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# **Financial Unorthodoxy**

Practicable Views on Money,  
Banking and Investing

**FREE SAMPLE**

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## 7. Individual Stock Portfolio

### Public Companies

A share of a publicly traded company is often considered a certificate of partial ownership. The magnitude of the claim is proportional to the investor's position relative to the entire market capitalization<sup>38</sup> of the company. While the investor stands to benefit from his stake in certain ways, the relationship between an investor and his stock is only loosely defined and the concept of ownership deceptive.

The shareholder's primary means of participating in the profitability of his investment is through dividend payments, which he is entitled to receive, should management grant them. He also stands to be compensated for his stake in case of a takeover and holds a very junior claim<sup>39</sup> to any remaining equity should the company go bankrupt. He may<sup>40</sup> enjoy the privilege to vote on and put forward proposals that alter the operations and identity of the company. On the other hand, the stock investor does not assume any liabilities of or any responsibility for illegal activ-

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<sup>38</sup> Number of shares outstanding times (last) price per share.

<sup>39</sup> This claim is usually inferior to lenders and bond owners, meaning that in most bankruptcies shareholders will be left with nothing.

<sup>40</sup> Some companies offer shares with and without voting rights

ities by the company. The supervisory board is elected by shareholders to uphold their interests against management or outside parties.

Ownership of a company's stock is not commensurate with the common notion of *owning* a portion of that company. The relationship of a farmer to his tractor (capital invested for productive output) is much different than that of a shareholder to *his* company. The stock market investor buys into the vague hope of receiving cashflows from profitable company operations or benefitting from increased valuations in case of a takeover. Any gains from trading the shares depend on other market participants' desire to buy that very same, loose claim at a different price.

Most dividend paying companies will distribute them quarterly, semi-annually or annually. The ex-dividend date is the day before shareholders are registered to receive their payment. If you purchase shares after that date, you are not eligible to receive the most recent patch of dividend payments. The share price usually reflects the decrease in equity that results from a reduction in the company's cash holdings, by dropping in line with the per share amount of the dividend that is to be paid. A company's ability to pay a dividend and sustain it, depends on its profitability over the medium- and long-term, which in turn depends on its real productivity,

competitiveness and a variety of social, legal and macroeconomic factors. We shall look at evaluating companies in chapter 19.

## **The Life of a Share**

Dilution is the expansion of the supply of shares outstanding. Much like a central bank, a company can elect to dilute its shareholders by increasing the supply of shares available and thereby reducing existing holders' proportion of the equity, dividend and share price pie. Dilution together with the initial offering of shares (IPO) are the primary ways for companies to capitalize on their valuations. While dilution may at times be unpopular with existing investors<sup>41</sup>, it is generally a socially beneficial practice and exemplifies the purpose of free financial markets: raising capital for productive endeavors.

A buyback program is an increasingly popular tool of financial engineering, which acts as the inverse of dilution. When a company buys back its own shares, it not only artificially boosts demand for its stock, but also improves per share valuation multiples as well

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<sup>41</sup> Dilutions paired with some good marketing can sometimes lead to the elongation of what would otherwise have been a sooner and less devastating demise of a dying company.

as dividend yield. The denominator of these ratios consists of the number of shares outstanding. It shrinks as shares are taken off the market. A buyback is a balance sheet transaction that transfers cash-equivalents<sup>42</sup> into intangible assets in the form of marketable securities. This may improve the equity position of the company, if the shares rise in price and remain elevated upon completion of the program. Buybacks are hailed as a great way for companies to capitalize on suppressed share prices and diversify cash holdings. They are certainly great for management who are often compensated in stock of the company or whose performance is measured based on the stock price. They are also not exactly beneficial to society as capital flows into the stock market rather than directly to shareholders through dividends or towards improving efficiency and productivity of the business.

Private investors effectively forfeit their ability to impact the company's stance on matters of finance, operations and structure due to the plutocratic nature of the voting system, which will be dominated by asset managers, large insiders and government entities. You will get no meaningful say with regards to

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<sup>42</sup> In the super low interest rate environment of the early 2020s it has been popular to buy shares back using debt. This type of leverage almost always sacrifices long-term prosperity for short-term gains of shareholders and in particular management, who often receive bonuses and stock option packages.



takeover deals, including the valuation of your investment or the type of compensation you are to receive (cash, stock or stock options for instance). However, if your stock trades with some liquidity, you might be free to elect to sell out of the deal before it occurs.

## **The Price of a Share**

The price of a stock depends on the momentary agreement of sellers and buyers. The share price of a company on your screen is some approximation of the last price at which at least two parties exchanged their holdings. Leaving the technicalities of the orderbook for chapter 21, I would like to use the following paragraphs to provide you with a fundamental understanding of what a price represents:

The market capitalization (market cap) is the USD<sup>43</sup> value obtained by multiplying the share price times the number of shares outstanding. When the media proclaims that Apple is worth 3T USD or has gained 70B USD in a day, they are referring to its market cap, which merely describes the last price at which some market participants were willing to trade some of the

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<sup>43</sup> Assuming USD as the base currency again.

shares<sup>44</sup>. Your ability to realize that value depends on someone else's desire to pay that price precisely when you want to sell.

Assume ten people inherit one share of a company valued at 10M USD or equivalently 1M USD per share. After some years have passed, one shareholder manages to sell his stock for 2M USD, while the other shares continue to lay dormant. Does that mean the company is now worth 20M USD? Financial media and the private equity industry would tell you that it is. It could be worth 20M USD, much more, or much less. However, claiming that 20M USD is the correct valuation, based on one transaction alone, would strike me as rather ambitious. Stocks in general and large cap stocks in particular are, of course, much more liquid than this scenario portrays. I hope to have shown you though how prices are set, how one may use the perception of value to impact prices on low volume or through strong narratives, and how there is no guarantee that the prices on your screen today are a reliable representation of real wealth in the future.

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<sup>44</sup> Consider the volume of shares traded. Volume weighted prices may be a better estimator of actual liquid value during normal times. Who knows what price you will be able to realize in times of crisis.

There is no fundamental reason for the price of a stock to converge with any notion of intrinsic value over any timeframe or the current price be a guarantee for the price you will receive at any point in the future. Both intrinsic value and price are changing every second, with the former likely being unknowable, while the latter often gets mistaken for the former. The value of your investment is only ever apparent in hindsight.

## **Investment Thesis**

The stock market investor seeks a real return on his investment through the growth in profitability of the underlying company or changes in perception about any such developments by other market participants. He may view an equity investment as taking a stake in a productive enterprise, as a real investment towards economic growth, as a speculative trade based on market mechanics or psychology, as a way to exchange fiat currency for a claim to potential, future fiat currency cashflows<sup>45</sup> or as purely a diversification play.

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<sup>45</sup> In a hyperinflationary currency collapse gold tends to outperform stocks. This may be due to the fact that the social and economic turmoil that results from such a crisis is not exactly conducive of a prosperous business environment.

Despite great ambiguity about the true value of any equity investment, the stock investor generally has to believe that the business is sound and likely to operate in a conducive environment going forward<sup>46</sup>. The trader may not have to pass such judgment, as he seeks to profit from technical perturbations in markets over relatively short periods of time.

## **Risk and Reward**

By owning stocks, you assume risk pertaining to the viability of the business enterprise that you invest in. While price and value converge perhaps only occasionally, most bankrupt companies will indeed be taken off the exchanges and become worthless. By extension, you are thus exposed to operational risks, policy and macro changes that impact your stock and the perception of other market participants of any available or imagined information. You are also exposed to monetary policy changes which will not only affect the cost of capital for businesses, but also the overall economic outlook and the net present value of your future dividend cashflows.

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<sup>46</sup> This applies to long investors; short sellers must generally take the opposite view.

You assume counterparty risk through your broker and its partners, including the banks which hold your portfolio's cash and the exchanges which facilitate your trades. There are risks surrounding technical and legal issues. There are political risks with regards to taxation regimes and governments' oversight of your investment activities. In extreme tail-risk scenarios it may be questionable whether you will be able to assert ownership of your portfolio<sup>47</sup> and if so, liquidity and transferability may be impaired.

The reward for these risks is primarily the chance to make outsized gains when the real economics of a business or people's perception thereof change drastically<sup>48</sup>. The stock market is relatively accessible, liquid and intelligible on a surface level. In comparison to other betting endeavors, I believe it yields a much higher chance of at least nominally positive returns. In the later portion of the book, we will examine a few broad concepts that may serve as a good starting point for the implementation of equity investing strategies.

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<sup>47</sup> Consider what happened to owners of Russian stocks when sanctions were imposed in response to the Ukraine war in 2022.

<sup>48</sup> Consider a business that pays a 1USD dividend annually and you buy it at 20USD for a dividend yield of 5%. The company witnesses incredible growth over the next three years and trades at 100USD, while the dividend yield remains at 5%, meaning it pays a 5USD dividend annually. Your nominal yield on the initial investment has just gone from 5% to 25% in only three years, disregarding the appreciation of the stock price.

## 8. Derivatives

### Stock Options

A financial derivative is any instrument which derives at least part of its value from some metric of another financial asset or benchmark. There are a multitude of different derivatives for a variety of circumstances and intents, such as swaps or daily leveraged certificates. For this chapter, however, I want to focus on option contracts for stocks and similar products, assuming USD as our base currency for simplicity.

A stock option is a contract that specifies the details of an agreement between the buyer of the contract and the seller. The buyer of a call option has the right to acquire 100 shares of the underlying stock at the strike price of the contract, up until the contract expires<sup>49</sup>. The buyer of a put option has the right to sell 100 shares of the underlying stock at the strike price of the contract, up until the contract expires.

Every option contract consists of a strike price, an expiration date and a market price at which the option can be bought or sold, called the *premium*. The strike

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<sup>49</sup> This applies to so-called American options which can be exercised at any point till expiry. European options, which are less common, may only be exercised on the day of expiration.

price defines whether the option is in-, at-, or out-of-the-money. A call with a strike price of 98USD for a company trading at 100USD is said to be in-the-money, implying that the owner of this option has the right to buy 100 shares of this company for 98USD. Whether this derivative trade is profitable, depends on the premium he had to pay for the contract. Had he paid less than 2 USD in this case, he would have realized a gain upon exercising this option or selling his call before expiry. The expiration date indicates the day after which the option expires either worthless, if it remains out-of-the-money, or gets exercised, if it is in-the-money<sup>50</sup>.

If you sell options, you take the opposite side of the trade. Selling a put means that, if the option expires in-the-money, you will need to take possession of 100 shares from your counterparty, paying the strike price of the contract while pocketing the premium. Similarly, for a sold call, you will have to sell 100 shares at the strike price. Selling put or call options (going short) requires you to either sell against an existing short or long position, respectively<sup>51</sup>, or to hold

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<sup>50</sup> If the (call) option you bought expires in-the-money, you usually get to choose if you want to pocket the difference in prices or take possession of the shares.

<sup>51</sup> A sold call requires as collateral 100 shares long, while a sold put requires as collateral a position of 100 shares short. If you are 100 shares short (-100) and you are required to buy 100 shares, since your short put position expired in the money, then the two

the cash necessary to deliver the shares upon expiration in your account.

Option contracts serve three purposes: hedging, leveraging and volatility betting. Options permit hedging by allowing you to decrease volatility and taking a short- or medium-term bet against the long-term theory behind your initial stock position. For instance, a dividend investor may want to retain ownership of his stake in a company, however, due to the risk of some near-term negative outcomes he may choose to buy puts on this stock. In theory, if the stock falls, his put contracts will appreciate in value and may offset some of the (temporary) losses of his stock position. This could decrease volatility and even increase returns.

The leveraging aspect results from the fact that, for the price of the premium of the option, you get to control approximately 100 shares of the underlying<sup>52</sup>. As you go further out-of-the-money, premiums gener-

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claims cancel and your position is closed. If you do not have the proper position in shares, either none or too few, any excess liability resulting from your option sales will be cash secured and your broker will make sure that your leverage is within regulatory bounds when you try to make the transaction.

<sup>52</sup> Assume a stock trades at 100 USD and you buy a call expiring in two days with a strike of 101USD for 100USD. You effectively control shares worth (roughly)  $100 * 100 = 10000\text{USD}$  on a 100USD buy-in. If this goes against you, you will find your position approaching zero rather quickly.



ally decrease meaning that leverage increases. This is the primary source of lottery-like returns often flaunted on social media. However, leverage tends to scale with risk. There is no reason to believe that there is an edge to be had, without some very deep scrutiny of markets and opportunities.

Lastly, options allow traders to make non-directional bets on changes in implied volatility through strategies such as iron condors. Options prices are akin to future contracts and their pricing implies future volatility for the underlying share price. In other words, through the option chain we can derive the option market's expectation of the magnitude of a move in a given time frame. Using option strategies, traders can bet on changes in volatility without a need to guess which direction prices will move in.

One can buy calls, sell calls, buy puts, sell puts or trade any combination thereof, including different expiration dates and/or strike prices. Every combination will have a different risk/reward profile. *Financial Unorthodoxy* is evidently not a book about options trading, which in its entirety, like most areas of finance, could fill libraries, but I would like to highlight some practical uses throughout the book.

## Black Scholes and the Greeks

The price of an option is called the premium. It is commonly denominated on a per share basis, meaning an option that trades at 1.00 costs 100USD to buy. If you sell an option, you collect the premium, but you need to put up collateral in the form of shares or cash<sup>53</sup>. Your hope is that the option expires worthless (out-of-the-money) or that you can buy it back at a lower price. If you buy an option, you pay the premium upfront and hope to exercise the option at a favorable price or benefit from gains as the price of the option appreciates, while the underlying moves in your direction or demand for your contract increases.

Option premiums are set by market forces and they are traded just like stocks until their expiration: Two parties agree on a price at which they want to transact the contract. The Black Scholes model seeks to *estimate* different components that make up the price of an option, based on a range of assumptions. These estimated components are the so-called *greeks*:

Delta estimates the sensitivity of the option's premium to the price of the underlying stock. All else

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<sup>53</sup> Many brokers will require a margin account for selling options, so this transaction would decrease your buying power, increase your maintenance margin and, if your portfolio leverage exceeds 1, also increase your loan costs. Margin accounts will be reviewed in chapter 18.

equal, a 1USD price increase of the underlying stock will yield a USD change in the amount of delta for the contract's premium. Delta is not constant but varies in relation to the option's strike price relative to the current share price of the underlying stock. Delta is instrumental in hedging when trying to understand the relationship of your stock versus derivative position. In order to fully hedge a stock position, you want the number of shares you own to be equal to the number of option contracts times their respective delta value<sup>54</sup>. Delta also serves as an approximation of the likelihood that the option will expire in-the-money. You can roughly estimate the leverage factor of your long option trade by multiplying the contract's delta with the underlying stock price and dividing by the price of the option.

Gamma estimates the sensitivity of delta as its first derivative. All else equal, a 1USD price increase in the underlying stock will yield a change in delta of the magnitude of gamma. Gamma indicates the rate of change of delta and is highest the closer the option strike is to being at the money. This implies that absolute change in delta and therefore the volatility of option premiums is highest the closer the strike price is to the actual stock price.

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<sup>54</sup> These values are estimates that change every millisecond, so for practical use this should be regarded as a conceptual guide not an exact mechanism.

Theta estimates the option's loss in time-value as the date of expiration approaches. All else equal, for every day that passes the price of the option will decrease by the USD amount of theta. Theta is greatest for at-the-money options and generally grows exponentially in relative terms as expiry approaches. That is, the relative value an option loses increases with every day that passes, in particular within the last few weeks, but primarily affects options that are within a delta of  $>0.25$  for practical purposes.

Vega estimates the option's sensitivity to the volatility of the underlying stock. All else equal, if the volatility increases by 1% the price of the option will change by the USD amount of vega. Vega is of particular importance to event traders, who seek to benefit from inefficiencies that sometimes arise around big corporate events such as earnings releases. It often occurs that options' estimates of implied volatility diverge from the realized volatility that actually follows and this creates opportunities for traders willing to make such bets.

Rho estimates the option's sensitivity to benchmark interest rates such as government bond yields. All else equal, a 1% change in the interest environment will change the option's price by the USD amount of rho. Generally, rho is negligible unless you are trading options with expiration dates months to years out.

Any sophisticated option chain will provide you with these *greeks*. It is important to understand their meaning and appreciate the complexities of option pricing. Still, the actual premium is purely a result of supply and demand for the contract. These prices need not be rational or adhere to the inference of the model.

The mathematics of options trading is complex. I believe it is important to have a basic understanding of options, in order to flesh out your view of the financial world and not fall victim to false promises. You can dive really deep into this subject and there are excellent resources available even for free. However, options are not inherently more profitable than other instruments. You can make great returns without ever touching one. Should you be intrigued by the subject, I would encourage you to look deeper. Knowledge of options complements trading stocks, but it is not a key driver of long-term profitability for most investors, in my view.

## **Investment Thesis**

The stock options trader may seek a real return on his investment or a decrease in volatility across his portfolio by using options as insurance contracts. He

may want to smooth his return by selling options against his position which generates cashflows in the form of premiums. He may try to profit from statistical advantages that the option markets may reveal or leverage himself to near infinity to meet his personal risk tolerance.

## **Risk and Reward**

Stock options are derivatives of publicly traded shares; thus, all the risks of the previous chapter apply. Additionally, option markets can be highly illiquid at times, resulting in enormous spreads between bid and ask prices as well as slow order executions. Transaction costs may be extremely high in relation to the value of the contract. You are also exposed to risks of early, or unexpected assignment, which can mean that the required collateralization for this position changes drastically and instantaneously, increasing your risk of being liquidated (margin called) as well as exaggerating the costs of holding an oversized position. When selling naked, cash secured options you are often required to deploy a margin account, which comes with its own set of risks, to be discussed in chapter 20.

In return, you can use options to significantly improve your risk-adjusted performance for existing holdings, boost your nominal return through almost limitless leverage and save on fees when entering and closing out positions through short-sold options. Option prices are comparatively volatile and great care must be exercised.

## 16. Asset Price Drivers

### Price versus Value

This chapter will explore some of the major drivers of asset prices. Determining the *true* value of any asset is fundamentally a philosophical problem which I will not attempt to solve, yet even a derivation of an asset's economic value through estimation of its utility remains difficult. I shall also neglect the ineffectual task of decomposing an asset's price into current value plus a component of expectations about future unknowns or unknowables. Rather, we will look at factors that in general make the fiat-currency, nominal price of an asset go up.

### Economic Realities

An asset may appreciate in value as its usefulness improves. Such improvement is often the result of innovation. For instance, a company's stock may appreciate in response to their sales of a new and desired product. A metal may be in high demand as new technologies require its use. Real estate may appreciate in price as citizens' preferences shift. These are non-fiat changes that tend to have a positive effect on the



price of the asset involved in the creation of real value. Likewise, an increase in the population stimulates demand for goods, services, real estate and money. These effects are particularly pronounced, if the wealth is distributed evenly among the growing population.

## Monetary Policy

Monetary policy is decided upon by central banks with the presumptuous aim of managing the supply of fiat money and the economic cycle<sup>75</sup>. It wields three primary powers to meddle with markets in pursuit of bureaucrats' vision for the economy: interest rates, monetary policy and control over bank activity.

Most central banks have the power to set the inter-bank interest rate, which is generally the equivalent of a conceptual risk-free rate. While the rate defines the short-term borrowing costs for banks, it also directly influences credit markets such as those for government debt, mortgages, bank deposits and bonds more broadly. Lower interest rates stimulate demand for new loans, thereby increasing the money

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<sup>75</sup> Instead of using the term *economic cycle* central banks will say they manage *employment*.

supply through the fractional-reserve lending scheme, which ultimately leads to the appreciation of asset prices across the board.

Central banks will directly expand the money supply by buying assets such as mortgage-backed securities and government debt with newly created money. Such actions distort market function. They act as particularly localized perversions of interest rate<sup>76</sup> pricing mechanisms and subsidize those who bankers and politicians wish to support. Every holder of the currency foots the bill as his position is diluted, while some assets gorge themselves on the central banks' seemingly infinite nectar.

Controlling bank activity and by extension lending standards is another powerful tool to affect ease of credit, money creation and the appreciation of asset prices. When lending standards are easy, money gets created rapidly and asset prices skyrocket. Through various direct lending regimes for troubled institutions, central banks can become the arbiter of economic viability. They consequently play a key role in deciding on who fits the bill and who gets the price<sup>77</sup>.

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<sup>76</sup> When central banks print money to buy government debt, they are pushing down the cost of interest as they generate artificial demand for these debt instruments.

<sup>77</sup> In 2023 alone the Swiss National Bank has backstopped a forced takeover deal of de-facto bankrupt Credit Suisse by UBS, while the US Federal Reserve Bank has brokered many deals of failed

Through abuse of these powers, central banks have progressively evolved into institutions of central planning. They are players in the markets, supporters of political ideologies and, either directly, or indirectly involved in shaping an economy to their, rather than the market's liking. For instance, the European Central Bank (ECB) punishes its subordinate banks who are willing to lend to companies whose business goals do not align with that of the ECB. They are also eager to transfer wealth between member states of the European Union by effectively deciding who to give the printed money to. The unelected ECB, among other central banks, has granted itself political powers that cannot be reconciled with a democratic system. The resulting manipulation of asset prices is just one manifestation of this troubling development.

## **Fiscal and Government Policy**

Government spending and policies play a dominant role in asset pricing. Government deficit spending

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banks making generous gifts to certain depositors and acquirers. "This is not a bill for the taxpayer", they will cheekily or ignorantly claim. It is in fact a bill for every owner of CHF, USD or any debt instrument in those currencies, respectively. Unlike the laws of nature, the laws of men seem to only ever approximate consistency at the best of times.

leveraged through debt creates a highly inefficient economic environment, where winners and losers are chosen based on ideology or nepotism. A prosperous future is sacrificed for a wasteful present, as subsidies incentivize uneconomical endeavors and public debt crowds out the private economy. This parasitic nature of an uninhibited system harms growth, while also burdening future generations with the need to recalibrate the fiat-debt pyramid scheme at some point<sup>78</sup>.

Government policies such as tax law, work law, environmental laws, trade policies among many others have a direct impact on any asset held within or beholden to its jurisdiction. Government accountability, stability and corruption are more opaque realities that equally impact the viability of investments.

Governments have the power to significantly alter the trajectory of your investment at any point in time. A balance needs to be struck between control and overreach. Governments undoubtedly serve an important role; however, we should not easily forfeit our sovereignty and economic freedom by favoring, or even demanding government intervention and

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<sup>78</sup> This point could be reached when creditors realize that they are not ever going to be adequately compensated for the money which they lent to the government or when pensioners recognize their loss of wealth as retirement funds get stretched in real terms.

control. A market upon which the government acts only seldomly and in accordance with clear purpose and reason, is one which minimizes the advantages of those closest to the leadership and maximizes that which markets tend to do well: allocating resources comparatively efficiently. There must be rules, but they should be clear, binding and consistent. If they are, asset prices will more closely reflect their true value to all people, not just those in power.

## **Geopolitics, Public Health and Nature**

Geopolitical events such as wars, embargos or restrictions will evidently have a significant impact on the value of assets, particularly for the conflict party which is deemed weaker. Public health will greatly influence productivity and a society's needs, while public health events may have temporary consequences that pave the way for lasting change. Political overreach, regardless of the true dangers of the event, appears to be a common side effect. Perception often trumps reality and that seems distinctly applicable to the management of risks pertaining to natural catastrophes. When they occur, they will markedly change the price of local assets, however, the mere anticipation of risk may lead to a skewed perception of value.

## **Expectations and Sentiment**

All of the above and many other idiosyncratic factors are together scaled by the perception of market participants in order to arrive at the current price of an asset. Additionally, many asset prices will reflect a time horizon of undefined duration, which digests the expectation of what will happen, based on what is perceived to be happening, fused with a current macro mood and a sentiment about various developments. We must also remember that the financial markets are plutocratic systems, where the visions of governments, big institutions, money managers and super wealthy individuals count for much more than yours or mine. One may conjecture that in the medium term, knowledge of these players' intentions might be more financially fruitful than an accurate forecast of what will actually happen in the future.