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Theory of Reflexivity

At the risk of labouring my point from the last few months regarding the uncertainty of the market I would like to take a closer look at one of my heroes of the hedge fund industry, and try and convey his concept of reflexivity and what it means for investors in the stock market. George Soros is truly a remarkable man, a survivor in every respect having lived through the Holocaust and then survived and prospered in the stock markets for more than 50 years, but probably more importantly are his humanitarian and philanthropic contributions to the world at large. However, despite all these achievements Soros wishes to be remembered for his philosophical contribution, more specifically his *Theory of Reflexivity*.

In his most recent book entitled, "*The Crash of 2008 and What it Means*" he writes in the most lucid and fluent prose compared to the 9 previous books he has authored. He in fact titles the 2nd chapter of this book "*Autobiography of a Failed Philosopher*" in which he details his failed previous attempts at conveying his philosophies on how the markets operate. I remember reading as a very young student "*The Alchemy of Finance (published in 1987)*" and not having the foggiest clue what Soros was trying to say, it appears I wasn't alone and Soros was shunned by the academic community for his seemingly incoherent attempt at explaining a theory at odds with the academic convention.

Let me quote a few ideas from his latest book in no particular order explaining the theory of reflexivity directly from Soros:

Reflexivity can be interpreted as a circularity, or two-way feedback loop, between participants' views and the actual state of affairs. People base their decisions not on the actual situation that confronts them but on their perception or interpretation of that situation. Their decisions make an impact on the situation, and changes in the situation are liable to change their perceptions. The two functions operate concurrently, not sequentially.

Consider classical economic theory. In its use of the concept of equilibrium, it is imitating Newtonian physics. But in financial markets, where expectations play an important role, the contention that markets tend towards equilibrium does not correspond to reality. Rational expectations theory has gone through great contortions to create an artificial world in which equilibrium prevails, but in that world reality is fitted to the theory rather than the other way around.

In essence what Soros has put forward as his *magnum opus* is a theory in which it is impossible to forecast an outcome with certainty, as the actors involved in the process each imprint their own bias or expectation into the



equation, thus rendering the outcome dependant on the unknown reaction of the participants. Soros goes further in his elaboration and explains that the fundamentals of a given market can and do change to reflect the prevailing reality. In other words a fundamentally strong economy can falter on the basis of a perceived weakness in the economy and visa versa. Soros puts forward a disequilibrium hypothesis in which he explains the markets are designed to boom – and – bust. It may be argued that Soros did not necessarily originate the general thesis as there have been other economic philosophers who have made similar contentions, albeit in other theoretical constructs throughout the ages. I would like to suggest that in this book Soros has put forward a theory that is lucid and succinct and has the benefit of 20 years of refinement and more than 50 years worth of market experience at the “coal face”; however, I end my analysis with a last quote which to me leaves the usefulness of the theory with more questions than answers.

According to the new paradigm, events in financial markets are best interpreted as a form of history. The past uniquely determined, the future is uncertain.

The problem I have is that as a market practitioner what am I am to do with this theory? How does this make me a better market analyst or trader? Or does the raw understanding that markets cannot be accurately forecasted give me the edge? I believe that understanding the very reflexive nature of the markets is a large part of the success market participants who have endured many cycles in the market display and utilize. In future newsletters we will try and explore ways of profiting from an uncertain future, now that we have made the emphatic point that markets are far from certain. To conclude this letter I wish to quote from an interview between Robert Soros and Michael Kaufman in which I believe the most insightful comments of the whole book are made, George Soros the Philosopher will hate me for this, as I think the more insightful accidental philosopher is the son not the father.

My father will sit down and give you theories to explain why he does this or that. But I remember seeing it as a kid and thinking, Jesus Christ, at least half of this is bull-sh!t. I mean, you know the reason he changes his position on the market or whatever is because his back starts killing him. It has nothing to do with reason. He literally goes into a spasm, and it's this early warning sign. If you are around him a long time, you realize that to a large extent he is driven by temperament. But he is always trying to rationalize what are basically his emotions. And he is living in a constant state of not exactly denial, but rationalization of his emotional state. And its very funny.

Michael Berman, Ph.D.