Sequoia Curiosity Corner

Black Swans

Just how uncertain are uncertain times?

> *“The benefits are clear: we are saving time and, by keeping Bias low, maintaining healthier inventory”*

Understanding the intricate systems and complex relationships within the banking sector is virtually impossible; its recent collapse suggests that this is true even for those within it. Amidst the bankers, economists and philosophers tripping over themselves to explain the causes of this collapse is a former trader with some fascinating ideas, the (slightly self-righteous) scholar of probability – Mr Nassim Nicholas Taleb.

Several years ago Taleb proposed that we should re-examine our approach to risk. He believes that our lives are dominated by events that could not reasonably have been predicted and are “outside the realm of our expectations, because nothing in the past can convincingly point to [their] possibility”. These events, or ‘Black Swans’, do not fit on a normal distribution curve and therefore cannot be accounted for using conventional risk assessment.

Examples of Black Swans include 9/11, the First World War and the rise of the home PC (such events do not always have to be negative). The collapse of the US sub-prime mortgage market also serves as a good example, although interestingly Taleb believes that the consequent failures of the finance world were not. In 2007 he argued that banking was too complex and efficient and therefore susceptible to shocks – even noting specifically that Fannie Mae was “sitting on a barrel of dynamite”. He has consequently shot to fame for being one of the few who predicted the crunch.

Whether his proposals to make banks Black Swan-proof (by reducing this complexity and introducing slack into the system) are ever introduced remains to be seen. His regular outbursts on the stupidity of bankers may discourage them from listening to him; anyway, ‘there are enough people predicting crazy events for one of them to get it right…’ (Nassim Taleb, 2006)