Financial Issues

Dyrehaugen Web Notebook

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Finance

The finance sector is dancing to any music that makes money for the moment.

Finance is not production, but it seems to be involved in every aspect of it.

Indeed, under conditions of financial capital abundance, finance operates not so much as “a system for the allocation of resources” than as “a weapon by which the claims of wealth holders are asserted against the rest of society”.

Piketty himself gets into some murky waters because his “Marshallian apparatus” sees capital “more as a stock of accumulated savings rather than a claim on future output”.

Finance is a way to separate foolish retail investors from their hard-earned savings.

Finance is useful. Financialisation, on the other hand, describes a situation in which ordinarily non- financial activity is seconded into service for finance. When finance escapes its marketplace, it is because it has been allowed, or even solicited, to do so. (Part 2 of this paper has detailed the reasons for, and effects of, financialisation.) Definancialisation, then, refers to the process of restoring ordinary non-financial activity so that it can operate normally, and removing dysfunctional social dependencies on finance. Percy (2021) Universal Basic Prosperity: Sustainable prosperity for the 21st century

Finance is both dumb and dangerous. It is dumb because it can only read numbers, unable to understand, much less assess, difficult social problems or complex business or engineering strategies. And it is dangerous because the people at the helm of financial institutions think they are smarter than they are, which leads them to assume that they should steer the ship…. Financialization has become so deeply rooted that we seem to have unlearned politics. By blindly relying on price tags, we have deprived ourselves of the skills for building consensus and developing effective strategies that avoid imposing the greatest costs on people whose lives are not “priced in.” No one benefits more from this calamity than finance. But those returns cannot last indefinitely. (Katharina Pistor)

2

Investment externalities

Beslik

Mainstream investing, for 100 years, ignored and still ignores negative externalities generated via their investment decisions. And gets paid for it.

Companies that manage relevant and material environmental, social, and governance aspects of their business operation, as well as how they manage what they produce, provide, and sell, will have a significant impact on their long-term valuation.

As such, it will also impact their long-term financial performance, given that valuation is mirrored in that performance over time. All of this is naturally connected to the pricing of material and relevant positive and negative externalities, which, at least in Europe (EU Taxonomy), has helped create an initial price and cost framework that can be used, at least to some extent, to understand implications on companies and sectors subject to these investments.

The major investment styles can be broken down into three dimensions: active vs. passive management, growth vs. value investing, and small cap vs. large cap companies. ESG and Impact investing are investment philosophies rather than an additional approach to mainstream investing as such.

Mainstream investing across the world does not care, or has no intent to do so, or is not mandated by fiduciary requirements, to address any negative externalities generated through the investments they make.

Mainstream investing operates in a form of 'market failure' and does what it can to maintain that failure. In fact, it is incentivized to do so.

What determines the difference between mainstream investment philosophy and ESG & Impact investment philosophy is the definition of 'return' or outcome on your investments. Return and outcome are certainly interpreted in a different way depending on the investment philosophy deployed.

Beslik (2023) The Frontier of ESG & Outcome Investing 2030

3

Time Diversification

Kritzman

Although an investor may be less likely to lose money over a long horizon than over a short horizon, the magnitude of a potential loss increases with the length of the investment horizon.

The notion that above-average returns tend to offset below-average returns over long horizons is called *time diversification.*

Specifically, if returns are independent from one year to the next, the standard devia- tion of annualized returns dimin- ishes with time. The distribution of annualized returns consequently converges as the investment horizon increases.

Kritzman (2015) What Practitioners Need to Know About Time Diversification

Kurtti

Academics have long debated the concept of time diversification, which questions whether time reduces the risk for stock investors or not. Prominent academics, led by Paul Samuelson, have shown (usually mathematically, employing utility functions) that time doesn't reduce risk. However, investors and financial advisors generally believe that risk decreases with time.

Defining loss risk as the expected loss considers both the probability of loss and its average depth, making this metric effective for fat-tailed returns.

For investment horizons of less than 4-7 years, empirical loss probability has been lower than what is predicted by a theory based on normally distributed, independent and identically distributed (i.i.d.) daily returns. Conversely, when losses occur, they have been deeper than what the theory predicts. This appears to be due to the fat-tailed nature of the returns, which is maintained by the correlation in the return time series.

Long-term loss risk, as measured by the expected loss, decreases over time (with reasonable stock allocation levels). Time diversification works when the investment horizon is long and the investment level is sensible.

At 100% stock allocation, in the short term (less than a few years) loss risk initially increases and then levels off. Time diversification only begins to work after more than five years.

Time diversification requires a shorter time to start working as the investment level (Kelly fraction) decreases.

Loss risk decreases over the long term as a function of time, but for most investors, the psychologically significant drawdown risk may be the limiting factor.

Mean reversion is not needed to explain why the empirical long-term standard deviation and loss probability for stocks are lower than theory predicts. A too-small sample size (a too-short return history) can largely explain the phenomenon.

Stock return history is very short and underestimates the real long-term investment risk. A short return history typically does not include the rarest events (returns) that will occur over a long enough time frame.

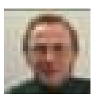
[Kurtti (2023) Time diversification works (eventually)](Time diversification works (eventually)

Part I

Appendices

Appendix A

About



Dyre Haugen and *Dyrehaugen* is Webian for *Jon Martin* - self-owned Globian, Webian, Norwegian and Canarian with a background from industrial research policy, urban planning and economic development consulting on global, regional and urban scales. I am deeply concerned about the (insane) way humanity (i.e. capitalism) interfere with nature. In an effort to gain insights in how and why this happens stuff is collected from around the web and put together in a linked set of web-sites. The sites are operated as personal notebooks. However, these days things can be easily published to the benefit of others concerned with the same issues. But be aware - this is not polished for presentation or peer-reviewed for exactness. I offer you just to have a look at my 'work-desk' as it appears in the moment. Any comment or suggestion can be mailed to dyrehaugen@gmail.com You can follow me on twitter as @dyrehaugen. Thanks for visiting!

Appendix B

Links

Current Dyrehaugen Sites:

- rcap - On Capitalism (loc)
- rclm - On Climate Change (loc)
- recs - On Economics (loc)
- rfin - On Finance (loc)
- rngy - On Energy (loc)
- renv - On Environment (loc)
- rsts - On Statistics (loc)
- rurb - On Urbanization (loc)
- rvar - On Varia (loc)
- rwsd - On Wisdom (loc)

Blogs:

- rde - Blog in English (loc)
- rdn - Blog in Norwegian (loc)

Discontinued:

- jdt - Collection (Jekyll) (loc)
- hdt - Collection (Hugo) (loc)

Not listed:

- (q:) dhe dhn jrw56
- (z:) rcsa rpad rstart

Appendix C

NEWS

C.1 230319 Silicon Valley Bank

Tooze

One of the underlying frailties of the global banking system right now, are the unrealized losses on bonds incurred by banks as a result of central banks hiking interest rates to combat inflation. As interest rates have gone up, bond prices have gone down. This is bad news, if billions in depositor-withdrawals force you to sell the bonds thus "realizing" the loss. But, if you are not in dire straights, if you are not selling off your portfolio in fire sales, where do you run if the financial world seems to be falling apart (again)? The safe place to run to is … yup … government bonds. They are safe. The market is liquid. Plus, they are cheap right now!

So, a crisis that was triggered in part by bond prices going down, led investors to run into bonds and drive prices back up. A panglossian friend of the markets might say that this is the self-equilibrating invisible hand at work. This is not how it felt last week.

Tooze (2023) Chartbook #203 Banking crises, states of exception & the disappointment of sovereignty - a roundup of last week

C.2 211118 OCC Nominee fight

The Prospect

> "She does not see banks as the clients of the OCC."

After several months, President Biden has finally chosen a nominee to head the Office of the Comptroller of the Currency (OCC), a key financial regulatory post. It's Saule Omarova, a Cornell professor and critic of financial overreach.

Omarova immediately faced a flood of criticism from the banking industry, described as “radical” and “Biden’s most polarizing pick for a top financial regulatory job.”

Thus far, Omarova has been primarily condemned for musing in an academic paper last year about how individual bank accounts at the Federal Reserve could replace private deposits. The U.S. Chamber of Commerce on Tuesday announced their “strong opposition” to Omarova for precisely this reason.

THE CHOICE OF OMAROVA breaks sharply with precedent for the traditionally bank-friendly office. Established by Abraham Lincoln as a branch of the Treasury in 1863, the OCC is the main regulator for federally chartered banks, overseeing roughly two-thirds of total assets in the U.S. banking system. The agency is self-financed through the inspection fees it charges the banks it oversees, a funding mechanism critics of deregulation have identified as a conflict of interest.

The history of the OCC over the past half-century gives those critics abundant evidence that the agency operates as a bank advocate masquerading as a prudent regulator.

The Prospect (2021) Wall Street’s Attacks on Biden Nominee Are a Red Herring

C.3 210421 GFANZ: Low Carbon Banking

Banks and financial institutions with more than $70tn assets have pledged to cut their greenhouse gas emissions and ensure their investment portfolios align with the science on the climate.

In the initiative, chaired by Mark Carney, the former governor of the Bank of England, 160 companies, including 43 banks from 23 countries, will set targets to cut the carbon content of their assets by 2030, in line with an overall goal of net zero emissions by 2050.

The forum, the *Glasgow Financial Alliance for Net Zero*, aims to encourage the financial sector to divert investment towards low-carbon infrastructure and technologies, and to discourage high-carbon investments, ahead of Cop26, the vital UN climate talks to be hosted by the UK in Glasgow this November.

Janet Yellen, the US Treasury secretary, and John Kerry, the US special presidential envoy for climate, are backing the alliance.

GFANZ [will be] the gold standard for net zero commitments in the financial sector. The alliance would not allow banks to “greenwash” their commitments.

However, since the signing of the Paris agreement in 2015 banks have poured at least $3.8tn into fossil fuel financing.

The financial system is fuelling environmental breakdown on a catastrophic scale, and what we really need is for central banks to play their roles as regulators and take concrete action to prevent all of the firms they oversee from making investments that are incompatible with governments' climate targets.

Banks signing up to GFANZ would be required to show "credible plans" for reducing their investment in high-carbon assets, but would not face a deadline for exiting fossil fuel investment. Advertisement

Officials said there would be no blanket requirements for companies to stop financing coal, for instance, and banks would be allowed to make their own judgments on the carbon content of their portfolios, on a case by case basis.

Guardian

C.4 210406 Biodiversity and Financial Stability

NGFS and INSPIRE launch a joint research project on 'Biodiversity and Financial Stability'

A growing number of central banks and supervisors have recognised the need to extend their focus from climate change to the challenges of addressing the implications of broader nature-related risks and the conservation of nature and biodiversity. Doing this will involve understanding the impact of finance on the provision of key ecosystem services as well as the consequences of biodiversity loss for financial stability.

Companies are highly dependent on the services that ecosystems provide, but may at the same time have a harmful impact on the environment. The financial risks that stem from a loss in biodiversity are a serious threat to the financial sector that urgently require better understanding by policy makers and regulators to which the new NGFS/INSPIRE Study Group will provide an important contribution.

Appendix D

Sitelog

Latest Additions