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# Too many investors are falling under the spell of false omens

Ian Harnett: Viewpoint

**The more people search for anomalies, the more anomalies they will spot** Mitch Reardon/Getty

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How many black swans have you spotted recently? The fall in trading volumes on stock markets appears to reflect a world full of potential black swans: eurozone collapse, US fiscal cliff, Middle East conflict, all set against a backdrop of debt-induced low growth — economies sustained, zombie-like, only by ever larger bouts of quantitative easing.

This “new normal” is a world full of uncertainty rather than “risk” — one in which traditional “top-down” investment approaches appear to offer little. What is striking, however, is just how similar this feels to the “great moderation”. Back in 2006-07, the consensus was that low and stable inflation, healthy and stable economic growth, Chinese expansion and strong profit growth were all structural trends. That old “new normal” was characterised by low macroeconomic volatility, low policy volatility and low market volatility. The business cycle was dead.

Into this apparently serene world flew a strange, rare, bird — the black swan. The original notion of the black swan, propounded by the philosopher Karl Popper, was based on the idea that if someone saw that all the swans on a particular village pond were white, they would have a good working hypothesis that all swans were white. This would be reinforced by visiting the next village etc.

The trouble is that searching for more white swans can never prove that all swans are white, while the sighting of a single black swan disproves the hypothesis completely.
The key lesson for investors is that “anomalies matter”.

During the great moderation, searching for black swans was not a popular pastime and few wanted to hear about the anomalies, or the emerging risks. The credit crunch ushered in a different zeitgeist. Today, the only things worth analysing appear to be “fat-tailed events”, and only potential black swans get attention. Everyone is seeking the next black swan, and the more people search for them the more they spot.

Unlike the villagers in Popper’s narrative, we now appear to inhabit a world where all the swans on our local pond are black. Our Facebook friends tell us of the black swans in their village, and Twitter is abuzz with stories of the black swans that inhabit the ponds of the eurozone, US and Asia. Increasingly, the majority of investors appear convinced that all swans are black.

While this phenomenon may be real, and the proportion of black swans really may have increased, it could just be that this apparent rise in black swans is one of perception.
In his book *Thinking, Fast and Slow*, the psychologist Daniel Kahneman explains how our minds subconsciously overestimate the probabilities of unlikely events and compound this by overweighting unlikely events in decision-making. The framing of questions and statements also has a big impact on our perception of probabilities. The mind responds better to vivid stories than to abstract data.

The implications of Mr Kahneman’s work for investors’ views about black swans are readily apparent.

With so many people searching for them, it is easy to overestimate their numbers. If these risks are framed as something that “could” happen, rather than the probability that they “will” happen, they become more believable. If they are then presented in a strong narrative, our natural tendency is to believe it. Mr Kahneman also warns that frequent repetition encourages affirmation of ideas — regardless of veracity. Thus, those who shout the loudest and most often may have the largest followings on their blogs or appear more frequently on TV. They will probably have their views accepted.

Investors need to be aware that just because the consensus is repeated loud and often it need not necessarily be true. Investors would do well, as Mr Kahneman advises, to overcome the “urges of intuition” and focus instead on time-consuming, detailed analysis —

anchoring their views in the “base rate probabilities” of events instead of believing that “this time is different”. In the post-credit-crunch new order, many investors perceive that few reliable macro-to-market relationships survive. These “white swans” are now the anomalies.

In reality there are many examples of macro relationships that persist, having worked for many decades across many countries and having survived different foreign-exchange regimes, political alignments and even the odd banking crisis or two. One example is how equities tend to beat bonds in periods when US unemployment trends lower.

The problem is that with few investors searching for such constancies we have moved from a world of probability and risk to a world of uncertainty.

In today’s “new normal”, white is the new black when it comes to swans. But perhaps we should recognise that a single white swan is all that it takes to prove that not all swans are black.

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