Book Review

The Black Swan

by Nassim Nicholas Taleb

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While not an easy read, we find much wisdom and perspective in Nassim Nicholas Taleb's book, *The Black Swan*. The central thesis of the book revolves around the idea that a relatively small number of low-probability, high-impact events have dictated the course of human history. Taleb cleverly refers to these events as "black swans," which are both unexpected and unforeseeable. Through repeated examples and analyses, he leads the reader to understand that we are all, in fact, frequently "fooled by randomness." At its core, the book is really about risk, so there is a high degree of relevance between Taleb's message and the financial markets. There is also a philosophical undergirding between many of the concepts explored in the book and what we do at Crawford, including a shared appreciation for the uncertainty of the economy and markets. We acknowledge that the future is highly uncertain, and the ways in which we invest are designed to help protect against the unexpected. This acknowledgment of the risk inherent in investing is implicit in the framework that we use at Crawford as we seek to implement our investment strategies and portfolio policy.

Taleb argues that to understand both the prevalence and authority of these black swan events, one must acknowledge the commonality of the narrative fallacy in everyday life. The narrative fallacy revolves around the idea that humans are always attempting to fit stories and patterns into and onto what really, at the end of the day, consistently boils down to be disconnected events and facts. Our attempts to make sense of the random series of events that make up life result in senseless explanations of reality and ultimately prohibit many from recognizing the dominance of these unpredictable events.

How do these abstract ideas relate to market behavior? Behavioral biases and human nature can influence decision-making, lead to security mispricing and inefficiency, market volatility, and, ultimately, opportunity for long-term investors. Within the investment profession, we all ceaselessly try to define and explain the success and/or failures of investments and portfolios in relation to the markets or sectors, and we employ financial statistics to demonstrate skill and proficiency. But as it turns out, the vast majority of both professional and private investors are "long volatility" to a degree that is often underappreciated and misunderstood. This can be great when markets are going up, which happens to be the majority of the time. However, when the black swan shows up or the fear of a black swan emerges, being excessively long volatility and owning lower-quality companies can lead to permanent loss of capital, further irrational behavior, and at a minimum, is disruptive to the long-term benefits of compounding returns.

Taleb believes that market behavior is inherently random, and black swan events lurk around every corner. At Crawford we don't entirely agree with this conclusion, but we do certainly acknowledge our inherent black swan blindness and seek to foster a lower-volatility and higher-quality bias across portfolios. In taking this approach, we are acknowledging that we cannot predict the future or gain an investment edge by better estimating short-term earnings changes and business inflections with a high degree of precision. Therefore, we pursue an approach which seeks to smooth out the inherent market volatility and tends to work relatively well in most market environments. That is, our strategies are engineered to participate in up markets and provide superior downside protection when the market declines, narrowing the range of outcomes for our investors.

Taleb also discusses the fallacy of silent evidence. This is the tendency that we have to, in looking at history, only see the positive parts of any and every process. This fallacy works to propagate a sort of future blindness that, here at Crawford, we refer to as behavioral investment bias. It is difficult to grasp the importance of protecting on the downside when markets returns are robust for a long period of time, just as it can be challenging to stick to any investment thesis and stay fully invested when the market is down. At Crawford, we have had the same investment philosophy in place for over 40 years. We have weathered cyclical periods of downturn that have temporarily seen markets rise and fall, and we have lived through numerous periods where our strategies come in and out of favor with the broad market. Throughout all of this, we have held fast to that belief that our philosophy, both rooted in quality and starting with the dividend, will prove successful in the long run. Having a well-grounded investment philosophy that can be maintained and that has worked over the long term is a critical element to successful outcomes, and aids in the avoidance of behavioral biases.

Further, Taleb discusses the asymmetry of events. At Crawford, we emphasize the somewhat different but related asymmetry of numerical values. While we are not trained mathematicians, we recognize that our numerical system was designed to explain nature and is a less than perfect representation. We also recognize that numbers, specifically negative investment returns, can have a certain asymmetrical quality to them. Simply stated, when a portfolio loses less value in a market decline, that same portfolio will have a higher base to appreciate from when the market begins to recover. In addition, moderating loss can help prevent decision-making errors and accelerate recovery. The alternative to this is excess risk, often fueled by an agency problem between money managers and their clients. Avoiding this requires discipline and conviction around a long-term focus, not to mention incentives that are oriented towards both return and risk. This focus can be inherently difficult to maintain when markets are soaring, but our commitment at Crawford is unwavering.

In conclusion, we think it is worth noting that Taleb also touches on the very systems that modern society has in place that reward those who cure, as opposed to the systems (or lack thereof) that reward those who prevent. This argument feels timely with the pandemic looming over us, but we feel it also can be directly applied to the work that we do at Crawford. We classify ourselves as optimists, but also certainly want to be "those who prevent," as we seek to produce attractive results while countering market volatility with investments in stable, predictable, consistent businesses that we define as high-quality.