Think piece

1912–2012 A CENTURY OF PROFESSIONALISM

CII

Number 77 May 2012

INDEPENDENTLY PROMOTING DEBATE AND FRESH THINKING IN THE FINANCIAL SERVICES INDUSTRY

The Money Myth

Alexander Davidson

Summary

- Many private investors have lost faith in the integrity of numbers and of markets – and so are in need of a different approach to mere numbers to help understand the mind of the market.
- Classical mythology provides many valuable lessons that still resonate today. This is certainly the case when applied to the behaviour of modern financial markets – after all both have human nature at their heart.
- This Thinkpiece puts forward five areas where examples from Greco-Roman mythology can aid the private investor – helping them steer clear of sharp practices and make sensible investment decisions.
- From the examples provided, which has a cast list of mythical figures including Odysseus, Medea and the Sybil, one is able to draw a number of rules that can complement more traditional approaches to investing in financial markets.

The Chartered Insurance Institute is the world's largest professional body for insurance and financial services and is the leader in awarding qualifications to industry practitioners. Our Thinkpieces are a key part of our ongoing commitment to promoting innovative thinking and debate within the insurance and financial sectors. In 2012 we are celebrating our Centenary as a Chartered body.

CII Introduction: With technological advances and ever more complicated investment vehicles, it is easy to forget that financial markets are driven by humans and human nature. Keeping this in mind is important if one is to make sensible investment decisions and avoid unnecessary difficulties. Lessons from the past, whether based on fact or mythology, can teach us a lot and we would do well today to remember this. In his Thinkpiece, journalist Alex Davidson, offers up examples from classical mythology that show human nature has changed little in two and a half thousand years and provides five rules to help would be investors bear this in mind.

The trial of Asil Nadir has brought back memories of his company Polly Peck. Some investors made up to 1,000 times their money on this 1980s penny stock, and then lost all their gains. Poly Peck's fluctuating share price, based on changing perceptions, was a perfect illustration of the money myth, the fiction that you can get something in financial markets for nothing.

The fallacy that low price necessarily means good value has seduced penny share punters for decades. The gap between myth and reality applies, sometimes less obviously, to all financial markets. The game continues because investors will not learn from their mistakes and the City will not put the customer first.

Let us remember that market activity is about people, and their greed and fear...

Many investors have now lost faith in the integrity of numbers or markets. They seek instead any hint of buying, selling or takeover interest behind the scenes. They want to follow the smart money. The markets remain opaque, despite the efforts of regulators to introduce transparency in the aftermath of the crash.

As private investors we need some new methodology beyond the realms of numbers and technology to help us understand the mind of the market.

Secrets of Mythology

The old wisdom is best. If we consult classical mythology, we can benefit from the lessons of more than two and a half thousand years ago. This provides all that we need to protect ourselves from the sharp operators in financial markets and to navigate our way round the legitimate activity and make sensible investing decisions.

If this sounds disingenuous, let us remember that market activity is about people, and their greed and fear. This plays out in ancient mythology with a clarity never yet matched. The old fables grandly combat today's market propaganda with the truth. By using mythology to combat the money myth, we are fighting fire with fire.

In this thinkpiece, we will focus on the following five areas where Greco-Roman mythology can help you as an investor:

1. Mis-selling in financial markets
2. Unreliable numbers and forecasts
3. Respect for risk
4. Self reinvention
5. Spilling the beans

Harnessing the power of the ancient mythology, we will emerge with a set of rules that you can apply profitably as an investor. Let us first now turn our attention to each area.

1. Mis-selling in financial markets

Mis-selling is rife, and is not confined to penny shares. Before the crisis, the investment banks bundled up dubious mortgage securities and sold them. Professionals connived in the money myth, believing, in some cases because they wanted to, the flawed logic that you can slice away risk. At wholesale as well as retail level, salespeople are charming each other and investors into accepting damaged goods as perfect.

To understand how the salespeople work, let us turn to Homer's *Odyssey*, and Circe, the enchantress who welcomes Odysseus and his men into her palace. This fair-haired goddess sings sweetly and weaves an immortal tapestry. Odysseus's men are tired and hungry when they accept her invitation and her hospitality, disregarding such warning signs as bewitched wolves and lions behaving strangely.

Circe mixes drugs into the food and wine of the weary travellers, and once they have lost all memories of home, she strikes them with her wand. They develop the bodies and voices of pigs, but their minds are unchanged. She locks them into a sty. Here are the forerunners of today's buyers of dud stocks or funds who succumb to the salesperson with a fake double-barrelled name and plummy accent, operating from a boiler room at a concealed address in Marbella.

To avoid this trap, we must recognise and confront the sorcerers, just as Odysseus did with Circe. Odysseus gained the help of Hermes, messenger of the Gods, in combating Circe, and eventually mastered her, even gaining her respect. As investors, we have decent financial advisers and advisory stockbrokers at our disposal.

As retail investors, we must be alert too if we subscribe to new issues. In *Metamorphoses*, the ancient Roman poet Ovid describes how Proserpine is picking flowers when Pluto, god of the underworld and also of wealth, abducts her. Investment banks perform a similar trick through their sales pitches to get at a client's their money. Retail investors are allocated fewer shares than institutional counterparts in IPOs and share placings, and sometimes on worse terms. They are encouraged to buy and hold, but this is not necessarily in their interest.

Retail banking might seem saintly in comparison, but, appearances can be deceptive. The business model bears comparison with the practices of Medea, a con artist of Greek mythology who was also arguably a wronged woman. A major part of banks' image is ritual. The bank conveys the image of competence and reliability, as if deep rooted in hard cash. If too many customers should seek all at once to withdraw their cash deposits, the bank would not have enough to pay them. This is the secretive system of fractional reserve banking at work. It is a *confidence trick*.

Just as the Greeks had consulted more than one oracle to obtain a consensus forecast, sophisticated investors view several analysts' forecasts.

In the financial crisis, it was starting not to work. The government bank rescues came at a potential cost to the taxpayer. This came as a nasty surprise, just as when Medea, estranged from her husband Jason, arranged delivery of a robe and a golden coronet to his new wife Glauce, and they turned out to be poisonous.

Just as Medea had the support of Helios, in whose chariot she escapes from the consequences of her crimes, so banking can call on the backup infrastructure of central banking, regulators and government. The emergency support has so far not been withheld, and has made it easier for the banks to cast their spell on the public.

2. Unreliable numbers and forecasts

Now more than ever, the markets play a propaganda game, backed by governments. The strategy is in the interests of keeping the City a world leader, but claims its victims. We must see through not just sales tactics but the overconfident forecasting.

The fallacy of faith in numbers is a lesson that may take from the Ancients.In Aeschylus' *Prometheus Bound*, Prometheus explains that he is chained to a rock at the world's edge as punishment for, among other things, inventing for mankind, numbers, which he describes as chief of the stratagems.

The ancient Greeks relied on the divine oracles for forecasts that helped them make such life-changing decisions as whether to go to war or to enter a particular marriage. The Delphic oracle, with its priestess of Apollo, issued ambiguous forecasts that subsequently, by selective interpretation, the ancient writers could claim got it right.

Just as the Greeks had consulted more than one oracle to obtain a consensus forecast, sophisticated investors view several analysts' forecasts. The numbers can vary depending on the underlying assumptions, such as the discount rate, and can be ammunition for corporate financiers seeking new clients.

These and other numbers forecasts, such as the prospective price/earnings ratio, are based on assumptions, typically using consensus figures based on what the company has chosen to tell all the analysts at once. They are the only uncertain numbers, because they are based on the future, but, for this very reason, they are the ones most in demand.

3. Respect for risk

As investors, even if we shun misleading salesmanship, we can be exposed to risks we do not understand. Money management is the best way to cope, but the part of this which is to cut losses and running profits is rarely followed. It is too tempting to take a profit too early and too painful to crystallize a loss.

To demonstrate the courage that we require, let us turn again to The Odyssey, where Odysseus sails past Scylla in his ship only by sacrificing men to that man-eating monster. He reasons that it is better to lose six men than the entire crew. We must take the same approach to investments, and, for that matter, to the brokers that promote them.

Risk taking can pay off on legitimate investments, but it should not be disproportionate, a theme that runs through the ancient mythology. There is a point at which speculation becomes gambling. Businesses today push past conventional frontiers, incurring cyber risk on the Internet and political risk in foreign countries. Reckless risk taking can fail. Some business leaders act like Phaethon, a young man in ancient Greek mythology, who drives the chariot of his father, the sun god, against his advice, and crashes it.

An unexpected scandal implicating the company or a few wrong remarks by the chief executive can destroy reputation quickly, and a damage limitation plan needs to be in place. Of course, with the best will in the world, there are some areas and accumulations of risk that we are not yet in a position to understand.

Some business leaders act like Phaethon, a young man in ancient Greek mythology, who drives the chariot of his father, the sun god, against his advice, and crashes it.

Systemic risk is nothing new. More than two and a half thousand years ago, the pre-Socratic philosophers debated how far the world was of one piece. In discussing cosmic cycles, fifth century philosopher Empedocles suggests that elements in the world become part of the one, and yet do not cease to be. Today, earthquakes and volcanic ash remain individual risks, even as they threaten systemic impact.

In financial markets, an incompatibility of juxtaposed products and activities across asset classes and geographies in the financial sector had always been present but it took the crisis, and the unprecedented technological advances and risk taking that went with it, to draw attention to it.

When risks turn sour, elements that in combination constitute systemic risk can break up. This is much as in Empedocles' 'twofold birth of mortals', where creatures emerge perhaps in unity and disintegrate perhaps in strife, with a point where the bodies are in bits. These philosophers' speculations about systemic risk were hardly less sophisticated than ours today.

4. Self reinvention

Financial crises come in cycles. The City, after failure or disgrace, including near bank failure, repackages itself into a new form. The processes are akin to metempsychosis, part of the ancient Greek culture of beliefs. Plato's Republic tells the myth of Er, where anybody who dies has 1,000 years of after-life, and is then reincarnated to start a new life on earth. Any who visited heaven are morally complacent but any who went to hell are cautious.

In financial markets today, no less is true. After having received its government bailout, AIG has restructured its operations. The group is unlikely to resume the sideline of reckless investment banking activity that had caused its near downfall.

As institutions start afresh, so do their personnel. At the extreme, staff crosses the bridges between the 'bad' and 'good' City. They may use false names when working for the boiler rooms but their real names when they have moved to regulated firms. A man, who honed his craft in the boiler rooms of Marbella or Madrid, will bring in business quickly to a respectable stockbroker.

There is some contamination carried over, and financial markets are bad at the same time as good. As the pre-Socratic philosopher Heraclitus says, doctors take fees from the sick, producing good and illness at the same time. We might not always know where the dividing line comes. If an investment bank is taken over, changes its name and reinvents itself, is it the same bank? As Heraclitus says, we step into the same river, and we don't step into it; we are and we are not.

Regulators are reinventing themselves no less than the industry that finances them. The UK's planned new tripartite regulatory regime, with its early announcement, has the intimidating bark of Cerberus, the three-headed guard dog of classical mythology, but may share its weaknesses. In Virgil's *Aeneid*, the Sybil, a prophetess, throws drugged sweet cakes at Cerberus as it guards the gates of hell. The creature snaps them up with his jaws, and then falls into slumber, allowing her and Aeneas past.

The Sibyl has warned Aeneas that it is easy to enter the underworld but hard to leave it. The same can be true of the stock market, where collapsing prices can make you feel locked into your portfolio.

5. Spilling the beans

Misinformation conceals much. The second-hand way the City packages its information for investors is like the shadows shown to prisoners in the cave of Plato's *The Republic*. The PR industry puts across a one-sided message in a convincing and interesting way, packaged in a form that journalists often reproduce uncritically.

The skills of the PR professionals are as old as civilisation. The sophists of fifth century Athens were practitioners of the same craft. Catherine Osborne, professor of philosophy at East Anglia University, in her book *Pre-Socratic Philosophy: A Very Short Introduction*, has described the sophists of ancient Greece as the 'spin doctors of all time'. She notes that they had created a demand for the skills they were offering to sell to any who could afford to pay their high charges. Anybody had the right to speak in the assembly, and the sole source of influence was, in practice, the speaker's ability to persuade an audience."

The discrepancy between appearance and reality continues in financial PR, where the spin has to be professional, but spin it is. By courtesy of the media, the stories spread like Chinese whispers. The PR man stands by like a demented referee to channel the flow. Retail investors strive to be let into the secrets of financial markets. The prisoners are looking to escape from the cave. They still do not know how, but the wind is blowing more their way.

Whistleblowers are more tolerated in financial services, giving the prisoners a chance of seeing the reality. Firms understand they if they ignore issues raised, they may lose reputation.

The Rules

So here we have it, five areas where ancient mythology can help you as an investor and in understanding markets. Let us draw some rules. These can do no more than complement our traditional fundamental and technical analysis, our focus on macroeconomics, and our practical knowledge of how markets work, but they add value.

1. Sweet talking manipulators are everywhere in financial markets. Resist them early and firmly.
2. Numbers and forecasts are flexible. Do not take them at face value.
3. Take calculated risks as an investor, and respect the power of the unknown.
4. Financial markets, backed by governments, reinvent themselves. Where you have put your money today may be somewhere else tomorrow.
5. Most press coverage of financial markets is disguised spin. Be aware of your ignorance.

As this thinkpiece has aimed to bring out, if you invest directly in financial markets, you are dealing with human nature in the raw. The rules are a veneer. Once you understand this lesson, flagged by ancient mythology, you can invest with open eyes.

If you have any questions or comments about this Thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact us: thinkpiece@cii.co.uk or on: +44 (0)20 7417 4783.

Alexander Davidson is a senior editor for Thomson Reuters Accelus, where he specialises in regulation and compliance. He is author of many financial books, including three acclaimed *Times* newspaper guides to how the financial markets work. Before becoming a journalist he was a City share dealer, until publication of his bestselling first book, *The City Share Pushers*, which was subject of a Channel 4 documentary. He is a well known commentator on financial markets. His new book, The Money Myth: A Classic Introduction to the Modern World of Finance and Investing, which develops some of the themes in this article, is published on 1st May 2012 by FT Pearson at £20.

The CII is the world's leading professional organisation for insurance and financial services, with over 100,000 members in 150 countries. We are committed to maintaining the highest standards of technical expertise and ethical conduct in the profession through research, education and accreditation. In 2012 we are celebrating our Centenary as a Chartered body. For more information on the CII and our policy work, see: www.cii.co.uk/policy.

Qualified CII members: reading and reflecting on this Thinkpiece can count as *Structured CPD* under the CII CPD Scheme.

The CII Thinkpiece Series

The CII Thinkpiece series consists of short 1,500–2,500-word articles on subjects of interest to the insurance and financial services profession and stakeholders, and are written by a range of contributors. We publish them *not because we necessarily agree with the views* (or believe that they reflect in any way the policy of the CII or its members), but *to promote a free and open debate*.

All articles are freely and openly available on our website: www.cii.co.uk/thinkpiece. If you wish to be added to a mailing list to receive new articles by email, please contact us at thinkpiece@cii.co.uk

Recent articles in the series:

No.75: **The Forgotten Hero? The Role of Employer Group Risk Schemes in Closing Protection Gaps**, by Ron Wheatcroft FCII and Keith Williams (May 2012).

After what seemed like a flurry of regulatory activity in a relatively short space of time, the European Insurance & Occupational Pensions Authority (EIOPA) was formed in January 2011. In this article, Gabriel Bernadino, Chair of EIOPA provides a perspective on the Authority's first year of operation.

No.74: **From Brussels with Love: A Perspective on Developing Insurance Regulation at the EU Level**, by Karel van Hulle (May 2012).

With EU insurance regulation landscape more relevant to individual firms than ever before, Karel van Hulle, the European Commission's lead official on insurance & occupational pensions, and author of many of the proposals under discussion in these areas, offers his own strictly personal view of insurance regulation in the post-financial crisis world.

No.73: **Is it Possible to Have Sustainable Flood Insurance without Sustainable Flood Risk Management,** by David Crichton (April).

Climate change models are predicting more extreme and uncertain weather. A particular concern stems from extreme rainfall events, with Scotland, Wales, and much of Europe managing to reduce the incidence of flooding using sustainable flood management methods. However, England's refusal to consider more sustainable solutions is resulting in a growing incidence of flooding. Will the demise of the Statement of Principles pave the way for the introduction of sustainable flood management in England?

No.72: **The Need to Know: Transparency and Confidentiality in Insurance**, by Duncan Minty (April).

Telematics has been welcomed by onservers for finally providing insurance pricing that is usage-linked and non-discriminatory. However, like GPS devices in mobile phones, it requires customer acceptance of reduced privacy in exchange for better services. Recent stories about insurers selling customer data has left the public justifiably unsure whether the industry could be trusted. What can insurers do to win back this trust?

No.71: **The Challenge of Age: Global Longevity Trends and Economic and Social Implications**, by George Magnus (23 March).

George Magnus ("the man who predicted the financial crisis") argues that the current economic turmoil is colluding with rising longevity to severely depress returns for the elderly. Governments, societies and industries must take robust action now in order to ensure that rising longevity is celebrated rather than feared over the decades to come.

No.70: **Rethinking Risk: The Future of Insurance and Renewable Energy**, by Steve Kingshott (9 March).

With rising fuel prices now a routine feature of our time, and the spectre of a "peak oil scenario" in the not-too-distant future, investing in renewable energy has become not just a matter of curbing CO_2 emissions any more. Steve Kingshott, CEO of Renewable Energy at RSA Insurance describes the work the insurance industry is doing to help deal with the challenges in renewable energy investment and development.

No.69: **Taking Charge: Employer Ownership of UK Skills,** by Trevor Matthews (16 February 2012).

A skills system that fulfils the needs of employers and individuals is vital to the future competitiveness of the UK economy. Trevor Matthews, Commissioner of the UK Commission for Employment & Skills (and CEO of Aviva UK) articulates the sector's needs to government and its work seeking solutions of its own. This framework that seeks to raise skills and professional standards is an illustration of the vision of employer ownership of the skills system

No.68: **Who Saves for Retirement? Analysing Incentives for Saving Using the Wealth & Assets Survey,** by James Lloyd and Timothy Fassam (26 Jan)

James Lloyd of the Strategic Society Centre and Tim Fassam of the Prudential summarise the results of an extensive survey exploring public attitudes driving pension saving, and draw conclusions in the context of the Government's new workplace pension auto-enrollment system starting this October.

No.67: **Insurance Regulation in 2012: Finding Solutions to the "British Dilemma",** by Mark Hoban MP (11 January).

Financial Secretary Mark Hoban MP summarises the UK Treasury's latest work in insurance regulation, including the UK regulatory reforms, Solvency II, and response to the European Court's gender ruling. He the UK's dominance in the global insurance markets both retail and wholesale which cannot be underestimated, and any regulatory reforms must be reflective of the unique issues in this sector.

No.66: **Retaining Today's Knowledge for Tomorrow: Capturing the Knowledge of Retirees**, by Adele Wilter (12 December 2011).

Knowledge loss can be an unintended consequence of retirements and can prove costly for firms. Adele Wilter of Capita Consulting provides a short guide on how best to capture this knowledge and prevent a brain drain.

No.65: **Dealing with Disputed Claims: Is Jackson the Answer, or a Reminder of the Need for a New Approach**, by Anthony Hurndall (29 November).

Amidst all the commentary on the Jackson reforms, Anthony Hurndall (Chief Executive of the Centre for Justice) describes an alternative model that avoids the aggressive adversarial approach of litigation whilst actually bringing about workable results. At a time when insurers are looking for cost effective and proportionate approaches to settling claims disputes, what is proposed here might just be the fresh approach that is needed.

No.64: **Road to Ruin, Next Exit? Insurance Reflections on Corporate Governance and Risk Management,** by Ian Canham (22 November).

Assesses the implications of a report published earlier this year by Cass Business School in association with AIRMIC and Lockton. In this thinkpiece, Ian Canham (partner in risk solutions at Lockton) provides his personal views towards this study and draws observations and conclusions for the future of corporate governance in the real world.

No.63: **The Virtuous Circle? Sustainable Economics and Taxation in a Time of Austerity,** by Walter Stahel (10 October).

In the current economic landscape, Western governments have to make tough choices in balancing a taxation system that promotes economic growth with dwindling resources with which to provide a safety net. Walter Stahel of the Geneva Association calls for a fundamental rethink of taxation policy in favour of supporting the economy's most important asset: its labour.

No.62: **The Role of Professionalism in Securing Consumer Trust and Confidence,** by Adam Phillips (31 August 2011).

Why are regulators and firms suddenly taking staff professional standards so seriously? Will this make a difference for the end consumer? Adam Phillips, Chairman of the FSA's Financial Services Consumer Panel, offers his personal perspective on why professionalism plays a role in improving public trust and confidence.

No.61: **Back to Basics: Rethinking Risk Management,** by Simon Ashby (9 August).

The global financial crisis has sparked considerable debate and analysis of its causes and of the lessons to be learned. This paper seeks to make sense of the crisis in terms of its implications for the management of risk. It reflects on the future for the practice of risk management, and provides some recommendations for financial institutions, and their regulators. Many of the recommendations are built around the notion that mangers and regulators should place more emphasis on the micro-level human/social aspects of the crisis.