

An uncertain walk down Wall Street

Time and again newspapers pejoratively liken Wall Street with a “Casino” to underscore the almost lawless, greedy, selfish behaviour of its key players. However, who is it who really takes a hit from this unfavourable comparison?

Let us consider a simple casino game, say Roulette . Without manipulations of the hardware there is a 18 in 37 chance of a bet on the red numbers to double the wager. Thus by the law of statistics the odds are slightly against the player and the casino wins on average.

For likening a casino to Wall Street it is straightforward to call the investors players or traders, and the Croupier would assume the role of a trading platform, but what about the circling ball? The ball, after circling a few times around the wheel, and then staggering downwards, would have to quote the prices. Obviously, that's the point where the analogy fails, and it does fail miserably.

Taking the ball's task seriously we instantly notice that traders are not necessarily part of the game at all. A croupier can throw the ball and spin the wheel as often as he likes and the ball will always give a lucky number, never mind if there are winners.

By contrast, a share price can only be quoted when there are at least two players around: a buyer and a seller. It seems odd to imagine that these two act unconsciously as a ball, subject to uncontrollable physical forces, which let them in the end to agree on a price.

In fact, a close-up of the ball's movements has made some people develop tools for predicting the Roulette's outcome. Equipped with high speed cameras and computer power, it is indeed possible to know in advance where the ball's dance will probably end.

All this would not be possible, however, without the stability, reliability of the law of physics, and most importantly the absence of a ball's own will. Do we really think that traders are like that? Certainly not. Therefore, and for nothing else, Wall Street is not a casino.

In fact, a player on Wall Street does know (we do at least hope so) at every single point in time exactly what he is up to, he can decide for himself to trade or not to trade, what prices to accept and what to reject. There is no outside force or law that lets him act like a puppet on a string.

However, if Wall Street is not a casino, so what? For one thing we have to realise that Wall Street laws are not the laws of statistics, the law of Wall Street is Wall Street, or more precisely, Wall Street traders' laws. Therefore, any attempt to model Wall Street prices by laws of statistics as mathematicians, physicists and economists love to do are eventually bound to fail.

Even worse, there are not even black swans around, events which have a close-to-zero probability because everything depends on human action, subjective forces, not objective ones we would need to write down probabilities for the occurrence of black swans.

From a more practical point of view Wall Street volatility is all about humans too. Since all humans are individuals, so is their contribution to price fluctuations; the more humans are trading the more volatile markets will be. Hence, the very popular value-at-risk models, liquidity simulation exercises by command of regulator and the like all are doubtful by construction as they do not account for the generic subjectivity inherent in asset prices.

The true challenge therefore seems to be to develop risk management tools and regulation that is able to serve both aims, efficient financing of economic activity and incorporating the genuine subjectivity of market outcomes in all decision making. Calling Wall Street a casino should be no option any more, it is just too offensive from the point of view of the casino.