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THE SUB-PRIME CRISIS AS A 'PREDICTABLE SURPRISE':

LESSONS TO BE LEARNED

"We have also seen the emergence of a whole range of intermediaries, whose size and appetite for risk may expand over the cycle...accentuating real fluctuations, and exposing themselves to tail risks..."

Raghuram Rajan
University of Chicago
September 2005

"When the music stops, in terms of liquidity, things will get complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing..."

Charles Prince
CEO, Citigroup
July 2007

From Black Swans to Predictable Surprises

Nassim Taleb defines his 'black swan' events as unexpected outliers that have extreme impact, and that are rationalized as predictable and explainable after the fact. We explored some of the strategic management implications of black swan events in last September's *Letter*:

- Make room for unanticipated contingencies in your strategic plans and decision-making processes.
- Weight your expectations not by perceived plausibility, but by the harm they might cause if you are wrong.
- Consider adopting 'barbell' investment strategies (e.g., if adopting a risky strategy, consider buying downside insurance).
- Replace 'normal' distributions with 'power law' distributions in simulations. The latter recognize asymmetrical outcomes such as Pareto's 80/20 rule.

Then last November we heard Michael Watkins (Harvard, IMD, Genesis Advisors) discourse on 'predictable surprises', which sounded a lot like Taleb's black swans, except for one important difference. Watkins' extreme impact events really were predictable, and were actually pre-

dicted before-the-fact. The predictions were simply not acted on.

Examples of predictable surprises that turned bad? There were serious airline security concerns well before 9-11. There were serious auditor independence concerns well before Enron. There were serious hurricane preparedness concerns well before Katrina, and yes ... there were serious financial intermediation industry concerns expressed well before the sub-prime mortgage crisis hit the headlines in August 2007. The Rajan and Prince quotes above are but two examples indicating that knowledgeable observers were aware of the build-up of a toxic combination of factors that would produce the sub-prime crisis well before it actually erupted into the open six months ago.

So Watkins' predictable surprises have an additional strategic management implication beyond those that follow from Taleb's unknowable black swan events. It is to construct triggers that move organizations beyond just predicting bad outcomes, to taking action to prevent them. In other words, Watkins' thesis takes us out of Taleb's fatalistic black swan world, into a more hopeful, pro-active one. This *Letter* explores this powerful idea, focusing on the financial intermediation industry in general, and its pensions sector in particular.