Fooled by Randomness
The Hidden Role of Chance in the Markets and in Life

By Nassim Nicholas Taleb

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Rating: 7

This is a most curious book that few will read in a day. I confess that it was consumed in fits and starts from my bedside table. It has an odd, idiosyncratic style (readily acknowledged by Dr Taleb in his preface) which has not been curtailed by any "dulling of the editorial process". The text is that of a brilliant mathematician and successful trader, who has scant respect for myths and false gurus. Taleb has also published *Dynamic Hedging* (Wiley, 1997) and in 2001 was inducted into the *Derivatives Strategy* Hall of Fame. He has an MBA from Wharton and a PhD from the University of Paris Dauphine. We wander with him into *epistemological opacity*, *skewness*, *asymmetry* and the problem of *stationarity*!

The book revolves around one indisputable proposition, called the *black swan* problem after the famous work by philosopher David Hulme: *no amount of observations of white swans can allow the inference that all swans are white, but the observation of a single black swan is sufficient to refute that conclusion*. This, seemingly obvious but fundamental proposition has great significance for understanding the markets and investment, as is well illustrated in the book – even in Australia, which has *cynus atratus*, a jet black variety of swan (p 102). Thus, you should never discount the possibility of the *rare event* which seems to happen when least expected. I found great parallels when reading this work, between the mathematical theories of randomness (which is not to be confused with chaos theory), and events of recent years in international equity markets – and the book, although full of anecdotes and philosophy never strays far from market/investment related issues. The fact that markets zoom up for a twenty year bull run, and financial planners and fund managers produce neat charts depicting this fact (*mea culpa*), does not prove that they will not go down for the next four, ten or twenty years – for rare events, of unknown magnitude and duration, can and do happen.

Or, to put it another way, and as Dr Taleb brutally observes: "reality is far more vicious than Russian roulette". Many investors unwittingly play Russian roulette, but label their activity under some alternative "low risk" name. True leaning in the mathematics of randomness, leads to his chilling observation that the "degree of resistance to randomness in one's life is an abstract idea, part of its logic counterintuitive, and, to confuse matters, its realizations non-observable". And, as he further points out, when delving into what is now being called "behavioural finance", we are not wired in a way to understand probability. That is unfortunate, as for all investors, the issue of probability (eg, repayment of principal under a bond or the future earnings of companies and hence value) is fundamentally important – in fact it overrides everything.

You will not learn a great deal about Monte Carlo simulation or quantitative finance, but you might – vaguely and dimly – see the link between this area of mathematics and the work of Einstein, Keynes, Karl Popper and George Soros. Dr Taleb seems to aspire to these heights of intellectual activity, which is just as well as he has, he says, "close to 95%" of his day to think, read, and research. He clearly has spent a great deal of time reading history, which has given rise to the theory of *ergodicity* – which you will not find in *Encarta*, but which kills many a trader; for as he observes "somehow, overall, history is potent enough to deliver, on time, in the medium to long run, most of the possible scenarios, burying the bad guy". Bad guys, he muses, were straining their eyes and credulity in looking up the Nasdaq slope into early 2000, and believing that life would go on this way.

After laying the foundations of random theory, Taleb applies this to comment upon and implicitly praise the work of Shiller, and then he pours scorn upon one of the industry greats: Robert C. Merton, whose hedge fund (LTCM) blew up due to the black swan problem. There is no mercy spared for LTCM, which of course is a good example of a rare event in the bond market – and is simply another manifestation of history teaching us that things that never happened before, do happen.

The reader might, like me, struggle with many pages, but then another blinding truth comes shooting through that gives comfort and solidifies prior thinking in this most difficult of fields: investment. He explains how the "science" of econometrics may well be complete baloney – and, having read some books on this and been impressed at the time, this mature questioning now rings true. And, he takes it further by drawing upon the work of Robert Lucas, who earned himself a Nobel Memorial Prize in Economics by "arguing that if people were rational then their rationality would cause them to figure out predictable patterns from the past and adapt, so that past information would be completely useless for predicting the future". This confirmed my view of charting or so called "technical analysis".

Or, take this highly practical observation: "the first counterintuitive point is that a population entirely composed of bad managers will produce a small amount of great track records. As a matter of fact, assuming that the manager shows up unsolicited at your door, it will be practically impossible to figure out whether he is good or bad." He goes on to explain how volatility in fact will help some bad managers to make money. Still believe in picking outperforming mainstream fund managers?

One wonders if his work is having a serious influence, for at least one major institutional global research house, has recently changed analyst's recommendations to include a score for probability in their view. For as Taleb explains, by application of simple maths, it is not the estimate or the forecast that matters so much as the degree of confidence with the opinion.

Finally, the reader will learn one of the keys to investment: the personal awareness that we think with our emotions "and there is no way around it". If, like Taleb, you are aware

of this, you at least stand a chance, for as he confesses, he is just like everyone he ridicules in the book – but at least he is aware of it. "No matter how long I study and try to understand probability, my emotions will respond to a different set of calculations … if my brain can tell the difference between noise and signal, my heart cannot". Watch CNBC for (sometimes entertaining) noise, but seeing signals is tricky and requires learning and discipline.

How do black swans appear in life? As with markets, unexpectedly. He has a character in the text: Nero. Nero was a true professional who took randomness seriously in his professional work and amassed great wealth from trading. He eschewed the normal excesses of the rich, but could not handle weekend traffic commuting from the City of London to his Cotswolds retreat. He bought a helicopter, took lessons and then, on one windy day, crashed near Battersea Park. "He was alone in it. In the end the black swan got its man".

If you persevere, you will enjoy and learn a lot form this book. Some of the learning might already be there, but Taleb will draw it out from emotional sub-consciousness into mathematical reasoning, and you will be richer for that.

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