Brown, Aaron - Red-Blooded Risk

John Wiley & Sons, 2012, [Finance] Grade ★★★★

I really don't know what to make of this book. Parts of it are hugely interesting, even brilliant, and other parts are simply strange. It's a mighty and personal exposé of philosophy, psychology, politics, gambling, statistics and god knows what else. All of the above is tied to risk taking and risk management. Aaron Brown, who paints a picture of financial markets that has profoundly changed the development society a large, is risk manager at Cliff Asness' hedge fund giant AQR. With a 30-year career in the financial markets Brown has also been a trader, a portfolio manager, head of mortgage securities and a risk manager at institutions like Citi, Morgan Stanley and others. To top it off he's been a finance professor and a world-class poker player. Brown is one of the first generation Wall-Street quants that apparently often had a background in the gambling world.

There are plenty of highlights in the book but one important theme touches on what has been called "Knightian uncertainty", i.e. Frank Knight's distinction between "risk" as something unknown but measurable and with predictable variation and "uncertainty" as something where the outcomes were likewise random, but governed by an unknown probability model. There are also parallels to Nassim Nicholas Taleb's Mediocristan vs. Extremistan. Brown points to the fact that in relation to this "probability" means two things; the frequency of something recurring and a degree of belief in a proposition. The first is something that you should exploit in your day-to-day business through measured risk taking and the other is something you should prepare for so you make sure you live to see the next day when it occurs.

Brown stipulates three iron rules for risk takers 1) you need to have an edge in all your bets, 2) your bets must be as independent as possible so you're not effectively making the same bet over and over and 3) you must size your bets properly. On the one hand you cannot lose so much that you are taken out of the game but on the other hand you must bet big when the right gambles appear. Those rules lead to a second theme of the book, that of the Kelly criterion vs. modern portfolio theory. Possibly the best chapter of the book is *When Harry met Kelly* that describes how the risk management of Harry (Markowitz) focused of diversification while that of contemporary (John) Kelly instead emphasized the position sizing giving optimal long term returns. They both agree on the fact that you shouldn't put all your money in one stock. For Markowitz this was because you should minimize the stock specific risk of the portfolio while for Kelly it was because it was a case of overbetting. If you loose your money on that one bet you also give up the chance to participate in all the future possibilities to profit. MPT has become finance mainstream but the Kelly criterion is still pretty much confided to the domain of hedge funds and traders. In this mainstream finance looses a valuable opportunity to understand how volatility affects multi-period results.

The author's writing in many respects resembles that of Taleb. Brown's self-perception is equally extended; he fosters an opinionated outsider mentality; clearly has a similar philosophical interest and is extremely talkative. Even though the language is forthright and there is almost no mathematical notation, this book is not an easy read as the reader often will find himself lost in a number of side stories, anecdotes and metaphors. At times a section off the beaten track will lead back to the topic of risk and an important insight, but at times it will not. In between the texts there are, believe it or not, a number of manga strips! In what is almost a separate – and interesting - story within the story, Brown develops the notion of derivates as the future of money. Personally, I think Brown to some extent overstates the financial industry's impact on Main Street.

It is entirely fitting that the Amazon customer review grades for the book includes no average grading's. The reader will not stay unaffected.

Mats Larsson, March 24, 2014