

The Great Lesson Of 2007



There is no such thing
as a “standard” deviation.



Every once in a while, one reads an essay that one wishes had been expanded into a little book; Joan Didion’s lovely meditation on Georgia O’Keeffe comes readily to mind. Too often, however, one comes across a book whose message might far better have been encompassed in an essay. Malcolm Gladwell’s *The Tipping Point* is a well-known recent example of this latter phenomenon.

Sadly—because it is so much scattershot, vitriolic fun—Nasim Nicholas Taleb’s *The Black Swan*, published at the turn of last year, is also a book that should have been a short, more powerfully-focused essay. Its message is simple: all really important events are (a) highly improbable, (b) have profound and far-reaching effects, and (c) are followed by desperate attempts to explain them in the context of what has gone on before.

In my newsletter, when the book came out, I summarized the bulk of it in two sentences. The first of these was “We do not know what we do not know,” and the second is the subject of this essay, for it is, to me, the great lesson of the financial year just past: *There is no such thing as a “standard” deviation.*

The mind of man resists randomness and chaos—it does not naturally tolerate ambiguity—and so it craves systematic explanations for things it cannot understand. If primitive man could not comprehend the quixotic wildness of wind and water, he turned these forces into gods, and made sacrifices to appease them. An inexplicable solar eclipse became an angry sun god, abandoning us because we had done something

wrong—a sin which demanded expiation. It did not—and does not—matter that our explanations were wrong: they met a deep need in us to see order where there is really chaos.

You may smile at this, and put it down to forces of ignorance which human advances have since vanquished. But just before you do that, ask yourself why the investing public and the “advisors” who serve it—faced with the incontrovertible fact that there

is no statistical evidence for the persistence of performance—count the number of Morningstar stars a fund has, and believe it tells them something about future performance. It’s the same basic human need: any simple, systematic “explanation,” no matter how little it actually explains, is preferable to the terrible ambiguity of reality.

We wish, above all other *desiderata* in investing, to put definable limits around random reality. And so we



examine the chicken entrails and tea leaves of such pseudo-scientific measurements as R-squared, Sharpe Ratio and above all “standard” deviation, as if they could safeguard us from the randomness of wind and water that is economic/financial/market reality. And we end up less rather than more able to anticipate important events—less rather than more able to respond to them cogently.

And reality—for good as well as ill—always comes at us out of deep left field. The Black Death of the Middle Ages, Columbus’s accidental (and wholly unconscious) discovery of the new world, Pearl Harbor, the Internet, and September 11: characterize them

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as good or bad, and you miss the point. They are decisive, and they are outliers. No system of thought prepared the broad range of humanity for them, and thus they were intense surprises.

So let it be with the defining event of 2007: the subprime mortgage crisis. There was no way for the normal mind—and apparently no way for any number of genuinely extraordinary minds—to see it coming. One can put it down to the inevitable *reductio ad absurdum* of an epic real estate bubble brought on by an insanely accommodative monetary policy. One can also, and with no less justification, point to all the previous collapses of the risk management function which have characterized the banking system at the tops of all previous credit cycles. And one can surely blame a whole new generation of exquisitely complex mortgage derivatives—and the benighted superquants who mistook their mathematical models for market reality.

Each of these strands of the disaster is true; each (and all) can help us understand the carnage to which they led, and specific mistakes that ought not to be repeated. But the plain facts

are twofold. (1) They did not provide us anything like sufficient warning before the fact, if only because they took place on a scale hitherto unimaginable. (2) Next time—and there will surely be another next time—the disaster will come from another, wholly unanticipated quarter. We will all be watching for CDOs, SIVs, XYZs and all the other usual suspects to poke their heads out of their mouseholes, while another monster altogether strolls through the unguarded front door.

There is no such thing as a “standard” deviation. The ultimate preparedness is one’s tolerance for ambiguity, not some abstract mathematical formulation for

standardizing the randomness of financial experience. Indeed, the more one is bound by these false abstractions, the more one is a potential victim of the idea that “This time it’s different.” It’s always different—and, in the largest and best sense, it’s never different.

When your abstractions fail you, the wrong thing to do is to start searching for another abstract paradigm—as I already hear so many commentators (and advisors) doing. The right thing to do is to seek higher, better realities.

Perhaps the first and greatest of these is that it was always a mistake to forsake mainstream equities in the quest for that ultimate chimera, the “safe, high-yielding debt instrument with a guarantee of the return of principal.” Virtually all of the money that has been lost at the retail level in hedge funds, real estate and, yes, subprime mortgages fled into those assets in revulsion from the greatest bear market in equities since the Second World War, in 2000–2002. (The fact that said bear market was only the logical outcome of the greatest stock market bubble in human history does not seem to have been decisive in a lot of people’s thinking.) Had long-term, diversified

equity capital stayed where it was, and kept accumulating equities at prices no one will ever see again, it would be (relatively) all right.

The second great truth is the higher sameness of all financial folly, and of the crises that ensue, and of the long-term recovery which always follows. Subprime will shortly be, like dot.com before it, a distant memory—while the deepest, most flexible, most entrepreneurial, most transparent economy on the planet drives its equity values to new heights. “This time” is always different in the details, but never different in this higher sameness. Ten years from now, everyone will rue that he did not buy equities—and especially, I suspect, financial and real estate-related equities—on the worst day of this evanescent “crisis.” Look at the tsunamis of sovereign capital flowing into our financial companies from the Middle East and Asia, even as the U.S. domestic investor flees them. What do they see that we don’t?

But finally—and the whole point of this essay—the very highest truth is that you can never standardize the randomness of human experience, and especially of financial experience. Heraclitus said, two and a half millennia ago, “You could never step twice into the same river, for other waters are ever flowing on to you.” The best advice advisors can give long-term investors is: tolerate ambiguity. Expect the unexpected, for we do not know what we do not know. Don’t ask the future to be exactly like the past, because it will refuse, and in ways that won’t necessarily please you. Embrace randomness. There is no such thing as a “standard” deviation.

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