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When investing, be prepared for anything

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COLUMNIST: FINANCE

My favorite book is Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets (FBR), by Nassim Nicholas Taleb. In fact, Fooled by Randomness is the only book I've read three times. I'm not alone in my esteem of the book; FORTUNE magazine selected it as one of "The Smartest Books of All Time," and it has been on a number of bestseller lists. Unlike other investing books that can be overly technical, Fooled by Randomness takes a more philosophical approach to investing. While there are a number of invaluable lessons in the book, a few of the more interesting and most applicable investing concepts are reviewed in this article.

Beware of the black swan

Before the Boston Red Sox overcame a three-game deficit against the New York Yankees in the 2004 American League Championship Series, no major league baseball team in history had ever come back to win a seven-game post-season series after losing the first three games. The comeback wasn't impossible; it just hadn't happened before. This is what Taleb refers to as the "black swan" problem: just because something hasn't happened, doesn't mean it can't or won't.

The black swan problem originated with the assertion that all swans were white, since no non-white swans had been observed. However, the discovery of black swans in Australia in the 17th century proved irrefutable evidence that all swans were not white. Another name for a black swan event is a perfect storm. A perfect storm refers to the simultaneous occurrence of events which, taken individually, would be far less powerful than the result of their chance combination. Black swans and perfect storms can manifest themselves in a variety of ways, but unless you're aware of what your "black swans" are, it is difficult, if not impossible, to plan for them.

Preparation and pure luck

The Boy Scout motto, "be prepared," has much greater implications than just scouting.

In his book, Taleb uses the term "probability blind" to describe the way humans typically seek to attach reasons to events when none exist. Taleb states that "our brain has been wired with biases that may hamper us in a more complex environment, one that requires a more accurate assessment of probabilities." Humans, by their very nature, are fond of finding patterns or attributing things to skill when none exist. An example of skill attribution when luck may be more fitting is active management outperformance.

Virtually every money manager has a brilliant, convincing strategy that explains why and how he (or she) will outperform his (or her) peers. However, by definition, only half of these managers will do so. Those managers who do outperform their peers end up appearing on CNBC, where they get the chance to personally attest to their unique ability, foresight and brilliance. What we don't see, though, are those money managers who are equally brilliant and have equally convincing strategies who do not succeed and underperform their peers.

Is the outperformance skill or luck? It's tough to say. Those who succeed tend to claim skill, and those who don't succeed tend to claim luck (or the lack thereof). In The Prince, Niccolo Machiavelli contends "that even if fortune (luck) is the arbiter of half our actions, she still allows us to control the other half, or thereabouts." The

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overall dramatic effect among active managers is known; however, over a 10-year period, 20 money managers out of 10,000 will outperform each year, based on luck alone (i.e., no skill necessary). It may surprise the reader that the actual distribution of the historical performance of active money managers is remarkably close to a random "luck" distribution. This suggests that there is a greater amount of luck involved in money management than most recognize.

It is easy to look back and select a money manager who has done well historically (something known as hindsight bias) since all the managers who have performed poorly go out of business (something known as survivorship bias). However, the ability to accurately predict which managers are going to outperform in the future is much more difficult.

Virtually any investment profile or prospectus includes text that states something to the effect that "past performance is no guarantee of future performance." This text has broader implications than most investors realize. Having a proven, documented system in place is a must for anyone, investment professional or individual investor, who contends that using active money managers is a value-added activity over index investing. While we all would like to think we're above average, we all can't be from Lake Wobegon. If you can't (mathematically) prove that you can beat the index, you may as well buy the index.

In summary, I would highly recommend picking up a copy of Taleb's book, Fooled by Randomness, if you're interested in learning more about investing. A naive investor is fooled by randomness, a true professional investor is not.

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