

Congratulations to
MODERNTRADER
 Best Business Magazine of the Year
 — 2017 Niche Media Awards

FREE NEWSLETTER

MODERN TRADER

FOLLOW

FUTURES FAVORITES TRADERS FINalternatives HARD ASSETS MODERN TRADER ALL + SEARCH

VaR: The number that killed us

By Pablo Triana

December 1, 2010 • Reprints

FROM THE ARCHIVES



On Sept. 10, 2009 former trader and bestselling author Nassim Taleb did something that he very seldom does: he wore a tie. Taleb has oftentimes publicly expressed his distaste for the blood-constraining artifacts, as well as for those who tend to don them, so the Lebanese-American let the world know that was a very special day for him by betraying a sacred personal disposition.

So what prompted the composer of "The Black Swan" to button his shirt all the way up on that fall date? He had been invited to a very solemn

venue by very distinguished hosts. And that was an invitation that Taleb had every intention of accepting. In fact, he had been waiting and expecting it for more than a decade. The *raison d'être* of the event for which his company was now being required had been close to Taleb's heart for most of his professional and intellectual life. It represented a central theme in his actions and ideas, close to an obsession. He had through the years incessantly warned as to the havoc that might be wreaked should others massively act in a manner counter to his convictions. Such concerns typically went unheeded (to the detriment, it turned out, of society), but now he was being offered a pulpit that seemed irresistible. This time, the world would have no option but to listen attentively.

As Taleb entered the Rayburn Building of the U.S. House of Representatives on Capitol Hill that September morning, he must have felt vindication. As he approached the sober room where several men and women awaited the start of the House Committee on Science and Technology's hearing on the responsibility of mathematical model Value at Risk (VaR) for the terrible economic and financial crisis that had caused so much misery, Taleb probably reflected proudly on all those times when, indefatigably and in the face of harsh opposition, he alerted us of the lethal threat to the system posed by the widespread use of VaR in finance. Now that the damage wrought by VaR seemed so inescapably obvious that lawmakers had been motivated into investigating the device, Taleb no longer seemed like a lone wolf howling at the moon.

What is so wrong about VaR, and why was Taleb so concerned about its impact? More importantly, why should VaR be held responsible for the crisis? VaR is a number that purports to estimate future losses derived from a portfolio of financial assets, and presents two major problems: 1) it is doomed to being a very wrong estimate, because of its analytical foundations and the realities of real-life markets; 2) in spite of such (well-known) deficiencies, it has for the past two decades become an ubiquitously influential force in the financial world, capable of directing decision-making inside the most important banks. In other words, by letting trading activity be guided by VaR, we have essentially exposed our economic fate to a deeply flawed mechanism. Such flawedness, as was the case not only in this crisis but also before, can yield untold malaise.

One dimension in a 3D world

Follow Futures



We Asked Traders

more >>



Top things I learned about life while day trading millions

Sponsored Content

Trading



Equities.com launches unlimited trading via Tradier Brokerage, Transforming into a news & fintech portal

Featured Topics

Commodities

more commodities>>

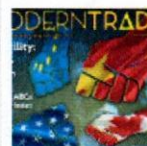


A Saudi-Iran oil war could break up OPEC

AccuShares*

Volatility

more volatility>>



Implied vs. Realized Volatility & the VIX

Financials

more financials>>

Making drones work for you