Taleb, Nassim Nicholas - Fooled By Randomness

Texere, 2001, [Behavioural Finance] Grade ★★★★★

The book is written by the previously unknown trader Nassim Nicholas Taleb who with this became instantly famous. He brings the concept of the black swan to life, which now forever will be associated with him. In his second book, The Black Swan, the impact of the highly improbable, he digs further into the same idea, but I think you should stay with the original. The title of the latter book explains what it's all about.

A philosopher meets the investing world, using his experience from investing to explain his theories about life, that's a short summary of this book. Taleb has a lot of ideas. For example the idea that modern human beings often are unaware of the existence of randomness. People tend to explain random outcomes as non-random and tend to view the world as more explainable than it really is. Therefore we look for explanations even when there are none to be found.

The book is divided into 3 parts. Part 1 is the best. Taleb discusses impacts of 'rare events' on both financial markets and on human history. Chapter 5 & Chapter 6 are among my top picks. In part 2, Taleb discusses the survivor effect, or mistaking success based on luck for success based on skill. In part 3, Taleb talks about tricks he has developed to try and reduce his statistical reasoning and live more rational. This is the least interesting part to me.

The book is a pleasure to read, anytime and anywhere. It holds a lot of great wisdom. In chapter 3 the author discusses how most people who are interested in financial assets tend to look at prices too often. Instead of focusing on doing research, or spending time with your family, the blackberry is always close at hand with updated quotes.

Nassim Taleb indirectly gives a good recipe against this addiction. Assume you are a happily retired dentist and we know you will earn 15% return per annum, with a 10% standard deviation. i.e in 68% of the years you will make +-10% around 15%, and in 95% of the years between -5% and +35%. On an annual basis this means that you are profitable 93% of any given year, so if you check your performance once a year, you will be happy almost every year! However, if you narrow down the timescale to 1 day, you will have a positive result 54% of the days, and if you narrow it down to 1 minute its 50.2% of the minutes. (1 day then means 241 happy minutes and 239 unhappy minutes.) Conclusions: in the short term, you only watch the variance of the portfolio, not the return and our emotions are not designed to handle the short term. Assume you are first -5%, then +5%, net zero, you have still had a negative effect since in general we are risk averse and dislike losses more than we like gains of the same size.

In another part of the book, called Rare Events, Taleb explains how he has made money. He has basically bet on black swans. He is a firm believer that the market systematically underprices unlikely events. He proved this in real life by making a fortune in the stock market crash in 1987, as well as in the last financial crisis. Further on he is skeptical of situations that have been very stable for a long time, as for examples various currency regimes. These are among the most prone to crash. This statement seems to hold a lot of truth, not least in the current European situation.

If you need another reason to read the book, it was selected by Fortune as one of the 75 "Smartest Books of All Time."

Bo Börtemark, May 11, 2012