

THE BLACK SWAN

The impact of the highly improbable

Nassim Nicholas Taleb

2007 Book summary

(Side bar comments by Wayne will be in brackets)

(This book is a great read. At times the author does get a bit technical. However, he will quickly stop dead with a profound and powerful story to reinforce his point. This book is about the following:

- Managing risk and reducing your risk of being a victim of life's circumstances
- Allows you to challenge the status quo in our society
- This book adds certainty in a world of uncertainty
- This book could cause you to read more

Before the discovery of Australia, people in the Old World were convinced that all swans were white. This book illustrates a severe limitation to our learning from observations. They do and did exist. They just did not know it. Seeing the existence of white swans does not confirm the non-existence of Black Swans.

- **A Black Swan is an event with the following three attributes:**
 1. It's an outlier, as it lies outside the realm of regular expectations, because nothing in the past can convincingly point to its possibility. (The pandemic threat. When and where?)
 2. It carries an extreme impact. (Stock market crashes or the Harry Potter books and movies). They can be positive or negative. It does not have to be rare or wild, just unexpected, it has to lie outside our tunnel of possibilities.

3. In spite of its outlier status, human nature makes us concoct explanations after the fact, making it explainable and predictable. (After the crash of 2000, it appeared that “everyone” knew that it was about the culprits who were cooking the books. So where was this brilliant knowledge months before the crash?)
- **The following is an interesting exercise to identify the role of Black Swans. Make a list of the significant events of your life:**
 1. How many were expected before their advent?
 2. How many came on schedule?
 3. How many occurred as you had planned?
 4. Measure the impact these events had on your life. Planned and unplanned.
 - Black Swan logic makes what you don’t know far more relevant than what you do know. Ie. 9/11 and the December 2004 Tsunami.
 - In fact, in such a strategic game, what you know can be truly inconsequential. (Those that live with Tsunami’s know they happen. So why were the early signs ignored? Investors know that stock markets dip, dive and crash over the years. So why are so many investors unprepared when these events occur? To learn more about this issue of risk management, ask Wayne for the “**Six Rules of Forecasting**” from the Harvard Business Review)
 - **What you know cannot really hurt you.** (With investing, if you know that markets really do dip and dive and that you have no control over this process, don’t get caught playing the short term “market timing” game. Plan for your last deposit to be faced with volatility for one to two years with good quality investments and you will win the long term game. Manage your debt and keep a reasonable amount of cash on hand for emergencies. It’s that simple).
 - Contrary to social-science wisdom, almost no discovery, no technologies of note, came from design and planning>>they were just Black Swans.
 - The strategy is, then, to tinker as much as possible and try to collect as many Black Swan opportunities as you can. (When the markets are down and you have managed your debt and emergency cash issues, this is a great “Black Swan” opportunity. You will be buying at a discount price just like you do at the auction when some other poor unfortunate person was forced to sell because of poor planning or circumstances.)

- **Page xxii>>Ingratitude**.....(Taleb makes some very interesting points on society and its ingratitude to those who solve problems.) “Everybody knows that you need more prevention than treatment, but few reward acts of prevention”. The examples he uses are 9/11 and wars. (Preventative acts which save you from loss during a stock market crash will not make the 6:00 P.M. news. However, suffering a major financial loss during the crash will).
- **This book is about uncertainty**; the rare events (Black Swan’s) that equal uncertainty. We need to study the rare and extreme events in order to figure out common ones. Taleb grew up in Lebanon as a teenager in Beirut in the 70’s. He reflects that for 13 centuries, this region lived in harmony with many cultures; Christians, Jews, Arabs, and Islam. Civil war suddenly broke out and this region was faced with 17 years of conflict and the “jewel of the middle east” was no more. This is a classic Black Swan event.
- **The antilibrary>>**A private library should be a research tool. The library should contain as much of what you do not know as your financial means allow you to put there. You will accumulate more knowledge and more books as you grow older, and the growing number of unread books on the shelves will look at you menacingly. Indeed, the more you know, the larger the rows of unread books. This collection of unread books is an **antilibrary**. (How many Black Swan’s lie buried in your financial library? What you do not know can hurt/benefit you)
- **The October 19th 1987 stock market crash was a Black Swan event.** It was the largest market drop in modern history. (Those who had cash on hand to invest benefited by this short term crash in the market. Those that did not need their investments and could afford to wait out this event, did not suffer. However, those that did need their investments, and had to cash out or panicked, did suffer. The lesson from events like this are:
 1. Live within your means
 2. Keep cash on hand for emergencies or opportunities
 3. Buy quality investments and do not panic when the markets dip, crash, correct or drop
 4. Rely on a financial coach to guide you through this process
 5. Have confidence in the world markets that this too will pass due to the rationale self interest of the “market”.)

- **Scalable professions or businesses:**
 1. One which you are **not paid by the hour** and thus subject to the limitations of the amount of your labour.
 2. If you work by the hour, no matter how highly paid, your income is subject to gravity. Your revenue depends on your continuous efforts more than the quality of your decisions. Ie. A restaurant, barber and dentist. These businesses cannot be scaled. There is a cap on the number of patients or clients you can see in a given time.
 3. Your revenue depends on your continuous efforts more than the quality of your decisions.
 4. Incomes from these sources are not Black Swan driven.
 5. The author of the Harry Potter books earns income from Black Swan logic.
 6. Look for business opportunities that add zeros to your output
 7. Separate the idea person from the labour person. Idea people have to think intensely.
 8. A scalable income source is only good if you are successful
- **The turkey problem**>>the same hand that feeds you can be the hand that rings your neck:
 - Consider a turkey that is fed every day
 - Every day the turkey feels that humans are looking after their best interests
 - On the afternoon before thanksgiving, the turkey soon learns that humans are not looking after their **long term** interests.
 - How can we know the future, given the knowledge of the past?
 - The turkey thinks that he is living a life of leisure. The turkey farmer knows the rules. Dinner at Thanksgiving Day for millions of families. **(The lesson is, don't be a turkey with investments. Buy quality and not something that will end up on the dinner table for someone else.)**
 - An acquaintance's unctuous past behaviour may indicate his genuine affection and his concern for my welfare; it may also confirm his mercenary and calculating desire to get my business one day.

- Humans have an optimistic bent. We have the genes of risk takers. Don't become an uninformed risk taker by being a turkey.
- (The sub prime lending scene of the summer of 2007 is a classic Black Swan/turkey scenario. As of 14/09/07, this is not a crash; it is however, a correction of the market. In my opinion, this market correction is a classic situation of **financial malpractice**. Due to a lack of disclosure, financial institutions in the USA and the rest of the world failed to do their due diligence to protect the individual investor. To date, this problem is mostly focused on the USA investor; however, the rest of the world still has to face increased volatility of the markets because of the USA lending practices.)
- (How can the individual investor protect themselves from these Black Swan events?)
 1. Buy only quality investments that can stand the test of time
 2. Seek quality advice from advisors that will look after your needs.
 3. Don't panic when the market acts with its predictable short term volatile ways. Plan for the medium to long term and wait out the short term volatility.
 4. Keep your debt under control and keep your cash ready to buy when the market does dip or crash for buying opportunities.)
- The awareness of a problem does not mean much>>>particularly when you have special interests and self-serving institutions in play.
- This book is all about showing you how not to cross a street blindfolded.
- What we see is not necessarily all that is there. History hides Black Swans from us and gives us a mistaken idea about the odds of these events.
- Page 55>>>we have a natural tendency to look for instances that confirm our story and our vision of the world>>>these instances are always easy to find.
- We like to tell stories>>, we like to summarize>>and we like to simplify. This does however severely distort our mental representation

of the world; it is particularly acute when it comes to a rare event like a Black Swan.

- The more you summarize, the more order you experience
- We attribute our successes to our skills and our failures to external events outside our control.
- Whenever there is a move in the stock market, up or down, the media feel obligated to give a reason. One should question the value of this information provided by their armies of fact-checkers.
- Sound bite types of information do not make the world simpler. Instead, they almost invariably make it look for more complicated than it is. (This “information” often disguises the real truth.)
- Governments are great at telling you what they did, but not what they did not do. (They next time you meet with your elected official, ask them to send you a report of their successes and failures over the past year.)

The “preference for insuring against probable small losses” at the expense of the less probable but larger impact ones. Page 77

- (As a financial planner, I often find it interesting that people will buy life insurance without a great deal of thought or resistance but disregard or delay buying products like Disability, Critical Illness, or Long Term Care Insurance. True, we will all die and life insurance can be a “guaranteed insurance claim”. However, the chances of a disability, critical illness or long term insurance claim are much greater.)

The “hedonic calculus>> it does not pay to shoot for one large win. Mother Nature destined us to derive enjoyment from a steady flow of pleasant small, but frequent rewards. (This may be one of the reasons why Dividend Mutual Funds or stocks are so popular. A steady flow of dividends back into your account rewards the long term investor)

Taleb separates the world into two categories that require totally different mind sets:

1. Some people are like the turkey referred to earlier, exposed to a major blow up without being aware of it.
2. While others prepare for big events that might surprise them. Black Swans

Why some history does not stand the test of time:

- The Phoenicians as we are often reminded produced no literature, yet they invented the alphabet.
- Phoenicians were more interested in commerce than in the arts.
- Inventing the alphabet served their commercial needs for record keeping. They were known as the “merchant race”.
- It now appears that the Phoenicians actually wrote quite a bit. However, they wrote it on a perishable brand of papyrus that did not stand the bio derivative assaults of time.
- Manuscripts had a high rate of extinction before copyists and authors switched to parchment in the 2nd or 3rd century. Those not copied during that period simply disappeared.
- (I have fax copies in my client files that are now starting to biodegrade. Will I face the same fate of the Phoenicians?)

Page 127 is worthy of reading in depth about risk taking:

- Those with military training and decision analysis are familiar with the expression>>”**unknown unknown**” as apposed to known unknown:
 1. There are known known’s>>things we know we know
 2. There are known unknown’s>>there are some things that we do not know
 3. But there are also unknown unknowns>>the ones we don’t know we don’t know
 4. Unknown unknown is an uncertainty that is unanticipated and, hence unaccounted for in a formal decision model.
 5. This phrase came about from the former U.S. Secretary of Defence Donald Rumsfeld at the Defence Department Briefing on 2/12/02

Why do we not see Black Swans?

- We worry about those that happened>>9/11, the stock market crash of October 1987
- We do not worry about those that **may happen** but did not>>the next pandemic?
- We love the tangible, the confirmation, the real, the visible
- We respect what has happened, ignoring what could have happened.
- We overestimate what we know, and underestimate uncertainty.
- The challenge is to know the difference between what we actually know and how much we think we know.

- When dealing with uncertainty, do not focus. This focus makes you a sucker. Look instead at the big picture. Think macro.

How “they” can get us>>we are swayed by the sensational.

Two challenges when dealing with “experts”

1. Those who are arrogant/confident and who are competent
2. Those who are arrogant/confident and are also incompetent
3. (Case in point>>the sub prime lending crisis of July 2007. Greenspan stated he had no idea how serious the problem really was. Not to be outdone, Nancy Hughes Anthony, the head of the Canadian Bankers Association said “when I joined the CBA 100 days ago, I’d never heard of asset-backed commercial paper”.)

Simple vs. complex>> Makridakis and Hibon reached the sad conclusion that “statistically sophisticated or complex methods do not necessarily provide more accurate forecasts than simpler ones”.

The unexpected>>the unexpected has a one-sided effect with projects. Consider the track record of builders, and contractors. The unexpected almost always pushes in a single direction: higher costs and a longer time to completion. A possible solution>>attach a possible error rate to their scenarios. Consider that the forecast may be 10% higher/lower, or the time line may be six months longer or shorter. It is often said that “is wise he who can see things coming,” Perhaps the wise one is **“the one who knows that he cannot see things far away.”**

Unintended consequences>>the classic model of discovery is as follows: you search for what you know and find something you didn’t know. Explorers ventured out in the Atlantic Ocean to find India. They found America instead. You can find something that you were not looking for and it changes the world. Sir Frances Bacon commented that the most important advances are the least predictable ones, those “lying outside the path of imagination.” Inventors do not worry about unintended consequences>>they thrive on them. As Pasteur said “luck favours the prepared.” The mere knowledge that something has been invented often leads to a series of inventions of a similar nature. In 1899 the head of the US patent office resigned because he deemed that there was nothing left to discover.

How to predict your predictions>> (If you expect that you will know in the future with certainty that if you continue to spend more than you earn, you will go broke, then you will know **today** with certainty that you have a spending problem. You can then take action today by cutting back on your spending.) You won't tell yourself, this is what I will figure out tomorrow, but today is different so I will ignore the information and have a pleasant expensive dinner. This is the **law of iterated expectations**>>If I expect something at some date in the future, then I already expect that something in the present.

Rational self interest>> You cannot predict how people will act. However, there is a strong link between rationality, predictability and mathematical tractability. A rational individual will perform a unique set of actions in specified circumstances. There is one and only one answer to the question of how "rational" people satisfying their best interests would act. Rational people must be coherent: they cannot prefer apples to oranges, oranges to pears, then pears to apples. If they did, then it would be difficult to generalize their behaviour. It would also be difficult to project their behaviour in time.

Why do we plan?

- For monetary gain
- Because its our job
- There may be an evolutionary dimension to our need to project matters into the future
- We also do it without such intentions>>spontaneously
- Knowing that you cannot predict, does not mean that you cannot benefit from unpredictability. The bottom line>>be prepared for all relevant eventualities.

Utopia>> a society that is governed from the basis of the awareness of our lack of knowledge vs knowledge.

A Black Swan global financial crisis?>>As our world financial institutions merge more and more into a smaller number of large banks and hedge funds, we risk facing a global collapse of the financial system. We will have fewer but more severe crises. Banks hide explosive risks in their (our) portfolios. Performance of these executives is difficult to observe on a short-term basis, and they will game the system by showing good performance so they can get

their yearly bonus. (The sub prime mortgage crisis in the summer of 2007 in the USA is a classic example of the global impact these financial institutions have on our lives.)

- (A financial planning tip from Taylor Financial Group>>don't be a "turkey". When taking income from your investments keep one to two years income in cash and draw from that account. When investing, think long term, three to five years and don't panic when life happens in the markets.)

The Bell Curve>> (Please read page 230 to see how dangerous it is to use the bell curve as an economic tool. Yet, the bell curve is used as a risk-management tool by regulators and bankers)

The central idea of uncertainty>> We can have a clear idea of the consequences of an event; even if we do not know how likely it is to occur. You don't know the odds of an earthquake; however, you can imagine how a major city would be affected by one. The idea is for you to make a decision, you need to focus on the **consequences** (which you can know) rather than the **probability** (which you can't know).

Grey Swans>> we can turn Black Swans into Grey Swans, by reducing their surprise effect. A person who becomes aware of the possibility of such events will not become a "turkey".

I hope you enjoyed and benefited by this book summary. My goal was to make you aware of how an **uninformed person** can protect themselves from the "**informed experts**" in our world. As you can imagine, I can only capture the key points that I found of interest or value to others. You will find your own gems in the book when you buy it.

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