FOCUS CONSULTING GROUP

THE BLACK SWAN

and High-performing Investment Teams

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Introduction

Unlike Nassim Taleb, author of *The Black Swan: The Impact of the Highly Improbable*, I'll get right to the point. (I enjoyed his book, but Taleb does like to hear himself write…so to speak). Here's the point: great investing is a matter of temperament. Warren Buffett acknowledges this point in his job description for a new CIO at Berkshire Hathaway: "...independent thinking, emotional stability, and a keen understanding of both human and institutional behavior." Taleb has some interesting things to say about independent thinking and human behavior in *The Black Swan*. And you have to love a guy who calls Nobel prize winners "idiot savants" and asserts that Paul Samuelson, Robert Merton, Jr. and John Hicks "wrecked the ideas of John Maynard Keynes." And who further argues that when lofty theorists like Merton and Scholes wade into the real world of investing — via Long Term Capital Management, (LTCM) — the results are "intellectual comedy."

Discussion

Evident in Taleb's work are several of the temperament/behavioral points we wrote about in High-performing Investment Teams. Specifically, Taleb embraces these qualities of world-class thinking (thereby avoiding "intellectual comedy"):

- choosing curiosity over defensiveness;
- separating Fact from Story (i.e., opinion and belief); and,
- learning to "hold one's story lightly."

First, a quick review of Taleb's main ideas. The title *The Black Swan* refers to an event that is:

- extremely rare;
- has extreme impact; and,
- is explainable after the fact.

For example: a terrorist attack on 9/11 or a black swan—both very rare but they do exist.

Taleb divides the world into two camps, when it comes to thinking about Black Swans or dealing with the general issue of randomness (risk):

1. Skeptical empiricist like Taleb
2. Platonic theorists like most investors and Nobel Prize winners

He lists the following characteristics for each camp:

A Lesson for Joe

The following is an example of what good decision-making does NOT look like. Senior portfolio manager, Joe, has assembled the team of analysts and junior portfolio managers and has asked for an update on a large holding. One analyst presents the positive case for the stock. As part of their process, a different analyst presents the devil's advocate case. Discussion ensues, and finally, Joe says to his junior portfolio managers, "Well, what do you think?" At this point, the assumption in the room is that Joe is looking for consensus on this stock: he wants to talk it through until he and the three junior portfolio managers are of one mind.

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Skeptical Empiricists: Taleb the "Feisty"	Platonists: investors and Nobel winners
Have the guts to say, "I don't know"	Respond, "you keep criticizing these models, but they are all we have."
Thinks of Black Swans as dominant source of randomness	Thinks of ordinary fluctuations as a dominant source of randomness, with jumps (Black Swans) as an afterthought.
Prefers to be broadly right	Is precisely wrong
Does not believe that we can easily compute probabilities	Built their entire apparatus on the assumptions that we can compute
Develops intuitions from practice, goes from observations to books	Relies on scientific papers, goes from books to practice
Not inspired by any sciences, uses messy mathematics and computational methods	Inspired by physics, relies on abstract mathematics
Ideas based on skepticism; on the unread books in the library	Ideas based on beliefs; on what they think they know
Seeks to be approximately right across a broad set of eventualities	Seeks to be perfectly right in a narrow model, under precise assumptions

Avoid Causal Attribution

From Taleb's point of view, most investors are operating out of the Platonic camp. As he said in his first book, we are fooled by randomness. As a result, Taleb warns us over and over not to fall for the brain's natural tendency to make causal links. He says, "Learn to read history, get all the knowledge you can, do not frown on the anecdote, but do not draw any causal links, do not try to reverse engineer too much—but if you do, do not make big scientific claims."

Another major distinction that Taleb makes is between the "bell curve" people who inhabit the world of Mediocristan v. the Mandelbrotian people who inhabit the world of Extremistan. Taleb provides the following table:

Extremistan (Taleb, et. al.)	Mediocristan (most investors and Nobel winners)
Scalable	Nonscalable
Wild (even superwild) or type 2 randomness	Mild or type 1 randomness
The most "typical" is either giant or dwarf, i.e. there is no typical member	The most typical member is mediocre
Winner-take-almost-all effects	Winners get a small segment of total pie
Vulnerable to Black Swan	Impervious to Black Swan
Corresponds to numbers, say, wealth	Corresponds generally to physical quantities, say, height or weight
Total will be determined by a small number of extreme events	Total is not determined by a single instance of observation
It takes a long time to know what is going on	When you observe for a while you can get to know what is going on
Tyranny of the accidental	Tyranny of the collective
Hard to predict from past information	Easy to predict from what you see and extend to what you do not see
History jumps	History crawls
The distribution is either Mandelbrotian "gray" swans (tractable scientifically) or totally intractable Black Swans	Events are distributed according to the "bell curve" or its variations

Assuming that the world is Mediocristan is dangerous to investors. As Michael Mauboussin points out:

"Black Swans have an extreme impact. We can readily demonstrate this point bylooking at long-term stock price returns. We gathered the daily price changes in the S&P 500 over the past 30 years or so, in excess of 7,300 observations. The compounded annual return over the period (excluding dividends) was 9.5 percent. We then asked a simple question: What would happen to the return if we knocked out the 50 worst, and 50 best, days?

The results are a testament to the impact of black swans. If you remove the 50 worst days (less than 0.7 of 1 percent of the sample), the return soars to 23.5 percent—1,400 basis-points above the actual results. Missing the 50 best days compresses the return to less than 1 percent, about a 900 basis-point hit.

While impressive, these numbers don't offer a proper point of reference. To do that, we asked the spreadsheet to calculate the mean and standard deviations using the actual underlying data, allowing us to simulate a bell-shaped distribution. Knocking out the 50 worst days from the simulated distribution lifts the return to 15.2 percent—good, but substantially less than the 23.5 percent using the actual data. Likewise, removing the 50 best days shrinks the return to 3.5 percent, a more muted result than what we see with the real data. This exercise clearly shows the bell-shaped distribution fails to capture extreme and high impact events."

Mauboussin adds that the final danger of the Black Swan is the way we interpret it after the fact: "Humans have a near insatiable desire to link cause and effect. Unfortunately, causality is often very difficult to deconstruct, even in retrospect. But coming up with a cause and effect story helps settle our minds, and provides a greater (albeit false) sense of control as we face the future."

Culture as Cure

The antidote to this erroneous thinking is to create a culture in which investment professionals practice the three behaviors stated earlier. They learn to:

- Choose curiosity over defensiveness
- Separate Fact from Story (i.e., opinion)
- "Hold their story lightly"

On the first point, Taleb comments throughout his book that intellectual curiosity is hugely important to superior investing. He warns that "scholarship without erudition and natural curiosity can close your mind." Elsewhere, he says of forecasters, "I wonder if [they] lack in intellectual curiosity or if they are intentionally ignoring forecast errors." (161) The opposite of a curious attitude is a defensive one. When people are defensive they tend to get very serious and very committed to being right. Taleb cites examples of celebrated financial names who reacted in this way when challenged by Taleb: "I [Taleb] discovered Merton's shortcomings from an angry and threatening seven page letter he sent me." The defensive response to a challenge is to shoot off an angry letter. The curious one is to wonder what you can learn from it.

Remaining curious and open ties into the second thinking skill: separating fact from story. As humans, we are always making up stories from the facts we learn. For example, we learn that a colleague is leaving for another job, and our mind goes to work: "he got a better offer" or "he doesn't get along with the boss" or "he must know something that I don't know…what is it!?" Taleb says, "we are explanation-seeking animals who tend to think that everything has an identifiable cause and grab the most apparent as THE explanation."(119) The key skill in world-class thinking is the ability to acknowledge which statements are facts and which are story. In our work, we hear statements like the following all the time: "the fact is that value stocks outperform growth stocks." Of course, this statement may be true for certain definable time periods, but it is highly debatable in general. Our rule of thumb for differentiating fact from story is simple: if one or more persons disagree, then it's not a fact. Far too many investment teams burn up valuable time arguing statements like the one above, instead of simply clarifying the statement (say, by specifying the time period and then getting accurate data) or acknowledging that they disagree and moving on. Good investors get clear on the facts and then get curious about the stories surrounding the facts.

Light not Right

After agreeing on the facts, the final skill is to "hold your story lightly." The idea here is that most of us are irrationally tied to being right. We defend a position as if our very life were at stake. Top investors are committed to learning, NOT to being right. Warren Buffet is clear on this point; he says that one of his great joys in life is disproving his best loved theories.

That attitude perfectly describes what it means to hold one's stories lightly. Taleb agrees with this notion and expresses it this way: "I like to stay light on my feet." People who refuse to hold their stories lightly often are the subject of "intellectual comedy" at a later date:

> "Heavier than air flying machines are impossible."
> *—Lord Kelvin, 1895*
>
> "Everything that can be invented has been invented."
> *—Charles Duells, Patent Office Director, 1899*
>
> "It is an idle dream to imagine that...automobiles will take the place of railways in the long distance movement of people."
> *—American Railroad Congress 1913*
>
> "There is no likelihood that man can ever tap the power of the atom."
> *—Robert Millikan, Nobel Prize winner in physics, 1920*
>
> *"Who the hell wants to hear actors talk?"*
> *—Harry Warner, 1927*
>
> "There is no reason for any individual to have a computer in their home"
> *—Ken Olson, President of Digital Equipment Corp, 1977*

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Summary

The three behaviors I've discussed here—curiosity, separating fact from story, and holding your story lightly—have proven time and again to be characteristics of a winning investor's temperament. I think they may benefit the reader as well…

but that's just my opinion and I'm holding it lightly.

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