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The Monkey, the Volcano, and the Dangers of Rationalizing Risk

By Steve DeBoth

Half way up the slope of a volcano lived a monkey. Like his fellow monkeys, he spent the majority of his days picking and eating fruit off the trees growing on the side of the volcano. Unbeknownst to his friends, however, he dreamed of one day opening his own banana pie stand where he could spend his old age providing delight to others, just making and serving pie, passing the time in enjoyable conversation. And picking lice, of course. He dreamed this every day as he foraged, and it made him happy.

But he knew he would only get there if he grew big and strong enough to build that stand, so he ate as much fruit as he could from the trees half way up the slope. One day a friend of his told him he was moving further up the volcano to get fruit, because as every monkey knew, the higher up the volcano you were, the better and more nutritious was the fruit. The monkey had been hanging out halfway up the volcano because it had erupted a couple times recently which had scared him, and he wanted to be able to make it down off the volcano before the lava could reach him. While picking lice off each other, many monkeys told tales of others in the past who had picked fruit too high up at dangerous times and who never made it back down.

His friend assured him, though, that now was a good time to be going higher, because the fruit up there had been growing ever more delicious and nutritious. "Hmmm," thought the monkey, "that would mean I would be able to build the pie stand sooner, for I would grow even bigger and stronger." But still, he was hesitant.

"Why has the fruit been growing more delicious and nutritious?" he asked his friend.

"Because the volcano has turned active again, and the ash from the volcano is nourishing the trees, and there is more ash falling the higher you go."

While picking a nice fat louse off his friend, he asked "But, isn't it more dangerous up there now? Aren't you worried the volcano will erupt and you will not outrun the lava?"

“Pshaw,” said his friend. “The volcano let a little lava out a few years ago, and nobody really got hurt. A couple years ago it let out A LOT of lava and it was pretty scary for a while, but then it stopped as quickly as it started and the fruit nearest the top grew LIKE CRAZY. I’m pretty sure it’s done erupting now for a while, and besides, if I think the volcano will erupt again, I’ll just move lower.” And with that, his friend was off, moving higher up the volcano under the wistful eyes of the monkey.

Days passed, and not only was there no new eruption, the monkey saw more and more of his troop heading higher every day. “Come on!” they yelled, “You don’t want to miss it! The fruit is more nutritious and delicious than ever!”

Finally, he couldn’t take it anymore. He could look up the mountain and see all his friends, laughing and frolicking and swinging, eating the fruit that was more delicious than ever. He could feel the rumblings of the volcano, but the lava from the last two eruptions had cooled and was already a distant memory. “I can get my pie stand so much faster if I were bigger and stronger,” he thought, and started moving up the slope.

He had not reached his friends yet when he saw a very old monkey walking down the volcano.

“Hey! Where are you going?” asked the monkey. “Isn’t the fruit at the top more delicious and nutritious than ever?”

“Oh my yes, my young friend, it is,” said the very old monkey, continuing down the slope.

“Then why are you going down the volcano?” he asked.

“Because,” replied the very old monkey, “I’ve lived through many eruptions, and some of them have injured me and it’s taken years and years to heal. The last one nearly got me, and I feel foolish I was in that position in the first place. I should know better, so I am going to move to a safer place before the next eruption finishes me off for good.” And like that, he disappeared behind a tree.

The monkey knew he was taking a big risk by going higher, but he promised himself he would only stay and eat the fruit long enough to get big and strong, and then he too would return down the volcano to build his pie stand far sooner than he’d ever dreamed. He kept going higher, right toward the top, where the fruit was even more nutritious and delicious then he’d imagined. He knew the rumblings meant that the volcano COULD blow, but it seemed like everyone was still OK, and besides, many monkeys that knew a lot more about volcanos than he did said right at the top was still the best place to pick fruit.

Even though the volcano had erupted a couple times in the past few years, the build-up inside the cone was more intense than it had ever been. When it did erupt, the lava flowed faster and stronger than anticipated and none of the monkeys at the top could outrun the lava this time. Every risk-taking monkey assumes it will be able to flee the danger in time, and although sometimes it can, the day inevitably arrives when it can’t.

When the new lava toward the top finally cooled and the fast-growing trees reappeared with all that new volcanic soil helping them create fruit even more delicious and nutritious than before the eruption, the old monkey made his way back up the slope. He was wise enough to know he was lucky to have avoided the danger when he did, even though he gave up some really great fruit for a little bit. In the end, living to eat the best fruit another day was worth it.

The Netflix Eruption *By Casey Clarke*

As we addressed in the Monkey and the Volcano parable, there eventually comes a time when extreme volcanic pressure releases itself all at once. Markets are no different. Extreme buying pressure over time inevitably leads to sudden eruptions that send prices falling; in many cases faster than they went up. In markets as with volcanos, energy and volatility doesn't disappear, it simply transmutes into another form. If you've been paying attention to financial markets the last few weeks, you've probably picked up on the fact that this process seems to be playing out currently.

Netflix has been a good example of just how suddenly risk can materialize. After a steady march higher in recent years, very much in sync with the broader stock market bubble, fortunes for shareholders abruptly changed. In a matter of weeks Netflix stock was down as much as -50%, bringing the share price all the way back to where it was in early 2018. That's almost four years of gains gone in 10 weeks. This is observation number one. When it happens, it can happen fast.

Observation number two is thinking about the psychology that's now in play and the options shareholders are faced with. Option 1 would be to sell the stock, take recent losses, and move on. Of course, this would make sense if the investor felt there was more downside ahead and wanted to avoid further losses. Option 2 would be to hold the shares and hope for a recovery in price. This of course would make sense if the investor felt the business prospects were still good for Netflix, the share price was fair, and the recent volatility was short-lived.

Although these choices seem pretty straightforward and simple, getting there isn't quite so easy. First, it's extremely difficult to stay calm and collected in the face of a -50% decline. Investors can have a very hard time making sound long-term decisions in the face of scary short-term volatility. Emotion tends to trump logic which leads many to sell good investments at very inopportune times (the same emotional response that leads most to buy them at less-than-ideal times). For others, selling what they recently bought because it went down in price is synonymous with admitting they were wrong. As we know, this can be challenging for some, which causes them to hold onto declining investments for much longer than they should. Again, if the investment made good sense when it was made and prospects continue to look good, then this might not necessarily be detrimental to long-term success. The problem arises when this isn't the case. Investors can have a very difficult time changing their mind in the face of changing facts and circumstances.

Finally, a mistake we see investors making repeatedly is thinking that a company's fortunes are always reflected in and correlated with the company's share price. They are not. In the case of Netflix, it's possible that the company continues growing and dominating the streaming market for years to come, but the stock can still go down over a comparable period of time. How, you ask? Because the price of a stock can get ahead of itself and detach entirely from the fundamentals of the company during euphoria-filled bull markets. Coming back into sync with those fundamentals (revenue and earnings, etc.) means that the share price has to come down even as the company's fundamentals continue to improve. This is exactly what happened with technology powerhouses Microsoft and Intel from 2000 through 2013. Although they continued to grow revenue at 5-10% per year throughout that period, their stocks were under water the whole time. It took 13 years for the over-inflated share price to get back in alignment with fundamentals, despite the fundamentals continuing to do just fine. Imagine if fundamentals actually deteriorated over that same period of time. The losses and outcome would have been much worse. Consider Microsoft and Intel a best-case scenario when a pent-up volcano finally erupts. The takeaway? The company might be fine, but that doesn't mean the stock will be. It's all about the price you paid when it comes to long-term return prospects.

So, what are investors in Netflix and stocks in general supposed to do? Well, the only option for those taking heavy losses at the moment is to do the best you can to override our natural wiring as human beings by keeping emotions in check and engaging in cognitive, rational thought. If the investment is still sound (not the same as the company), then it may be best to hold that struggling investment. If not, then don't be afraid to take the loss and limit the potential for further damage. The most impactful action one can take in this moment, however, is to work through this same process to pre-empt these sudden and extreme losses. See to it that what you're holding makes good medium and long-term sense. We've discussed the appeal of precious metals and other commodity categories in this regard. By contrast, the U.S. stock market indexes and those companies that play the largest role in comprising them, in our opinion, do not make good medium or long-term investment sense. That's where the bubble is focused; the epicenter, if you will.

Regardless of how sound an investment is over the medium to long term, it can still experience scary volatility over short periods of time. A good way to think about short-term market volatility within the context of our volcano parable is sound investments may also get hit when the volcano erupts. The difference, however, is that while stocks (and other extremely overpriced assets) get hit with the lava, sound, fairly-priced investments get dusted with a little ash. We can survive a little dust from a lower, cooler, vantage point and be back on our feet in relatively short time; so long as we don't panic, run frantically away from the mountain, and trip over a rock.

There are many more Netflix's out there; most at risk of getting hit with lava. On the other hand, there are plenty of investments that offer a better opportunity for survival, and once the dust settles, for success. Stay prudent, then stay patient; in that order.