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Financial Planning & Wealth Management

Ruminations on Terminology

I try (I really do) not to be the grammar police, but there are three terms used commonly – and improperly – regarding investments and markets. I can no longer sit idly by when even Warren Buffet (who I greatly respect) is getting it wrong. Now, after you read this, in at least one aspect you can be smarter than Warren.

I think the reason some terms are used at all is that investment professionals try to adopt the veneer of the harder sciences to gain credibility, but it doesn't help much when the appropriated terms aren't even used correctly!

Consider the term ***Negative Feedback Loop.*** A negative feedback loop dampens itself. A positive feedback loop increases in magnitude because it feeds on itself. For example, people buy houses causing prices to increase, causing people to want to buy houses to get in on the deal, causing prices to increase, etc. A negative feedback loop would be something like a thermostat. A temperature decrease closes the circuit in the thermostat causing the heat to come on and increase the temperature until the circuit opens again. This keeps the temperature at a relatively constant level. The 2008 Berkshire letter to shareholders is a good example of the misuse of this term:

> By the fourth quarter, the credit crisis, coupled with tumbling home and stock prices, had produced a paralyzing fear that engulfed the country. A freefall in business activity ensued, accelerating at a pace that I have never before witnessed. The U.S. – and much of the world – became trapped in a vicious negative-feedback cycle. Fear led to business contraction, and that in turn led to even greater fear.

The situation described is a *positive* feedback loop (or cycle) in a negative direction which is not at all the same thing as a negative feedback loop.

Reversion to the Mean is a second term often used incorrectly. Reversion to the mean is properly used to indicate that extreme occurrences are followed by less extreme occurrences. For example, suppose a husband and his wife are each five inches taller than average. Their children will also be taller than average but *not* five inches taller than average. Their heights will tend to "revert" toward the population mean. If this were not true, people would routinely be ten feet tall after a few generations of the tall folks breeding. In the context of the market, when people say "reversion to the mean" they don't generally mean because the market was up so much (say 20%) it will be above average again but not quite as much (say 15%), they mean it will be *below* average (like *minus* 10%) so that it approaches the prior mean. The proper term for this is negative serial correlation *not* reversion to the mean.

The third term is ***Liquidity.*** Marketability means you can buy or sell something. Liquidity means the act of buying or selling quickly won't change the price much. I have heard advisors say stocks aren't liquid because they can go down in value, or you should keep five years of living expenses in cash for liquidity. Substantially all of most people's portfolios are extremely liquid. All open-end mutual funds and all investments with trading volumes many times the size of the position you are trying to trade are extremely liquid. What people mean to say is that some investments are volatile (to which the appropriate response should be, "well, duh"). Volatility and liquidity are *not* the same thing, though illiquid investments are frequently volatile; volatile investments can be very liquid.

Finally, a bonus oddity – ***International***. The investment industry for some inexplicable reason uses the term "international" when they mean "foreign" and are then are forced to use "global" when they mean "international."

I now relinquish the post of grammarian...

Notes:

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