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Fear of a Black Swan

Risk guru Nassim Taleb talks about why Wall Street fails to anticipate disaster.

By Eric Gelman, assistant managing editor

(Fortune Magazine) -- In two bestselling books, "Fooled by Randomness" and "The Black Swan," Nassim Nicholas Taleb has explored the ways people misunderstand randomness and risk. At the heart of his thinking is the idea of a "Black Swan" - an unlikely but not impossible catastrophe that no one ever seems to plan for. In an e-mail and telephone exchange with Fortune's Eric Gelman that began with Taleb in the Yucatán for the equinox, the New York City-based former trader turned scholar and essayist expounds on the role of Black Swans in the current market crisis.

What is a Black Swan?

What I call a Black Swan is a surprise event - like the discovery of the black bird in Australia, which was unpredictable because swans in the Old World were all white. But unlike the bird, my Black Swan carries large consequences.

There are two types of businesses: those that are exposed to Black Swans and those that are relatively insulated from them - not because Black Swans cannot occur, but because their impact is not going to be monstrous. Your dentist's income will not disappear on a single day: No single event will carry big consequences for her. But trading profits can all be lost by a single transaction. So some businesses are insulated, some (like technology) are exposed to positive Black Swans, and others are exposed to negative ones.

Most people seem to have been caught off-guard by the subprime crisis, yet such an event was not only predictable but also inevitable. It was a Black Swan, yes?

The Black Swan is a matter of perspective. A turkey is fed for 1,000 days - every day lulling it more and

more into the feeling that the human feeders are acting in its best interest. Except that on the 1,001st day, the butcher shows up and there is a surprise. The surprise is for the turkey, not the butcher. Anyone who knows anything about the history of banking (or remembers the 1982 Latin American debt crisis or the 1990s savings and loan collapse) will tell you that the subprime crisis was so bound to happen. Banks are exposed to such blowups. Bankers have been the turkey, historically.

So I call these crises "gray swans." I've been telling anyone willing to listen that banks have a tendency to sit on time bombs while convincing themselves that they are conservative and nonvolatile.

I gather you don't have a lot of respect for the effectiveness of Wall Street's "risk management."

It is the "science" of risk management that effectively turned everyone involved into a turkey. If the Food and Drug Administration monitored the business of risk management as rigorously as it monitored drugs, many of these "scientists" would be arrested for endangering us. We replaced so much experience and common sense with "models" that work worse than astrology, because they assume that the Black Swan does not exist.

Trying to model something that escapes modelization is the heart of the problem. We like models because they do not require experience and can be taught by a 33-year-old assistant professor. Sometimes you need to say, "No model is better than a faulty model" - like no medicine is better than the advice of an unqualified doctor, and no drug is better than any drug.

The idea that catastrophe can strike without warning does not seem particularly hard to understand. Why doesn't Wall Street ever seem to allow for that possibility? And why doesn't it learn from past catastrophes?

Let me blame business schools and the financial economics establishment - they have a vested interest in promoting models and devaluing common sense.

I worked on Wall Street for close to two decades in trading and risk management of derivatives. I noticed that while portfolio models got worse and worse in tracking reality, their use kept increasing as if nothing was happening. Why? Because in the past 15 years business schools accelerated their teaching of portfolio theory as a replacement for our experiences. It looks like science, and they have been brainwashing more than 100,000 students a year. There is no way my experiences can be transmitted to the next generation because of these schools. We've had fiascoes in finance that they need to neglect because they contradict their models. The problem may also be the Nobel in economics that gave a stamp to these junky theories. Someone needs to make the Nobel committee account for this, for the damage to society - and I hope to do so.

Banks thought they were hedging their bets in the mortgage market. Clearly they were wrong. Would there have been a way to participate in the mortgage bond market in a prudent way?

Of course, in a less leveraged manner. But greed pushes bankers to take the maximum amount of "hidden risks" - those risks that do not show on a regular basis because the models miss it, but end up causing blowups. Banking is a very treacherous business because you don't realize it is risky until it is too late. It is like calm waters that deliver huge storms.

You can tell that there will be another blow-up, another Black Swan, but you can't tell me where it will occur - or can you?

I don't know where it may occur. But if you look at balance sheets and contingent liabilities, it is easy to know who may be exposed to negative ones and who may be exposed to positive ones. Furthermore,

some banks and hedge funds are more resistant than others to the Black Swan - we need to discriminate between them.

Is there any way to prevent drastic shocks to the financial system?

Occasional blowups are good if they are small and recurrent. When you live in Manhattan, you notice the quality of the food is high because restaurants are rapidly punished for their mistakes. But unfortunately we have been experiencing the opposite: rare but deep and systemic blowups.

Is there something fundamentally wrong with the structure of the U.S. financial system? What can be done to fix it?

In the past, the financial world had a very diversified ecology: banks going bust on a steady basis. They were not all homogeneous.

Today the entire banking system is dominated by a few monster banks, and almost all have the same exposures. So the system became less and less volatile while becoming riskier and riskier. So we moved from the more resilient ecology to a more concentrated architecture. I used to say, "You trade with a bank, you end up trading with J.P. Morgan (JPM, Fortune 500)." Well, it turned out to be true with the Bear Stearns (BSC, Fortune 500) rescue.

Did your personal portfolio benefit or suffer from the subprime crisis?

I prefer not to answer that, as I am trying to avoid talking about my nonintellectual activities. ■

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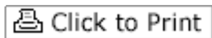

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