

Black Swans

The opening-night speaker at this year's Financial Planning Association convention was Nassim Taleb, the author of *The Black Swan: The Impact of the Highly Improbable*. A former hedge fund manager and options trader, Taleb is now a best-selling author who writes about the unpredictability of historically significant events. He warned us to be wary of "suspicious experts" -- economic prognosticators whose few good guesses among their innumerable bad ones give the erroneous impression that they have insight into the future.

In England in the Middle Ages, the phrase "you'll see a black swan before..." was used to describe a highly improbable event. As far as anyone knew, all swans were white. Then, in the 17th century, black swans were discovered in Australia and the phrase "black swan" has come to refer to an unpredicted event that occurs unexpectedly. For Taleb, a black swan event has three characteristics -

1. **Rarity** -- It was unpredictable, outside the realm of expectation, because nothing beforehand signaled its occurrence.
2. **Extreme impact** -- Its occurrence has massive consequences for the future.
3. **Hindsight bias** - After the fact, we can concoct a plausible explanation that makes the black swan appear less random and more predictable than it was.

There are good and bad black swans. The internet, FedEx and the personal computer are black swans. So were World War I, the sinking of the Titanic and 9/11. Each year 15,000 new fiction books are published. One or two dozen will be the black swans that generate 90% of publishers' annual profits.

Taleb believes that when we look back at the events preceding a black swan, our tendency is to incorrectly make a link between the two. In his opinion, theories about the cause of rare events must be taken with a grain of salt and the past can never be used to predict the future. He is particularly critical of Wall Street quants who used computer analysis of past data to calculate the downside risk of the now infamous mortgage backed securities. The downside risk was never accurately measured and, lo and behold, a black swan appeared. He recommends that we put less trust in computer models and more in human experience and perspective.

If the future is unpredictable, what advice does Taleb give investors?

- Play defense. Just like those who wish to live a long life, successful investors must avoid risks that have an unlimited downside.
- Don't allow the illusion of control brought about through elaborate mathematics and smooth talk mislead you. Charts showing past performance are of no value in predicting future risk.
- Keep your investments diversified. In doing so, you will be sure to own the next good black swan and will not be ruined by the next bad one.
- Avoid derivatives and leveraged speculative investments. Keep most of your portfolio in secure assets that you understand - the tried-and-true. Any speculative bets must be made with a very small portion of your portfolio -- with money that you can afford to lose.

Taleb believes that tomorrow will be vastly different than we can imagine and you might expect that he has a pessimistic worldview. But he is quick to warn audiences against believing in worst-case scenarios, because most black swans have been of the good variety. He said that most people look at the future with a fearful tunnel vision but he wants us to see the future in a 180 degree panorama of possibility. Dare I say that he believes in "facing the future with optimism and courage?" I agree with him. I believe that the human capital that will be released as freedom and capitalism expand around the world will yield a number of good black swans that will be far in excess of the bad ones.

Bear Market Blues

The FPA convention was held in Boston this year so it's only fitting that I quote Thomas Paine -"These are the times that try men's souls." These are the times that test our inner resolve. They test the quality of the downside protection that we took during the good times. The last two weeks have been a black swan event -- one of the most tumultuous periods in the history of the stock and credit markets. Again we are reminded that market volatility is the price we pay for the higher returns that stocks have provided over bonds and CDs. The IRS may call stock market gains "unearned income" but I think that investors in the stock market "earn" their money.

Welcome to the 13th bear market since the end of World War II. Officially, a bear market is one that falls 20% or more from a previous high. But I have a different definition -- a bear market is a period of time when people that think "this time it's different" panic and sell their stocks to people who believe that "this time it isn't different." Investors today are in a battle against panic and our instincts and emotions are not reliable guides in such stressful times. Each bear market is the product of unique circumstances that are often different from what has happened before. Each brings its own unique worries but they also set the foundation for periods of better returns in the years that follow -- for those investors who have the fortitude and discipline to look forward rather than backward. Perhaps some historical perspective will help.

- Bear markets are a normal and recurring element of the never ending cycle of economic growth. Since World War II one has occurred on average about every 5 years - slightly less frequently than the Summer Olympics. So we can expect to see 8 of them in a typical 40 year working career and, heaven help us, 6 more during a 30-year retirement.
- Long-term, equity market pricing must reflect the underlying fundamentals of the economy. Historically, our economy has maintained a long-term growth rate of about 3% above inflation. Add 3% for inflation and 4% for dividends and you get the oft quoted 10% rate of return for large-cap stocks. Bear markets have been temporary interruptions in a permanent upward trend. However, in the short term, emotions prevail and history reveals a continuous cycle between periods of irrational exuberance and irrational panic.
- The arrival of bear markets is unpredictable and their severity and duration are unknowable. If you take away anything from this article, I want it to be this truth. No matter what you hear, no matter what you think, no matter what the book title says, there is no formula or strategy for taking your capital out of harm's way in advance of a stock market decline. Stay away from the "suspicious experts." I've said it before; I'll say again -- market timing is the pursuit of an illusion, a modern-day equivalent of alchemy.
- The "equity premium" provided by stocks -- the long term higher return of stocks vs. fixed income investments - is the way the market compensates investors for enduring volatility. In times like today, we think of volatility as rapid declines in value. But a study of history reveals more rapid price rises than rapid price declines. Volatility should be looked upon as the extreme unpredictability -- both up and down -- of stock returns in the short-term. The bottom of a bear market is no more predictable than its arrival. History tells us that investors with the emotional maturity and financial discipline to remain invested through them have done very well.

So, if you weren't prepared for this bear market, what can you do to prepare yourself for the next one?

- Experience the happiness of owning high-quality fixed income investments. They are forgotten when the market is rising but act as portfolio shock absorbers when panic hits Wall Street. My personal philosophy is to have no more money invested in equities than is necessary to attain a client's retirement goals. For those about to begin retirement, I want them to have fixed income investments that are the source of at least a decade's worth of cash drawdowns. There will be more market declines ahead, they will come without predictability. It is hard to put a value on the security and peace of mind that come from having adequate cash reserves during bear markets.
- Remove individual company risk from your portfolio. Own the global stock market, not just selected segments, currencies or geographical areas. Owning individual stocks brings unnecessary additional risk into your portfolio. I don't care if Grandpa worked for the company. I don't care if it has been a blue chip standout for a hundred years. Any company is a year away from being ground into powder by mismanagement and handing it shareholders a 100% loss.
- Have a written financial plan -- one that is appropriate for your time horizon, risk tolerance and financial goals -- and stick to it. Your focus should be on your plan, not on what the market did yesterday or today

or what it might do tomorrow. Nobody enjoys a frightening market decline, but selling into a panic means that you'll be on the sidelines during the initial upward swing of the inevitable recovery -- whose timing and magnitude are impossible to predict. The most important factor in your financial plan is your commitment to fund it. The growth will take care of itself long-term, but insufficient funding is a recipe for failure. If you don't have a financial plan that brings clarity to your long-term financial picture, what are you waiting for?

- Live within your means, save as much as you can, avoid debt and invest for the long-term. Avoid foolish speculative investments. Make sure your fixed-income investments are of the highest quality. Do this for a long time.

This summer and early fall have produced changes in the financial landscape that were unimaginable six months ago. Slowly but surely the governments of the world are taking action to contain the problem and bring liquidity and stability to markets. There seems to be general consensus that the recently passed legislation will begin moving the toxic mortgage loans out of the credit system. Hopefully, this will restore confidence, which is essential to the health of global credit markets. It will not happen overnight. The fallout from the credit crisis will bring new regulations, a new aversion to risk by financial institutions and a firmer financial foundation for future economic growth.

In the short run, nothing is predictable - except the certainty of uncertainty. All market downturns bring fear to the forefront and the short-term performance of the stock market will always be a slave to the emotions of investors. I am confident that our current liquidity crisis will be solved and the world will not end. This time will not be different. If history is any guide, investors who have the optimism and courage to step forward in this environment will be handsomely rewarded.

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