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THE BLACK SWAN

November 6, 2007

We took the black swan as our logo when we started the company in 2004. It seems an excellent time to review why we did so and what it means.

Inductive reasoning involves drawing a general conclusion based on the observation of particular facts. It assumes that the past offers a reliable guide to the future. That certainly sounds reasonable. You see something happen, and it happens the same way every time the situation arises. Doesn't it sound logical to conclude that it will therefore continue to happen this way every time?

About 250 years ago, David Hume presented the problem of induction. His basic question was, "No matter how many times something has been observed in the past, can it ever be considered *proof* that it will continue to be the same in the future?" The answer is no. The black swan has commonly been cited to illustrate this point.

For centuries it was considered scientific fact that all swans are white. Millions had been seen over hundreds of years, and they had all been white. When the black swan was eventually discovered in Australia, it was instant and absolute proof that all swans are NOT white. No matter how many millions of swans are used to prove that all swans are white, and no matter how many years of consistent statistical data to back this claim, it only takes one black swan to prove they are not.

This is of great significance with regard to your investments.

Investors tend to rely on past observation in making their investment decisions. This is true regarding performance evaluation, asset allocation, beliefs about market behavior, what to buy or sell, and risk management. They look at past results and believe they have a reliable guide to future outcomes. The problem is that while past observation guides our beliefs, past observation does not make our beliefs true.

That is why every piece of paper you receive from your manager or broker will say some version of, "past performance does not indicate future performance." There has been a great effort to convey this message. Although everyone says this, and everyone hears this over and over, it appears very few people actually believe it. Rather, most investors seem to consider this some sort of obligatory phrase required by regulators but having no real meaning.

But it isn't. It may be the most important key to successful investing that you will ever find.

Lately, I've been seeing many people trying to find a way to get people to take this seriously. Nick Murray recently published an article in which he described an ancient society living on a large island complete with its own volcano. After having been calm and quiet for centuries, it erupted, killing an entire civilization. Despite plenty of unusual activity in advance of the eruption, no one left the island. Because none of the previous rumblings ever witnessed had resulted in anything harmful, they were convinced that it would be safe this time as well. Instead, it caused their extinction.

Nassim Taleb just wrote a best-selling book, [The Black Swan](#), expanding on these thoughts. He is an extraordinarily brilliant man, witty, and unconventional in his thinking. In his book, he distinguishes between events that are highly unlikely and also unrealistic, such as a man growing to be 50 feet tall, and events that are highly unlikely but realistic, such as two airplanes crashing into the World Trade Towers in 2001. He calls the highly unlikely but realistic events black swans. (I notice that black swan events defined in this way and which have occurred, are called "news" or "history". Black swan events that have not yet occurred are usually called foolish concerns.)

In my case, I use the logo of the black swan as a constant reminder not to assume that the past will repeat itself just because it always has. And that just because it hasn't happened yet does not mean that it will not happen. When I see someone making assumptions and decisions about the future based *solely* on past observation, I call it a black swan. Those conclusions I then regard with suspicion.

Until October, 1987, there had been no instance in history of a one day drop in the market of 22%. For those of us who experienced that day, it will forever be seared into our memories. Until the decline of 2000-2002, there had never, even during the Depression, been a three year decline of equal magnitude. I'll never forget that one either. Unlikely events, never experienced in the past, but they happened anyway.

Let me get to the point. As the largest investors attempt to protect themselves from these unknown risks, they create hedges and derivatives designed to spread the risk around and keep it away from their portfolios as much as possible. How do they do this? They use computer models to project the probability of future events **based on what has happened in the past!** Did anyone just see a black swan?

Their entire strategy is based on what "should" or what "should not" happen, as determined by a statistical analysis of past events. They plot this into bell curves and compute standard deviations. They believe that this gives them a reliable estimation of the likelihood of something happening in the future. They assume that if the computed probability is low enough, it means it won't happen. When it turns out that it does happen, it causes the massive shocks to the system brought about by the likes of Long Term Capital.

That is precisely what happened with the sub-prime fiasco. As these hedge funds and institutions sliced and diced the mortgages into new little pieces designed to accurately calculate, assign and redistribute the risk of default, they relied on past foreclosure and other data to compute the current "risk." Then the present stopped resembling the past. Foreclosures exceeded expectations, someone unexpectedly needed to sell part of their portfolio, people stopped buying houses for ever higher prices, and the whole thing began to unravel. Their models also failed to take into account the complete lack of buyer interest in these holdings as prices began to tumble.

This is just a tiny glimpse of what has been done. The total dollar value of all derivatives in existence is now estimated to be ten times greater than the entire annual production output of every human being on the planet. That is not necessarily a bad thing, by the way, but that's a topic for another day. What is of concern is that these activities require that serious investors avoid the traps of inductive reasoning.

The past is not a reliable guide to the future. At times this seems to me to be so self-evident that it couldn't possibly need discussion. Consider this. China and India together have a population of 2.5 billion people. That's almost 38% of the total world population of 6.6 billion people. As these two countries join the modern technological world, wouldn't common sense suggest that this might have some influence over how the future will unfold? Yet this reliance on past observation continues in even the most sophisticated portfolios.

We find that we have greater investment success by watching what *is* happening than by trying to replicate what *has* happened. It would be a huge mistake to ignore the lessons of the past. But it is equally a mistake to confuse learning from the past with feeling confidence that the past will repeat in the future.

Cindi Showalter

P.S. Is the sub-prime mess over? No. Does this signal the end of the current market run to the upside? No. Will this change which types of companies will increase in value? Yes. For eight years value stocks have been the better buy. The trend has clearly shifted back to growth. You will continue to see changes in your portfolio to reflect this. Happy Thanksgiving!