

How to Live in a World of Black Swans: Nassim Nicholas Taleb's Take on the Financial Crisis

By Susan B. Weiner, CFA
October 7, 2008



What do a turkey being fattened up for Thanksgiving and Federal Reserve Board Chairman Ben Bernanke have in common? According to Nassim Nicholas Taleb, author of the best-selling *The Black Swan: The Impact of the Highly Improbable*, both mistakenly act as if the past predicts the future. The turkey, getting fed for 1,000 days, expected only food from the farmer until the ax fell just prior to the holiday. Bernanke, author of "[The Great Moderation](#)," mistook a lack of volatility for a lack of risk. They both failed to consider the potential for a "black swan," the focus of Taleb's speech on "How to Live in a World of Black Swans," delivered to the Financial Planning Association's annual conference in Boston on

October 4. Taleb reviewed some of the concepts discussed in his book, and then concluded with a call for investing in robust "barbell" portfolios.

Black Swans, Mediocristan, and Extremistan

Three terms are key to understanding Taleb's take on the current financial crisis in the U.S.: black swans, Mediocristan, and Extremistan.



The term “black swan” refers to an unexpected rare event. It comes from the European assumption that all swans were white—until they discovered the black swan in Australia. According to Taleb, a statistical black swan:

- Must be of very low probability
- Carries massive consequences when it occurs
- Is not anticipated before the fact, but after the fact “everyone” acts as if they know exactly why it happened

Taleb divides the people’s world views into two camps: Mediocristan and Extremistan. Mediocristan is dominated by a belief in mediocrity. As Taleb said, “No single observation will make a big difference to the total.... One large unexpected event won’t matter much because it’s not going to play a large role.” This is the world view upon which portfolio theory relies, he said. It’s a world in which extreme events don’t exist.

Taleb believes we live in Extremistan, a world in which exceptions play a very big role. For example, of the 20,000 fiction books published annually, just five to 25 books account for one-half of book sales and an impressive 98% of profits. Or take the Standard & Poor’s 500 index. The 10 most volatile days account for 50% of the S&P 500’s returns over a 55-year period, according to Taleb. The role of single-day extreme returns is even more pronounced if you look at individual stocks, he noted.

“A lot of people in Washington and in the Federal Reserve didn’t know we live in Extremistan,” said Taleb. Because policymakers—and many financial firms—believed in Mediocristan, “they were making huge bets vs. Extremistan.” As they made those bets, they took comfort in their forecasts and metrics that encouraged them to overlook the possibility of rare events. Forecasts give an illusion of control and metrics like Sharpe ratios don’t work, said Taleb, who lamented how Excel spreadsheets have encouraged people to make projections much further into the future than in the days of paper and pencil.

Banks landed in their current mess because of reassuring forecasts about the very low probability of dire events. He said banks used forecasts of dire events that “will happen every 10,000 or 10 million years, so take the risk,” said Taleb. He figures that people who make long-term forecasts are going to be wrong because they take too narrow a view of what may happen. “The world is not reasonable. The world delivers crazy events,” he said.



Limit Your Risks to Live with Black Swans

Taleb suggested a strategy for living with black swans: limit your exposure to black swans with negative consequences, especially those that offer the potential for unlimited losses and limited profits. "If you don't know where the risk of rare events is, then don't leverage yourself," he added. "If banks had done this, we'd be smiling today."

Investors who seek a medium-risk portfolio should invest in a barbell portfolio that combines relatively risk-free investments with risky investments suggested Taleb, who said he's a big believer in diversification. He believes that because we can't assess risk accurately, it's hard to say that any investment is truly medium-risk. But you'd be pretty safe saying that a portfolio of 80% Treasuries and 20% high-risk investments is medium risk. Still, when you're choosing your high-risk investments, stay away from derivatives, he cautioned.

In conclusion, Taleb said, "Think of positive black swans. They're out there and no one is looking for them." Medicine has thrived on positive black swans, as the discovery of the side effects of mustard gas on soldiers led to chemotherapy, he said. Although Taleb didn't speculate about the nature of a positive financial black swan, perhaps the financial world's equivalent of a new drug treatment will eventually emerge from the current crisis.

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