Why won't my financial advisor beat the market?

Reflections on the 'Black Swan'

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Every time we meet with our investment advisors, we go over the same things. We look at the amount of cash contributed during that quarter, the ratio of equities, debt, derivatives, commodities and other financial instruments. We explore the distribution of assets among economic sectors and geography. Finally, we get to the numbers that concern us most, the bottom line rate of return net of fees.

Most of us listen to a prepared presentation discussing the implications of geopolitics, macroeconomics, trade negotiations and currency exchanges, among other things, on that rate of return. Most financial advisors will present a coherent viewpoint to proffer an understanding of the rate of return for that quarter. This effectively communicates that the financial professional has some insight that has guided the investment strategy. The implication is that this financial insight has offered the investor an edge and serves as justification for the financial advisor's fees.

The problem, however, is that if these financial advisors are so insightful, knowledgeable and informed, why do they rarely beat the market in the long term? Why can't our investment portfolios generate the consistently high returns reaped by Warren Buffet, George Soros and David Einhorn? And why do we continue to pay these people significant sums when the rate of return is comparable with an exchange-traded fund, which costs a fraction of personalized investment management?

IS IT ALL RANDOM?

Nassim Taleb is an author and academic who has spent his life studying randomness, uncertainty and epistemology. He has published multiple books on these topics including *Fooled by Randomness*, *The Hidden Role of Chance in Life and in the Markets* (1) and *The Black Swan: The Impact of the Highly Improbable* (2). In these books, he argues that a few rare and important events explain almost everything in the world. He terms these events 'Black Swans'.

Black swans have three attributes. First, they do not fall within the spectrum of expected behaviour. They are unique or random events, divorced from previous experience and, thus, unanticipated by any previous models. Second, these events are highly impactful. The third attribute is that human nature impels us to invent post hoc explanations for their occurrence. While they may not have been predicted a priori, these post hoc explanations offer us the illusion of understanding and predictability. An example of a Black Swan event would be the stock market crash of 1929. This event was unanticipated, highly impactful and has yielded a plethora of attempts at explanation.

Taleb goes on to argue that many phenomena in the world are susceptible to a Black Swan event. Such phenomena occur in circumstances in which the variable being described can be classified as scalable.

He classifies variables into two groups: those that are normally distributed; and those that are scalable. In a normal distribution, variables should conform to a predictable pattern. We should be able to describe a data set by presenting its mean, median, mode and standard deviation. This should allow a reader to develop predications about the probability of observing a specific value. Examples of such variables are height, weight and IQ.

Scalable variables are those that do not distribute according to a normal (or Gaussian) distribution. These variables include wealth, income, book sales per author, celebrity, population of cities and performance of financial markets. These phenomena are scalable in the sense that very large deviations can be observed. The wealthiest person in the world has a net worth that is >80 billion times the value of the poorest person. Furthermore, average wealth provides no real predictive insight into the range of possible wealth in the world. Mathematically, these variables do not conform to a Gaussian or normal distribution. Very significant outlying values can be observed and are very difficult to predict.

When variables do not conform to a predictable distribution, a whole host of problems can ensue. Fundamentally, this problem arises from our brains. We are inclined to predictability. We tend to think that when we see something happen once, it is likely to repeat and that there will be a tendency of observations to converge toward the mean. The human brain then tends to discount the likelihood that an outlying value (or event) will be observed. We are then surprised when such an event does occur. As surgeons, our training reinforces this cognitive bias. We deal in a world in which most observed phenomena do converge toward the mean, in which the bell curve often describes statistical distributions, and in which prediction is critical to diagnosis and treatment.

Taleb goes on to argue that our cognitive bias tends to ascribe the properties of Gaussian distribution to a plethora of phenomena, which are not, in fact, correctly described by those statistics. In an effort to understand our world, we tend to expect that scalable variables be described by nonscalable statistics. We tend to think that income, wealth and celebrity should conform to the same statistics as height and weight. When someone earns \$50 billion as the result of an initial public offering, we tend to invoke post hoc explanations for his or her financial success rather than evaluating the underlying error in statistical reasoning.

EQUITY RETURNS ARE SCALABLE

It turns out that returns on the stock market are not normally distributed; rather, they are scalable. In other words, one should expect extremely large returns and large losses to occur in real life with relative frequency, with a much higher incidence than would be anticipated by a Gaussian distribution. This accords with our intuition. Many people have seen that fantastic financial returns usually accrue to investors in small start-up companies that have experienced phenomenal growth. In most cases, we have no idea why some start-up soared while multiple equally ingenious ideas failed. In addition, bubbles that would never have been anticipated often cause crashes.

Our brains don't really like this randomness. We humans prefer to have an understanding of the world and ascribe unanticipated deviations from our expectations as outliers, oddities or 'freaks of nature'. As a consequence, we seek explanations for why these events deviated from our expectations, seeking special explanatory circumstances.

YOUR FINANCIAL ADVISOR BELIEVES IT TOO

Our investment advisors have an incentive to demonstrate that equity returns are not random, but rather the function of meticulous analysis

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and meritorious behaviour (you would never pay him otherwise). As a consequence, deviations in the market require explanation. And so begins the post hoc narrative to explain the reason why your investment in Shell Energy underperformed this quarter. The political instability in Ukraine and Iraq created downward pressure on oil refineries in the Gulf... and so on.

Ultimately, however, your returns usually compare with the returns of the entire market.

CAN YOU CASH IN ON A BLACK SWAN?

If it's all random, then how does one actually proceed? The key is to recognize that humans are not able to predict these events and, therefore, you can consider putting your money in a position to be in the right place at the right time. Some advocate investing in small

start-up companies because you never know which ones will hit. At the same time, one would like to mitigate the consequence of a negative Black Swan – an unanticipated decline in equity markets. Such mitigation can be achieved by placing the majority of cash into debt instruments with guaranteed returns. In this way, the downside can be mitigated while the upside can be exploited. However, the bottom line is that your financial advisor may be just as confused as the rest of us!

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