company or a factory. For the costs of packing up and moving are enormously high, and the degree of uncertainty in the new location may also be high. Physical presence is a long-term project, and we are well advised to measure the sustainability of locations in global historical terms.

Things are different with the most mobile of all assets, financial assets. Assuming that we do not wish to squeeze the last farthing out of the assets (or need to, on account of our situation), we are fairly free to invest on a *scenario-oriented basis*. This affects, for example, the question of where the assets shall be managed from. The *various legal systems* in the world are reliable to varying degrees in regard to attacks on private property. It is worthwhile studying history here. In addition to pogrom-like expropriations, there is also a wide range of types of fiscal confiscation, as well as the possible threats from an excessively elaborate legal system with too many greedy lawyers and arbitrary courts. Should it look more likely that the world is heading towards the worst-case scenario, we would urgently advise a review of the geographic aspect of asset management. *Diversification* across various legal systems might well not be a bad idea.

Those measures that can be taken at portfolio level are a good deal less expensive. We regard the possibility that the world will turn, so to speak, so that the Far East will gain in economic importance, but also that Latin-American countries, Brazil or Chile, will become more significant, as relatively likely. It will be necessary to reflect this development in the investment of assets. In doing so, it will be important not to include the new markets indiscriminately in the portfolio, as they are mostly still fairly illiquid and particularly subject to waves of enthusiasm and disillusionment. Here in particular, it will be necessary to pay special attention to the *question of sustainability*.

Withdrawal from familiar, and often successful investments in the declining industries of the West will be harder. But it may often not be necessary – particularly with regard to the stocks of internationally well diversified companies. The geographic diversification effect of the stocks of BASF, Holcim, Nestlé or Royal Dutch Shell is considerable. Things look different with fixed-interest securities, however. Bonds, often regarded as a "safety component", are very often issued by semi-state enterprises whose business models may be questionable over the longer term: certain German provincial banks for instance, or some utilities. Their economic performance is often poorly diversified geographically, and they are entirely dependent on their political environment. They would seem to be threatened under all three scenarios. The "safety component" in the investment assets thus requires consideration, not least as interest rates are so low that capital gains on these positions are no longer really conceivable. We suspect that their nominal value belongs in *Taleb's fourth category*.

Gold? Without at all wishing to give way to the temptation of "backtrading" – that is, making unfair reference to a successful past recommendation – we must come back to our position in 2006. We then recommended holding a strategic position in gold, to the tune of 5 to 10 percent of the total assets, "for a rainy day", so to speak. We suggested possibly keeping it in a separate portfolio, so as to ring-fence it from future investment decisions. We stand by this, despite the far higher current price of gold. Gold and, as a logical extension, our real-value portfolio (Realo), are a form of insurance, and should be understood, and handled, as such. It's not their value that counts, but their presence.

Feyerabend described the requirement to decide between scenarios, or even just to allocate them probabilities of occurrence, as "barren". With Mandelbrot and Taleb, we now know that this is

not only "barren" but can be wrong – and still wrong even if everyone does it in the same direction. Dispositions based on these (and other conceivable) scenarios cannot be definitive. Markowitz Optimization is replaced by concepts that deliberately incorporate inefficiencies and *reserves*. Methodological pluralism leaves its traces. Our profession as advisors in this jungle of scenarios, possible measures and various intellectual models, will become vastly more demanding than it was.

One final reference to the "black swan": the possibility – not entirely to be dismissed – of total personal catastrophe. As mentioned, Feyerabend had an answer: "What matters is having a few friends around – that's all". Which may well be why, over the thousands of years of human history, people have created times of the year at which attention can be paid to this last insurance, friendship. In this spirit, we wish you all a happy festive season.

KH, 7.12.2009