

From fat tails to Fat Tony

Predictions of socioeconomic variables are as dependable as the horoscope—so let's not rely on them in 2013. Instead we will need systems that don't fall apart when we make a mistake. This may seem blindingly obvious but apparently it is too "trivial", too easy to understand and implement to appeal to the zeitgeist. For, alas, though those who risk their own funds put a premium on simplicity and practicality, others—academics driven by "rank" and status, management consultants, economic "experts", and finance analysts—have an incentive to indulge in complexity and muddle.

This intrinsic limit to predictions is here to stay with us. It will not go away thanks to hard work by zealous researchers or more funding, more data, more computing power, and more complicated theories. For unpredictability is part of any system that is prone to "fat tails", that is, one whose properties are dominated by rare events—what I have called "black swans". Don't imagine that complexity, chaos theory, agent-based modeling or some other fad narrative will deliver better, more usable predictions than those failed economic methods we are still teaching our university students.

The truth is that selling a precise prediction to an anxious investor is like offering water to a parched explorer lost in the Sahara desert. Predictions are good therapy, arising from a human thirst for certainty. That might have been reasonable in some ancient world, but is hardly right for today's.

The reason is that predictions lead to increased risk taking, hence to the accumulation of fragile exposures in the "tails". In my new book "Antifragile: Things that Gain from Disorder" (Random House and Penguin), Fat Tony, a Brooklyn street-smart character, builds his success on the paradox that the only prediction one can safely make is that those who base their business on prediction will eventually blow up. So Fat Tony takes the other side.

Sensible discussion about the world in 2013 should therefore be based not on the predictive but on the normative: what should happen. I have four suggestions, all simple measures I call "heuristics"—practical and solid rules that come from experience—that can decrease the fragility of the economic system, selected because they are both uncomplicated (except for academic economists) and highly effective.

My first suggestion aims to deter the "too big to fail" effect and prevent bonus-earners from taking advantage of the public. A company that is classified as a candidate for a

taxpayer bail-out if it fails should not then be able to pay any of its staff more than a corresponding civil servant (since its employees have then become de facto civil servants). Otherwise people should be free to pay each other what they want since it does not affect the taxpayer. Such a rule would encourage companies to stay small enough not to force a bail-out in the event of their failure.

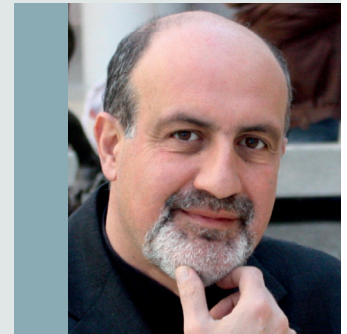
My second recommendation is to oblige those who start in public office to pledge never subsequently to earn from the private sector more than a set amount; the rest should go to the taxpayer. This will ensure sincerity in "service"—where employees are supposedly underpaid because of their emotional reward from serving society. It would prove that they are not in the public sector as an investment strategy. Currently, a civil servant can make rules that are friendly to an industry such as banking—and then go off to Goldman Sachs and recoup the difference between his or her current salary and the market rate. (Regulators, you may recall, have an incentive to make rules as complex as possible so their expertise can later be hired at a higher price.)

Third, we should force corporate managers to eat some of the losses. Contrary to public perception, corporate managers are no entrepreneurs, and hardly impressive agents of capitalism. Over the past 12 years in the United States, the stockmarket has lost its investors up to \$2 trillion (compared with leaving their funds in cash or Treasury bills). So one would think that since managers are paid on incentive, they would be hurt. Sadly, no: because of the options embedded in their profession, managers received more than \$400 billion in compensation. The money-losing manager does not return his bonus or incur a negative one (he calls it "incentive").

Enough already of the valueless frauds

Finally, in finance, let's ban the risk-management method called "value-at-risk" currently used by banks. This is a pure intellectual fraud that allows banks to take more risks in the "tails". And the method is as much in use after the crisis as it was before: J.P. Morgan lost billions on trades in 2012 while the value at risk predicted very small tail exposures. Value-at-risk is not the only fraud: there are plenty of other contraptions of quantitative finance that continue simply because those who teach and practise them are themselves never harmed.

Should a single one of my four wishes come true, 2013 will be a good year. ■



The world of finance needs four new rules, says **Nassim Nicholas Taleb**, professor of risk engineering at NYU-Poly (and a former derivatives trader)

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