

Equity Research

Mind Matters

Remember, Cassandra was right!

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Some are trying to argue that the mess in the US economy/housing market/credit market is an example of Taleb's black swan. Nothing could be further from the truth. Black swan events are inherently unpredictable. However, the events unfolding now are sadly all too predictable. They are following the standard pattern for a debubbling process. Numerous psychological barriers prevent us from listening to Cassandra, but it may pay to remember that her predictions were all too accurate.

■ Just in case you are unfamiliar with the tale of Cassandra's plight, she was a princess with whom the god Apollo fell in love. As a gift, Apollo bestowed the ability of prescience upon her. However, when Cassandra didn't return Apollo's affections he cursed her, such that no-one would believe her predictions. She foretold of the dangers of the Trojan horse, the death of Agamemnon and her own demise. Yet no-one would believe her; instead she was seen as mad.

■ Taleb tells us that black swan events have three characteristics (i) they are unpredictable, (ii) they have a massive impact, and (iii) they are rationalised ex post to make them seem less random. However, these characteristics simply don't describe the current juncture. The current situation is better described as a 'predictable surprise'. Such events are characterised by three features (i) at least some people are aware of the problem, (ii) the problem gets worse over time, and (iii) the problem eventually explodes into a crisis, much to the 'shock' of the decision makers.

■ The bursting of the housing bubble/credit bubble must surely fall into this latter category. Many have warned of the dangers. Even Federal Reserve governors were warning of the problems of lax lending standards! Robert Shiller went as far as to reissue his book, *Irrational Exuberance*, with a new chapter on the housing market.

■ If such events are indeed 'predictable surprises' the natural question becomes why don't we react to them? Four psychological hurdles stand in our way. Firstly, our old favourite, over-optimism. We all expect 'predictable surprises' to happen to others, but not to us. The illusion of control also creeps in, as we believe that we have influence over essentially uncontrollable events. Self-serving bias also has a role to play, as we have an innate tendency to interpret information and act in ways that are supportive of our own interests. Finally, myopia prevents us from thinking about 'predictable surprises'. We tend to follow Saint Augustine's plea of "Lord, make me chaste, but not yet!". If we are always focused on the short term, we miss the long-term picture.

■ Bubbles are a by-product of human behaviour, and human behaviour is all too predictable. The details of each bubble may be different, but the general patterns remain very similar. Such events are clearly not black swans.

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Remember, Cassandra was right!

Firstly, my apologies for three Mind Matters in the space of a week! Rest assured you will not be troubled by any more of my outpourings for the next couple of weeks as I will be swimming with sharks down in Sudan. For this final (short) pre-holiday missive I wanted to dispel a myth that I keep stumbling across of late.

It is sometimes said that the current issues in the US economy/housing market/credit markets are a black swan. My friend Nassim Taleb defines a black swan as a highly improbable event with three principal characteristics (i) it is unpredictable, (ii) it has a massive impact and (iii) ex post, explanations are concocted that make the event appear less random, and more predictable, than it was.

Nothing could be further from the truth than to characterise the current situation as a black swan. To claim the problems are a black swan is nothing more than an attempt to abdicate responsibility. If such events are clearly unpredictable then there is nothing we can do about them.

However, these events are not black swans, they are ‘predictable surprises’. The term was coined by Michael Watkins and Max Bazerman¹. A predictable surprise also has three characteristics (i) At least some people are aware of the problem, (ii) the problem gets worse over time and (iii) eventually the problem explodes into a crisis, much to the ‘shock’ of decision makers. As Bazerman says “The nature of predictable surprises [is that] while uncertainty surrounds the details of the impending disaster, there is little uncertainty that a large disaster awaits”.

What evidence do I have that the current mess was a predictable surprise? The New York Times ran a fascinating article² in mid December 2007. They noted that, seven years earlier, Edward Gramlich (a Federal Reserve governor) had warned that a fast-growing new breed of lenders was luring many households into risk mortgages that they couldn’t afford. The article also cites the Herculean efforts of Sheila Bair, a senior Treasury official, to persuade sub-prime lenders to adopt a code of best practice, and to let outside monitors verify their compliance to these standards.

Robert Shiller even went so far as to re-issue his book, *Irrational Exuberance*, with a special chapter dedicated to the housing market. Even yours truly (not renowned for having my finger on the pulse) wrote a note on 20 June 2005 entitled *Pictures of a mania? – US housing special* which concluded “All the criteria of a speculative mania seem present to me”. So a cacophony of Cassandras warning of dangers clearly existed³.

All this discussion of ‘foreseeing’ future risks might seem odd coming from someone who is known for being openly hostile when it comes to forecasting (see *The Folly of Forecasting*,

¹ Predictable Surprises: The Disasters You Should Have Seen Coming and How to Prevent Them, HBS 2004

² <http://www.nytimes.com/2007/12/18/business/18subprime.html? r=1&oref=slogin>

³ Apologies to those I have not mentioned. Space prevents a more comprehensive accreditation.

Chapter 9 of *Behavioural Investing*). However, I think a clear line can be drawn between analysis and forecasting. As Ben Graham stated “Analysis connotes the careful study of available facts with the attempt to draw conclusions therefrom based on established principles and sound logic.”

So the big question is: What prevents us from reacting to predictable surprises? I can think of **four major psychological hurdles** that hamper us in our ability to deal with predictable surprises. Firstly, **the ever-present over-optimism**. I explored the bullish bias in a recent note (see Mind Matters, 12 February 2008). Everyone simply assumes they are less likely than average to have drinking problems, to get divorced or be fired etc. It is highly likely that the same over-optimism applies when it comes to predictable surprises; we expect them to affect others but us.

In addition to over-optimism, we suffer from the **illusion of control**. This refers to people’s belief that they have influence over the outcome of uncontrollable events. For instance, E. Langer has shown (1975, *The illusion of control*, *Journal of Personality and Social Psychology*, 32) that people will pay four and half times more for a lottery ticket that contains numbers they choose rather than a random draw of numbers. The same study demonstrated that people will bet more on a coin toss before the coin is actually tossed, rather than after, as if they can influence the spin of the coin in the air! The illusion of control is exacerbated by information. The more you think you know, the more likely you are to suffer the illusion of control.

The third psychological barrier to recognising ‘predictable surprises’ is **self-serving bias**. This is an innate desire to interpret information and act in ways that are supportive of our own interests. So estate agents are unlikely to tell you that real estate is too expensive, just as companies will always tell you that everything is fine and dandy. A classic example of self-serving bias can be found in a recent Bloomberg story on Moody’s and S&P. None of the 80 ‘AAA’ securities in the ABX indexes meets the criteria that S&P themselves define! Yet only one of these bonds has been downgraded by S&P, and none by Moody’s.

The final hurdle is **myopia** (or hyperbolic discounting if you are a geek). This simply reflects the idea that consequences which occur at a later date tend to have much less bearing on our choices the further into the future they fall. If you like, this can be summed up as “Eat, drink and be merry, for tomorrow we may die”. Of course, this ignores the fact that on any given day we are roughly 26,000 times more likely to be wrong than right with respect to making it to tomorrow! Or, if you prefer, this myopic bias can be summed up by Saint Augustine’s plea “Lord, make me chaste, but not yet”. In a world in which short-term profits are valued so highly, it is exceptionally hard to focus on the longer-term picture.

Bubbles are a by-product of human behaviour, and human behaviour is (sadly) predictable. The details of bubbles change, but the general patterns remain very similar. Such events are clearly not black swans. Of course, the timing of the eventual bursting of the bubble remains as uncertain as ever, but the events themselves are all too predictable.

One final note. The world is a poorer place today. News has reached me of the death of two great contrarians. Nils Taube and Tony Dye have both passed away. Their willingness to stick to their guns and plough their own furrow should be an inspiration to us all. Both will be greatly missed.

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