



## NISMAN INVESTMENT SERVICES, INC.

January 11, 2017

### *The Known, Unknown, and Unknowable*

“A clear understanding of what we know, don't know, and can't know should guide any reasonable approach to managing financial risk.” The above title and quote are attributed to: *The Known, the Unknown, and the Unknowable in Financial Risk Management: Measurement and Theory Advancing Practice*, edited by Francis X. Diebold, Neil A. Doherty & Richard J. Herring.

In doing research for our year-end letter, I came across this book. I loved the title, but it is a very weighty topic and too much to undertake in one letter. I do agree with the premise, so here is my take on the subject. With the recent election now behind us, we now look to the policy changes that will be introduced, and how they will affect the markets. Let us first look at what we think are the “Knowns.”

The Brexit vote and the Trump election symbolize a shift toward protectionism and isolationism. They point toward a world in which many countries will be withdrawing from the global economy. Therefore as prudent investors, we need to look for companies focused on the domestic economy. Earnings risks for these corporations are less, compared to those businesses engaged in global trade.

Investors realized that having a president in favor of business and growth is positive for corporate profits. Policies calling for lower corporate taxes, fewer regulations, and a return of overseas profits to domestic balance sheets all suggest that our economy will awaken from an eight-year slumber. Investor optimism helped stocks rally by six percent from the day after the election until year-end. If the above policies are enacted, it should lead to higher share values.

Now what are the “Unknowns”? That is a much more difficult question to answer. We know that “fake news” is something that we have to take into account when making investment decisions. While we have heard of fake news stories focused on politics, they have been around for a few years in the stock market. One example was the stock of Twitter. Citing anonymous sources a fake website, parading as *Bloomberg*, posted a story that said the social media site was in talks to be acquired for \$31 billion. Twitter stock popped 8%. After being fact-checked, it quickly became apparent that the story was entirely fabricated. The stock price gave up the gain and finished lower on that day. Investors that bought on the story made a mistake, so we must be skeptical about rumors.

With a pro-growth administration come many caveats related to the challenges of passing new regulations and the fact they won't likely take effect until 2018. Should real and nominal growth increase, it will be a difficult environment for fixed income. The market knows that the Fed raised rates once last year, but what is unknown is if they will do it again in 2017. And if so, how many times? With the prospect of higher interest rates, our task will be to uncover bond investments that will maintain their value.

The fate of tariffs such as NAFTA is another major unknown. While we know that protectionism is on the rise, we do not know how this will play out. We will watch this area with interest on how it will affect your investments.

“Unknowable” is what we cannot know. A few years ago we called this a “black swan” event. This term as popularized by author Nassim Nicholas Taleb argued that black swan events are impossible to predict, yet have catastrophic ramifications. A recent example would be the housing collapse of 2008 that led to the great recession. Therefore, it is important for investors to assume the unknowable will occur. We plan for a black swan event by diversifying investments and maintaining cash in your account to take advantage of market dislocations.

As always, thank you for the trust you have placed in us. We shall continue to work diligently to meet your investment needs. If there are any changes to your financial situation or investment objectives, or if you wish to place and/or modify any reasonable restrictions to the management of your account, please contact us.

Sincerely,

Gail, Bob and Jay