M A R K E T   R I S K   A N D   E F F I C I E N C Y

Taming Global Village Risk

July 1, 2008

The Journal of Portfolio Management

Asset price bubbles have been part of modern capital markets since those markets first evolved some 300 years ago. Bubbles build and burst today much as they did then. Recently, however, the real economy has become less volatile, but financial markets have not; they remain volatile and unpredictable.

Why is this? What forces are driving market volatility? Answering those questions would provide investors a basis for an effective response in dealing with market risk.

Markets are, in effect, complex adaptive systems. They are composed of legions of decentralized decision makers who are continually digesting information and interacting in unanticipated and nonlinear ways. That markets are complex adaptive systems has critical implications for how we think about and manage investment risk.

In risk management, we must focus on the market mechanisms driving capital markets to higher volatility, including the emotions of investors, complexity of adaptive markets, advances in technology and improved mathematical modeling.

To ramp up risk management we need to find new tools to measure the interconnectedness of markets as well as the total amount of systemic risk, leverage and liquidity in the markets. With improvements in risk management, investors and regulators will be better equipped to mitigate the market volatility that often culminates in financial market instability.

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