5/8/2012 - Here is an article by Absolute Return Partners, LLC, located in London. Woody Brock is excerpted here in their length article:
http://www.creditwritedowns.com/2012/05/lessons-in-risk-management.html

Correlated mistakes Whether we like it or not, we will continue to make mistakes. It is simply part of human nature. However, the affect mistakes have on financial markets are compounded when they are correlated. A "correlated" mistake is one in which investors share a common forecast that proves to be wrong. An "uncorrelated" mistake is one where investors' forecasts are widely spread out symmetrically around the eventual outcome (the Truth)[2]. Our economic adviser Woody Brock makes the following observations on correlated versus uncorrelated mistakes:

"The more correlated the forecasting mistakes of the individuals in a market are, then the greater the market correction (and hence volatility) will be in the market once the Truth is learned. When forecasts are uncorrelated and distributed symmetrically around the Truth, then once the Truth is learned, for every seller there will be a buyer and market price does not change. There is no volatility. In the case of a correlated structure, the reverse is the case: everyone becomes either a buyer or a seller in unison, resulting in sharp changes in price."

Leaning on Kindleberger's work[3], Woody Brock goes on to conclude:

"In applying this insight to help explain the case study of the Global Financial Crisis three years ago, I arrived at what I have termed the Fundamental Theorem of Risk: A Perfect Financial Storm will occur when (1) investors have bets based upon very similar forecasts, (2) their bet is a "big" one, for example, a bet on the price of their principal asset (their house), and (3) both investors and their banks are maximally leveraged. It can be demonstrated formally that these three conditions will generate a Perfect Storm of maximal volatility — and note how perfectly these three conditions were met in the US housing market collapse. The role of excess leverage is to non-linearly amplify market distress."

Woody Brock's work is critical in terms of understanding why 2011 turned out so differently from 2008 and, more importantly, why the painful experience of 2008 is not likely to be repeated any time soon, at least not in Europe or the United States. In 2011, investors were (and still are) deeply divided as to the longer term consequences of the policy being pursued – witness the great deflation vs. inflation debate – so Woody's first condition (investors having bets based upon very similar forecasts) was not met in 2011 and is still not met today unlike in 2008 where all three conditions were fulfilled in abundance.

The all important question

… I will finish this letter by looking into the future and give my response to the all important question: Where should investors look for the next big crisis? Many pundits are pointing to the bond market as an accident waiting to happen. Andy Xie says that the current policy "will lead to

catastrophic bond market collapse"[4]. Frank Veneroso says "bonds and bunds at these yields are a sheer madness"[5]. Both men are widely respected and very astute observers of financial markets; however, if Woody Brock's logic proves correct, betting on the bond market as a major accident waiting to happen may prove rather futile. My money is on Asia. Here is the logic.

We know from experience that an asset bubble that bursts is likely to create what are often referred to as echo bubbles. An echo bubble is a follow-on bubble from the initial asset bubble and is usually created when monetary and/or fiscal policy is relaxed in response to the bursting of the initial bubble. Some market observers have actually argued that the financial crisis of 2008 was in fact the bursting of an echo bubble created by the very lax monetary policy created in response to the bursting of the dot com bubble in 2001-02.

We also know the effect artificially low interest rates can have on a country. Think Spain or Ireland, both of which adopted artificially low interest rates when they first joined the eurozone; however, rates were low at the time to accommodate a rather weak German economy. The low rates did wonders for Ireland and Spain in the early years of the eurozone membership but it is now painfully clear that enormous excesses were created as a result.