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Swan Dive

By Rana Foroohar

Nassim Taleb warned us that the crash was coming, and then made millions as the market followed his script. The author of the best seller *The Black Swan* explains what went wrong, how to prepare for the next economic disaster, and why we never see a disaster until it's too late.

On Wall Street, everyone has an exit strategy. Since the Street tends to be a highly profitable and highly unpleasant place to work, guys promise themselves, and their wives, that they'll hit their number in 10 years or so and then get out and live the dream: become an urban planner, open a fly-fishing school, caddy for Tiger, whatever. But of course, few ever do. The bonus-fueled lifestyle becomes a beast that must be fed.

Nassim Taleb is the exception. He made his big bucks when he was young, and then pulled the rip cord. The author of *The New York Times* best seller *The Black Swan*, and perhaps the most sought-after financial thinker in the world, Taleb is a former trader who predicted the global financial crisis. And he didn't just say the sky was going to fall, he actually described how it would happen, from the meltdown of Fannie and Freddie to the collapse of the derivatives market.

Taleb's cred as a market seer dates back to the mid-1980s, when he was working as a trader for First Boston. Signs of excess were all around.



Still, plenty of conservative investments can round out a Black Swan portfolio. **Charles Goldblum, president of Hurley Capital in New York**, for example, recommends short-term corporate bonds (four years or less) issued by companies that have less debt than cash and are generating lots of cash. They have significantly higher yields than Treasuries, and even if the company were to go under, the value of the liquidation would be more than sufficient to repay bondholders.

It was the age of Gordon Gekko, and big hair, red suspenders, and greed were all in style. Stock markets around the world were running way above their historic valuations. Taleb wasn't sure what would trigger the crash, but he was sure it would come, so he bought "put options." If the market rose, the options would slowly lose value. But if it plummeted, they would be worth a fortune. On Black Monday--October 19, 1987--Taleb's bet paid off. As other traders were contemplating suicide, he was sitting on roughly \$35 million. His slice of that "F-you money," as he calls it, made him a millionaire at the age of 28.

He quit working as a full-time banker, trading only sporadically for his own pleasure and profit. "Trading was only ever about achieving independence," says Taleb. "I never wanted to be a businessman. Once I made my money, I could get on with doing what I really wanted to do, which is think and write."

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Think, he did, and those thoughts gave birth to an entire philosophy based on the idea that the markets, as well as life in general, are a lot less predictable than most of us realize. It's a philosophy that made Taleb even richer last fall, when everyone else was losing big. As last year's market slide turned into a crash, separate funds managed by Universa Investments L.P., a Santa Monica, California-based hedge fund Taleb advises, posted monthly returns of up to 110 percent. Taleb himself scored an eight-figure payoff in 2008. While he won't outline particulars of his strategy (though it again involves put options), Taleb is eager to talk about *The Black Swan*, the best-selling work of nonfiction of 2007. The book, which outlines his philosophy of markets and life, is quite complex, but it is based on a simple truth. For centuries, it was taken as conventional wisdom that all swans were white.

There was no such thing as a black swan--one had never been seen anywhere in the known world, so it couldn't possibly exist. Then, when Australia was discovered in the 17th century, so were black swans. The wisdom of millennia had been wiped out in an instant. Black Swans are singular, outlier events, things that can't be predicted based on what we think we know. Black Swans encompass the crash of 1929, the discovery of penicillin, the rise of the Internet, and of course, the current global financial meltdown. Positive or negative, most of us think of them as once-in-a-lifetime events, like the hundred-year flood. We don't plan for them, and we don't lose sleep over them. We live our lives--and structure our portfolios--on a bell curve.

But to Taleb, Black Swans are inevitable--the norm, not the exception. To think that they won't happen is to risk ruin, or conversely, to miss enormous opportunities. "The world is extreme," he says, "and it's getting more so every day. This can open you up to great danger, but the trick is to learn to benefit from the fact that the markets, like everything else, are manic-depressive." Taleb isn't the first to identify the market's mood swings--investing pioneer Benjamin Graham described Mr. Market as bipolar in 1949--but Taleb questions the very concept of "normal" returns.

Taleb structures not only his portfolio but also his life on this philosophy. Take, for example, his low-carb diet. During our first interview at the Campbell Apartment, the sort of hip and atmospheric New York City bar that used to be packed with wealthy bankers and the lithe blond women who dated them before the market tanked, he insists we order a large cheese plate (no bread). Despite being a reluctant master of the universe, he is also a normal guy who is worried about his weight. "I really don't want the pictures you guys take for this profile to make me look fat," he confides. He moans about photos that appeared recently in *Bloomberg* magazine. "They looked fat! I'm not that fat!" It's true, Taleb is trim, which means he must be hovering below 198, the weight at which (he claims) he begins to look portly. "I'm starving now," he says, tucking into mounds of luscious cheese. "But later, I won't eat anything for dinner."

Extremism is in Taleb's DNA. Born into a prominent Christian family in Lebanon (his grandfather was the minister of the interior), he watched as his family lost everything during the civil war that broke out in 1975. Schools were closed, and the teenage Taleb spent months holed up in the basement, avoiding the ceaseless mortar fire and reading hundreds of books on everything from German philosophers to World War II history. In *The Black Swan*, Taleb recalls family members telling him that the war would last "only a matter of days," assuring him that the fighting in Lebanon would be different from the revolutions in Cuba and Iran, which drove millions from their homelands forever. In fact, the Lebanese civil war lasted 15 years, creating a class of melancholy expatriates such as Taleb's grandfather, who lived out his days in exile in Athens. "It's the worst thing to see someone in poverty," says Taleb quietly.

The episode was Taleb's first inkling that following the herd can have disastrous consequences. "In spite of [my grandfather's] position," he writes in *The Black Swan*, "he did not seem to know what was going to happen any more than did his driver, Mikhail." The difference, notes Taleb, is that while cabdrivers didn't presume to be experts, elites assumed their insider knowledge had predictive value. This leads people to make foolish assumptions, e.g., that a war will be short-lived or that housing prices will always go up.

This insight led to another Taleb maxim: Don't trust anyone in a tie. "You have to ask yourself why he is wearing a tie," he says. "More often than not, he's not an expert. He just wants you to think he is." After having the silver spoon pulled from his mouth by world events, eventually Taleb went to the Wharton business school, where he studied probability theory, and then on to Wall Street.

The stint in finance convinced him that money for its own sake could become a curse. He remembers being at a party with billionaire hedge-fund manager George Soros. "All these people were around him, fawning over him. And it was so fraudulent," says Taleb. "They were only interested in what he had to say because he was rich, not because they really valued his ideas. I knew that wasn't what I wanted to be when I grew up."

Yet even as he began to limit his social contact with people in the industry (most of Taleb's friends are writers, thinkers, and people much less wealthy than he is), finance gave him his freedom. Having earned a PhD in mathematics, Taleb became skeptical of the computer-driven models that banks and hedge funds were increasingly using to make their investments and manage risk. These models, some of which were created by Nobel laureates, tried to predict the future of the market by looking at the past, oftentimes stripping out the outlier events, or Black Swans, simply because they were anomalies.

But a Photoshopped image of the past is a lousy guide to the future, especially when the world is flat. "Globalization creates interlocking fragility, and technology speeds up the process and amplifies the results," says Taleb. Perhaps the best example is the fall

of Long-Term Capital Management, a hedge fund run by a team that included Nobel Prize winners. LTCM famously went belly-up in 1998 after its hypercomplex computer models failed to predict a series of events triggered by a fall in the Russian ruble. Because the models had excluded the possibility of such an enormous event, the partners had taken hugely leveraged positions--to the tune of \$1.25 trillion--and the fund almost brought the global financial system down with it.

As it turned out, the fall of LTCM was just a tremor hinting at the earthquake that hit last year. In his second book, *Fooled by Randomness*, and later in *The Black Swan*, Taleb warned of what was coming. In 2007, he wrote: "The financial ecology is swelling into gigantic, incestuous, bureaucratic banks...when one falls, they all fall. The increased concentration between banks seems to have the effect of making financial crisis less likely, but when they happen they are more global in scale, and hit us very hard.... True, we now have fewer failures, but when they occur...I shiver at the thought."

Like many economic thinkers, Taleb chalks up much of today's crisis to a lack of oversight from the 1980s onward, which allowed capitalism to grow unfettered. "How much of this is down to the Reagan ideology? One hundred percent. People became so focused on the bottom line. Companies were forced by Wall Street to overoptimize and maximize their returns, and that meant they didn't leave enough buffers in place or enough cash in reserve," says Taleb, who says the same goes for individuals. "There has been a psychological shift in the culture. Wall Street told us to invest, invest, invest in all these stocks. And it is good to invest in stocks. But now we're all overexposed."

To Taleb, people who went crazy on dot-com stocks or overleveraged themselves to get a bigger house are on the same continuum with bankers who, pushed to keep up high returns, turned a blind eye to the faults in their risk models. It's all part of an epidemic of hypercapitalism that was ignored by, or sometimes encouraged by, the government and regulators. Even Alan Greenspan has offered a *mea culpa*.

Taleb believes that the lack of smart regulation encouraged the buildup of enormous risk in the financial system, as traders, companies, banks, and individuals all made the same bets--for instance, that real-estate prices would continue to rise and interest rates on risky bonds would continue to fall. Then they doubled down, borrowing money to goose returns. The party train kept rolling until those sunny premises were proved incorrect, and then the train went over a cliff. Scared investors began to sell assets, banks stopped lending, and as the markets tanked, investors had to dump everything, the good and the bad, to repay the borrowed money. In some cases--Lehman, Bear Stearns--they had borrowed more than they could ever repay.

The bad news: Taleb is solidly in the camp that believes the light at the end of the tunnel is an oncoming train. He has been waking up in the middle of the night worrying about the American economy. He believes banks and major companies will fail. "I think depression could be a mild word for what's to come." And he doesn't trust Obama's team to fix things. "They are economists, not people who live in the real world, and many of them are associated with [former Citigroup director Robert] Rubin, who is one of the main people who got us into this mess."

What Taleb does offer is some extreme advice on how individuals should protect themselves. Instead of putting most of your money into medium-risk assets, Taleb advocates putting 80 to 90 percent of assets in supersafe places. Cash, Treasury bills, and blue-chip corporate bonds count, as do inflation-protected bonds. The rest, he says, should be placed on risky but potentially high-yield bets. Make as many of these bets as possible, in small quantities, to maximize the chance of benefiting from a positive Black Swan. Taleb himself holds vast amounts of T-bills, inflation-protected bonds, and wads of cash; he also favors small technology stocks and even venture-capital investments (The Black Swan was a big hit in Silicon Valley). "Even if you don't beat inflation on the safe stuff, you'll earn it back on the very risky investments. What's more, you'll keep your money," he says, noting that his mother-in-law put a chunk of her nest egg into bank convertibles, only to see them plunge 40 percent. "People tell you never hold cash, you don't earn any interest," says Taleb. "But I'll tell you what: Zero percent interest is better than negative 40!"

It's unusual advice, and plenty of investment managers would disagree. Many veteran traders, who, like Taleb, warned investors that a crash was coming, now see a great buying opportunity for blue-chip stocks (see "The Black Swan Hunter," page 99). Others point out that the Black Swan strategy may not work in an era of higher inflation (which many experts believe will result from the Federal Reserve's moves to put more money into circulation). If inflation spikes, T-bills will get hammered.

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Not surprisingly, Taleb has little time for money managers: "Investment managers who pretend to be market experts bankrupt people." Not that he casts himself as a personal-finance guru. In fact, his best tips tend to be the most general and common sense: Plan for a future that will be crazier than you expect, and set aside enough money so that you can live with the worst-case scenario. "We should all live more independently and creatively," he says, advocating a life of thrift over one spent working a dull corporate job. "People can live on very little if they choose to."

Easy for him to say. Taleb has made more money in the past year than most guys see in a lifetime. "I'm torn between being in the market and making some dough so I can impress people with my performance and they'll respect my ideas," he says, "and, on the other hand, working on real things like climate change. I often want to hide the fact that I'm getting the big bucks, because I don't really like money." He dresses discreetly, wearing a no-name watch and a sweater that could be Gap, could be Missoni. He lives in a Tudor-style house in an affluent but low-key suburb of New York City, and he is married with two children.

His only indulgence seems to be books. He has 14,000 of them, on every imaginable topic, spread across two libraries. (On his nightstand: Ed Smith's *What Sport Tells Us About Life* and a biography of Cicero.) He has time to read, since he doesn't watch TV or look at newspapers. "Too much high-frequency data is a problem," he says. "It doesn't help us, because we can't process it."

During a segue in our conversation, Taleb acknowledges that his multimillion-dollar book sales are actually a small part of his overall income. Then he quickly reaches for the check. I protest, explaining that in the interest of independent journalism, I need to pay. No dice. "I insist. I really wouldn't feel good about it otherwise," he says with a grimace. I realize that he may have made the equivalent of *Best Life's* entire operating budget by betting on gloom and doom in the past few days, and I get the feeling that he's not entirely comfortable with that idea. After all, this is a man who grew up hiding from bombs in a basement, dreaming of being a philosopher.

Still, the F-you money makes it possible for Taleb to leave our lunch and go not to a cubicle in a beleaguered bank on Wall Street, but to someplace more pleasant, like his local gym. He could afford to install a state-of-the-art workout space in his home, but private gyms, he says "are a curse, because they stop you from socializing." And socializing gives you the chance to meet new people, any of whom could put you on to the next positive Black Swan. Taleb's workout is characteristically extreme: He'll pump iron for several hours, but only once every few days. This mirrors the exercise habits of our ancestors, who had to be prepared for extreme events such as being chased by a predator or fighting a mastodon. And they never worried about hitting a number.