

Nassim Nicholas Taleb's Prescription for a Black Swan-Proof Economy

By Bruce W. Fraser
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Nassim Nicholas Taleb is not one for understatement. He has the cure-all for what ails the economy, which he proclaims with sublime modesty. The outspoken curmudgeon and author of the best-selling “*The Black Swan: The Impact of the Highly Improbable*” lived up to his iconoclastic reputation at an investment industry conference in New York last week.

The conference was sponsored by Barry Ritholtz, author of the blog “The Big Picture,” which takes a macro perspective on the capital markets, economy, technology and digital media from a somewhat contrarian viewpoint. Ritholtz is author of the recently released book “*Bailout Nation*.”

The U.S. economy is broken -- but not beyond repair –and that repair will not be a snap. It does not necessarily need more regulation, but more intelligent regulation – plus the will to let entities like Citibank and General Motors fail once they become too big and cumbersome and act irresponsibly.

It was vintage Taleb, who developed his theory that high-impact random events, which he calls “black swans,” determine the course of history. Taleb, a Lebanese, is a literary essayist, epistemologist, researcher and former practitioner of mathematical finance. He is currently distinguished professor of risk engineering at Polytechnic Institute of New York University.

Taleb described himself as “mathematical, not a mathematician.” Mathematics, he said, “has failed us in so many things.”

Those failures manifest themselves in the current problems with financial institutions like Citibank, and arose in the early 1980s when “we saved banks like Continental Illinois so we could allow Citibank to get too big to fail.”

Taleb blames the regulators but not necessarily the regulations they created.

“I don’t trust human beings. If we had the ability to learn, we would have learned from the Great Depression. If governments are subsidizing banks, you have incentives for people to make mistakes.” Unwise use of regulations, he said, is like a doctor who gives medicine to a sick patient, which sometimes results in creating a greater problem rather than a cure.



The previous speaker, Rep. Alan Grayson (D.FL.), a member of the House Financial Services Committee, called for a new set of more stringent rules and regulations to prevent systemic risk from rising again in the U.S. economy. Taleb disagreed, and said the economy does not necessarily break down because of a lack of regulatory enforcement, but rather the opposite. “The system blew up because of risks and regulations. We do not need any more regulations,” he told the audience. “I have not heard any regulator say we made a mistake on regulations.”

Taleb reviewed his 10 principles for a black swan-proof economy.

1. **What is fragile should break early while it is still small.** Nothing should ever become too big to fail. Taleb referred to Standard Oil, which by 1911 had grown so big that it was doomed to fail, forcing the government to divide it into smaller companies. Similarly, Citibank should have been allowed to die in the late 1980s because by then it had grown far too big and unwieldy. Subsequent tampering with it was a mistake, he said.
2. **No socialization of losses and privatization of gains.** Whatever needs to be bailed out should be nationalized; whatever does not need to be bailed out should be free, small and risk-bearing, according to Taleb. He criticized Robert Rubin, former Treasury Secretary and later a director at Citibank, for allowing the bank to take on too much risk. “Rubin made \$110-\$120 million during his tenure at Citibank and increased its risks geometrically, and it blew up,” Taleb said. “You had a mismatch between risks and composition. What system can support this?”
3. **People who drove a school bus blindfolded (and crashed it) should never be given a new bus.** Taleb asked rhetorically: “Are the people who created the recession capable of legislating their way out of it? This is the problem of government. I’m not against government.... But there is no evolution at the level of government. We have evolution at individuals’ level.” Governments don’t go bust; corporations die or should be allowed to die, he said, just as someone who crashed a plane should not be given a new plane to crash.
4. **Do not let someone making an “incentive” bonus manage a nuclear power plant—or your financial risks.** Chances are this person will cut corners on safety to show profits while claiming to be “conservative.” Taleb illustrated the point with an analogy. “If you lose money three days in a row, people think you’re a retard. If you lose money five days in a row they invite you out to lunch. There’s something strange about that.”
5. **With a complex leveraged system you need a counter-balance.** Complexity from globalization and highly networked economic systems needs to be countered by simplicity in financial products. “We have a complex (economic)



system with a lot of financial products,” that need to be simplified, according to Taleb.

6. **Keep sticks of dynamite, even if they come with a warning, away from children.** Complex derivatives need to be banned because nobody understands them and few are rational enough to know it.
7. **Only Ponzi schemes should depend on confidence.** Governments should never need to “restore confidence,” according to Taleb. The economic system cannot rely on confidence alone because it’s too complex.
8. **Do not give an addict more drugs if he has withdrawal pains.** Using leverage to cure the problems of too much leverage is not a cure; it is denial. “The debt crisis is not a temporary problem, it is a structural one. We need rehab,” he said.
9. **People should not depend on financial assets or fallible “expert” advice for retirement.** Economic life should be “definancialized.” We should learn not to use markets as storehouses of value; they do not harbor the certainties that normal citizens require. People should experience anxiety about their own businesses (which they control), not their investments (which they do not control), according to Taleb.
10. **Make an omelet with the broken eggs.** Finally, this crisis cannot be fixed with makeshift repairs...It needs to be rebuilt with newer, stronger materials. “Let us move voluntarily into Capitalization 2.0 by helping what needs to be broken break on its own, converting debt into equity, marginalizing the economics and business school establishments...banning leveraged buyouts, putting bankers where they belong, clawing back the bonuses of those who got us here, and teaching people to navigate the world with fewer certainties.”

Taleb took issue with published reports saying massive stimulative efforts by governments will eventually lead to hyperinflation. “I don’t expect hyperinflation. What I do expect is forecasting errors,” he said. Extreme events are far more likely than hyperinflation.

Taleb avoided discussing one of his newest ventures, the Black Swan Protection Protocol-Inflation Fund, which operates under the umbrella of Universa Investments LP, a hedge fund firm in Santa Monica, Calif., where Taleb is an advisor. Funds run by Universa, which is managed and owned by Taleb’s long-time collaborator Mark Spitznagel, gained more than 100% in 2008, according to a recent “*Wall Street Journal*” story. Universa now manages approximately \$6 billion, up significantly since its founding in January 2007, when it raised \$300 million, the *Journal* reported.



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