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Kiss Your Assets Goodbye If Certainty Reigns: Barry Ritholtz

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“The markets hate uncertainty.”

If you wandered anywhere near a television in advance of the midterm elections, the Federal Open Market Committee meeting or October’s [employment](#) report, that cliché was unavoidable. It was the pundits’ preferred proverb.

Wall Street has a sweet tooth for such investing maxims. They infect the trading community like influenza in December. Repeat mindless dictums ad nauseum, and they soon become the accepted wisdom.

The problem with these supposed truisms is they are no more accurate than the flip of a coin. A closer look at this uncertainty meme reveals it to be a false-ism -- one of those emotionally appealing phrases that ping around trading desks. The lack of evidence supporting their premise seems to matter very little.

To recognize how meaningless these statements are, consider the opposite: Could markets function without uncertainty? It takes only a little thought to realize that markets actually thrive on doubt, imperfect information and a lack of consensus.

Uncertainty drives the market’s price-discovery mechanism. Investing requires there to be differences of opinion. When there is broad agreement as to an asset’s fair value, trading volume falls. Without any uncertainty, who would take the opposite side of your trade?

History teaches that whenever the opposite occurs -- when certainty overwhelms uncertainty -- the herd tends to be wrong. In rare instances, when there is a near-total lack of uncertainty in the market, the outcome is usually a spectacular disaster.

When Certainty Rules

Recall the dot-com era, when everyone knew that profits no longer mattered. Uncertainty seemed to be banished. An epic [crash](#) followed.

After the Internet implosion, the opposite extreme was operational: Profitable, debt-free tech companies were being traded for less than book value. In a few rare instances, they were being sold for less than cash on hand. Investors had become certain that a dollar was worth only 75 cents.

There was little uncertainty heading into the March 2009 stock-market [lows](#). Almost everyone was sure the world was falling into the abyss. In that massive and indiscriminate selling, it seemed almost certain that no one was ever going to buy another [house](#) or car, or send their kids to school, or for that matter, clothe or feed them. How did the consensus work out in that instance?

No Reward

When we discuss uncertainty, what we are really discussing is risk. All unknown outcomes contain risk, and therein lies the possibility of loss. Risk is inherent in the concept of uncertainty. However, anyone looking for performance must embrace risk, for without it, there can be no reward.

Uncertainty is what makes alpha, or market-beating gains, possible. Smart traders know that uncertainty is where the money is. No uncertainty, no risk; no risk, no possibility of outperformance.

Since July, when the Era of Uncertainty began, the [Morgan Stanley Cyclical Index](#) -- those businesses most closely tied to this uncertain economy -- is up 26 percent.

Want some certainty? Go buy yourself Treasuries. You can pick up a very lovely two-year bond yielding 0.41 percent. (Good luck charging two and 20 on that!)

Track Record

The future, by definition, is unknowable. Investing involves making our best guesses about the value of an asset at some point after this moment in time. There will always be an element of uncertainty involved. We can discount various outcomes, engage in probabilistic analysis, but no one knows for certain what tomorrow will bring.

Those who claim to know fail to understand the most basic workings of markets. We need only consider the track record of Wall Street's prognosticators to know the truth in this statement. As much as the future is uncertain, the most likely outcomes are well understood.

As an example, consider the uncertainty of [tax rates](#). The 2001 and 2003 Bush tax cuts will either be eliminated, or they won't. Marginal rates will go up by three or four percentage points, or not; capital gains rates might revert to 20 percent from 15 percent, or not.

The impact on the economy isn't all that difficult to discern, even for Wall Street economists. Thus,

uncertainty is far less uncertain than you might have been led to believe if you paid any attention to the chattering classes. Even the tax on dividends -- which might rise from 15 percent at present to a 39.6 percent rate in the worst-case scenario -- is less uncertain than it looks. Many dividend-paying stocks are held in tax-free or tax-deferred accounts, or are owned by non-taxable pension plans, foundations and trusts. This mutes the impact of even this uncertain tax change.

Pundits may hate uncertainty -- it tends to makes them look foolish -- but markets harbor no such bias. In fact, markets thrive on uncertainty. It is their reason for being.

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