Why Nassim Taleb Thinks Leaders Make Poor Decisions

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by Laurence B. Siegel

Why do experts, CEOs, politicians, and other apparently highly capable people make such terrible decisions so often? Is it because they're ill-intentioned? Or because, despite appearances, they're actually stupid? Nassim Nicholas Taleb, philosopher, businessman, perpetual troublemaker, and author of, among other works, the groundbreaking *Fooled by Randomness,* says it's neither.

It's because these authorities face the wrong incentives.

They are rewarded according to whether they look good to their superiors, not according to whether they are effective. They have no skin in the game.

Seasoned readers of Taleb will be pleased to see the so-called "experts problem" pop up in living color in *Skin in the Game: Hidden Asymmetries in Daily Life*, Taleb's latest collection of essays on risk, rationality, and randomness. According to Taleb, dentists, pilots, plumbers, structural engineers, and "scholars of Portuguese irregular verbs" are real experts; sociologists, policy analysts, "management theorist[s], publishing executive[s], and macroeconomist[s]" are not.

The difference is that, when people from the first list are wrong about something, it's obvious from the results and they suffer; they have skin in the game. Bad teeth, crashed planes, and leaky pipes are bad for business. People from the second list rationalize by substituting a different theory. They were not really wrong but just early, and, if they're lucky, which is to say skillful at apple-polishing, earn promotion after promotion by not failing utterly. (Financial advisors can argue that the fiduciary standard is the most powerful tool for putting them in the first list.) *Skin in the Game* is full of insights like this, some recycled from his earlier work but many of them new. It is well worth the relatively quick read.

Despite the many good qualities of *Skin in the Game*, Taleb's work, including the present volume, is often infuriating. He is too sure of himself, too unkind to his enemies, too full of bluster and obscure humor. Acting on his belief that some kinds of experts are worthless, he has populated the book's dust jacket with anonymous tweets instead of celebrity testimonials. Here's the first tweet: "The problem with Taleb is not that he's an ass— (spelled out in full on the jacket). He is an ass—. The problem with Taleb is that he is right." I agree.

Asymmetry, or why we are ruled by the most easily offended

In chapter two of *Skin in the Game*, entitled "The Most Intolerant Wins," Taleb asks why we seem to be governed by the most easily offended. You have to refrain from smoking in the non-smoking section, but you don't have to smoke (that is, refrain from not smoking) in the smoking section, which, by the way, is much smaller. Few people really care whether you say Merry Christmas or Happy Holidays, but the latter has become *de rigueur* in some circles. Almost all soft drinks are kosher.

The reason, Taleb explains, is that, for any given issue, there are a few people who care deeply about it and a great many people who do not. Those who care are spurred to action, even violent action in the case of religious or political passions. The rest of us, wishing to be left alone, rarely fight back with equal vigor. The results of this process include the increasing domination of Taleb's beloved, multi-religious Lebanon by Muslims, for whom conversion to Islam is irreversible. Conversion away from Islam is at least theoretically punishable by death; Christians and Jews don't much care if you leave the faith.[1]

In ancient Roman times, Taleb explains, Christians were the intolerant minority that pushed their views on the Roman majority. That's how Christianity eventually became the official religion of the empire in 323 A.D. Times and players change but the principles of human nature remain the same.

Almost all soft drinks are kosher because it's relatively easy to make a drink kosher. So manufacturers put forth this small effort rather than have two kinds of each drink, one for observant Jews – a fraction of a percent of the total population – and one for everybody else.

If this argument sounds familiar, it's recycled in much more general form from Frédéric Bastiat, the great 19th century French economist. Bastiat wrote that, for any given government action, such as a tax levied to subsidize some activity, there are a few people who will benefit greatly by it and they will work day and night to see it enacted. The great many who stand to lose will typically only lose a few pennies and will put forth little or no effort to prevent it. Thus the number of rules, regulations, taxes, handouts, and special favors granted by government grows exponentially with very little acting to restrain the growth.

These are just a few of the asymmetries of daily life to which Taleb's subtitle refers. Once you understand the principle, you'll see it in everything.

Waiter, there's a fly in my soup

The New York deli called Lindy's is famous for its clientele of Broadway actors and comedians, and for having food so bad that it has inspired a bevy of jokes including the one that starts with, "Waiter, there's a fly in my soup." But, Taleb tells us, it is also well-known among mathematicians and other scholars as the place where the Lindy effect was first observed. This is the idea that the age of an inanimate object is a good indicator of its future longevity:

> Broadway shows that lasted for, say, one hundred days, had a future life expectancy of a hundred more. For those that lasted two hundred days, two hundred more. The heuristic became known as

> the Lindy effect.

Likewise, Judaism, 3,500 years old, will probably last another 3,500; Scientology will be lucky to get another 60. Shakespeare will last longer than Stephen King. Even living things that do not age on a particular schedule, like trees, tend to follow this rule. It could be because the old ones, having survived, are *anti-fragile*, a concept from Taleb's earlier book by that title; they are not just robust, but gain further robustness from exposure to stresses. Or maybe, like Shakespeare, they're just better.

This principle is very powerful and Taleb applies it to many topics, with the Lindy theme running through the whole book. Academia, for example, sometimes resembles an athletic contest in which the hardest-working or most aggressive participants appear to win. It should not. "The winner is the one who finishes last," said the philosopher Ludwig Wittgenstein; that is, the academic whose theories are least easily overturned, most enduring, had the best theories.

Investors would do well to understand the application of the Lindy principle to their enterprise. Indexing as a concept is about 75 years old; value investing is even older.[2] These great ideas are unlikely to be overturned any time soon. Instead, improvements around the edges are the best we can expect. The latest idea for earning alpha, whatever it is at the moment, will almost certainly turn out to be a flash in the pan, easily arbitraged away by the time it can be widely implemented.

Why are there so many employees?

To illustrate how the principle of skin in the game applies to labor contracting, Taleb compares the behavior of two private jet pilots. Bob is a freelance contract pilot who is sometimes useful to your little airline but is at other times too busy hauling Saudi princes to fancy resorts to do the work you need done. The result, an occasional stranded planeload of people, is disastrous for your business.

The other, a pilot-employee – I'll call him Bill – does more or less what you want, including working overtime in a pinch. Why the difference? Taleb writes,

> People you find in employment love the regularity of the payroll, with that special envelope on their desk the last day of the month, and without which they would act as a baby deprived of mother's milk… [H]ad Bob been an employee rather than something that appeared to be cheaper, that contractor thing, then you wouldn't be having so much trouble.

Economics dictates that employment is just one of many ways to contract for labor, and a particularly inflexible one that requires you to pay the employee whether you can keep them busy or not. You've probably considered replacing employees with contractors in whatever business you operate or work. Yet there are a lot of employees! Taleb's tale provides a clue to why: "Every organization wants a certain number of people associated with it to be deprived of a certain share of their freedom." Employment is the only legal way to achieve that sort of dependent relationship.

What's the connection to skin in the game? We tend to think of freelancers and entrepreneurs, such as Bob the pilot-contractor, as risk takers, skin-in-the-game players. And they are. But, as Taleb reminds us, "skin in the game is not [about] incentives, but disincentives." You don't want the employee to do what is best for himself in the short run – that's what contractors do – so you set up an alignment of interest between his long-run welfare and yours. As an employee with a family and a mortgage, and considerable costs if he has to get another job and relocate, he has skin in *your* game.

That's why we have so many employees.

Two very different kinds of risk

Since investing is applied philosophy, Taleb's whole book is relevant to investors, but the most directly applicable part is Chapter 19, "The Logic of Risk Taking." He draws the distinction, fundamental but rarely fully understood, between *ensemble probability* and *time probability*. (Like double-entry bookkeeping, this is one of those wonderful ideas that's obvious once you've heard it; less so in advance.) Ensemble probability involves a risk faced by a population at a given point in time, such as that of a hundred people visiting a casino once, where each person can make a one-time, double-or-nothing bet involving his or her entire fortune. In that single visit, about half of them will be ruined. The other half, having doubled their money, will be perfectly fine.

Time probability, in contrast, involves an ongoing risk faced by an individual over time. Consider someone visiting a casino 100 times in succession, also making a double-or-nothing bet involving his entire fortune. In 100 visits, that person *will* be ruined; usually ruin will occur after just a few visits. No one who behaves this way will ever be fine.[3]

With ensemble probability, then, as Taleb explains, "the ruin of one does not affect the ruin of others." With time probability it's the opposite: once you get a sufficiently bad outcome, the game is over and you cannot become un-ruined.[4]

This distinction is relevant to investing because the risks investors face involve time probability, not ensemble probability. In most aspects of life, we are accustomed to thinking about risk in the ensemble sense: a football team has a 2-in-3 chance of winning a game, a disease has a 10% mortality rate. So we are familiar with that kind of risk, and comfortable extending the concept to other aspects of life.

But, in investing, the state of a person's wealth at any point in time is contingent on her wealth at the previous point in time; returns are cumulative; investing exposes us to time risk, cumulative risk. We are not typically able to do the mental approximations needed to think about that – if the risk of getting in a car accident on the way to work is one in 10,000, what is the risk of driving to work 10,000 times? (It's not 100%, nor is it insignificant; it's 64%. You should go to work anyway.[5])

Thus, we need to be very careful when relying on intuition to tell us about investment risk. Investing involves more risk than you think. We also need to be wary of extrapolating from the past (and avoid the temptation that comes from the fact that it's so readily accessible). Paul Samuelson famously said that "we have only one sample of the past," meaning that far more things could have happened than did happen; there's only so much you can learn from studying history. But it's just as important that we will get only one sample of the future! The return pattern that we will experience is just one of the infinitely many possible ones, and it will not be the one that we "expect" statistically; it will be something different, possibly very different.[6]

Are you an IYI? I hope not

Consistent with his famously combative persona, Taleb takes pot shots – frequent and vigorous ones – at intellectuals, or, in his acronym, IYI. An intellectual yet idiot (IYI) is someone who is beloved by the public for his or her knowledgeable airs but who is actually full of baloney, having no practical sense. Taleb considers Steven Pinker, author of *Enlightenment Now* and a current darling, to be an example, and calls him a "journalistic professor," not the psychologist and linguist that he obviously is. (I'm reviewing Pinker's book, favorably, in an upcoming *Advisor Perspectives*.)

When one gets past the gratuitous insult, however – Taleb doesn't think much of journalists or professors – he has a point. When a real expert strays from his own field, he is susceptible to making the foolish mistakes of an amateur, except that an amateur is likely to be humbler.

Taleb has not convinced me that Pinker is a wandering amateur; maybe it's Taleb, not Pinker, who is wandering too far from the core of his knowledge. Intellectuals, whether or not IYI, must, when turning against their kind, be on guard against becoming AIYA: anti-intellectual yet ass—. (Pardon my French; Taleb inspires it.) At 16, I fit the description; I do not think Pinker does.

Dedicated to the one I love?

Book dedications are rarely interesting; they usually feature one's parent, spouse, or teacher. But, in an odd twist that allows us to see (a little) into Nassim Taleb's mind, he dedicates *Skin in the Game* to two well-known people whom I would have praised less lavishly. First, Ron Paul, "a Roman among Greeks"; second, Ralph Nader, "a Greco-Phoenician saint."

In a self-referential joke, Taleb's comment about Ron Paul reverses the dedication of his earlier book, *The Black Swan*, to the great mathematician Benoit Mandelbrot, "a Greek among Romans." It took me a bit of effort to find out, by searching through Taleb's tweets, that he admires the Romans' practicality:

> As I came to realize...[,] the Romans were no-B.S. Fat Tonys; they resented grand theories and favored prudent and progressive tinkering. Much of what they built, from constitution, to Roman law, to bridges, to low income housing, to their literature, to their imperial administration (still around in the structure of the Catholic church), has survived 2000 years.[7]

Paul, a doctor and former congressman from Texas, is an honorable – although occasionally goofy ("audit the Fed") – man who often stands alone in objecting to his colleagues' expedient political follies. I'm not sure (and Taleb doesn't say) why that makes him a Roman, but maybe an encomium is deserved; I would not have singled him out.

But Ralph Nader a saint? He certainly sacrificed personal income, and subjected himself to harassment, when making the case that U.S. auto companies were making dangerous cars; he had skin in that game. But Nader has a dark side. Despite having taken a poverty vow and very publicly living like a monk, he revealed a personal fortune of $3.8 million in his 2000 presidential election filing – not a large fortune but not monkish either. He has also founded nonprofit organizations that do research of dubious quality, and his latest crusade is a meaningless fight against share buybacks (an important mechanism for enabling investors to get cash flow out of their portfolios). Nader is an odd choice for sainthood.

Skin in the game everywhere

Like many authors who've discovered a principle that they believe applies in many aspects of life, Taleb isn't shy about discussing every aspect he can identify. They include the role of looks in choosing a surgeon: don't choose a dignified, handsome one – one who looks more like a butcher "had to have much to overcome in terms of perception." Military interventionism? He's against it, arguing that policy analysts who make war from comfortable offices don't know what it's really like on the ground and have no personal stake in the consequences. Religions, at least at first, demand extreme sacrifices from their adherents because their leaders know they can only hold the tribe together if its members can see that fellow members have sacrificed too: "The strength of a creed," Taleb writes, "did not rest on 'evidence' of the powers of its gods, but evidence of the skin in the game on the part of its worshippers."

This campfire-style storytelling makes the book seem, in places, more like a collection of loosely related essays, as I referred to it at the outset, than a coherent book. This approach has an upside and a downside. It's easy to read parts of the book without losing the train of thought, since many of the parts were written as magazine articles and stand well on their own.[8] The downside is that, if you try to read the book as a coherent whole, you'll find it too full of interruptions and asides.

Conclusion

Taleb's writing is nothing if not lively. What other philosopher, let alone investment writer, creates characters like Fat Tony, a worldly-wise trader who cares little for book learning; Yevgenia Nikolayevna Krasnova, a neuroscientist with three philosopher ex-husbands who writes a runaway best-seller called *A Story of Recursion*; and Nero Tulip, a thinly disguised version of Taleb himself? Taleb entertains, educates, and infuriates all at once, a heady combination for readers who score high on curiosity but frustrating for those who are just in a hurry to gather information and get on with it. This is Sunday afternoon, not Monday morning, reading.

Mercifully, *Skin in the Game* is also relatively short, unlike Taleb's previous book, *Antifragile*. It can be consumed effectively by a casual reader and does not require sustained attention.

Skin in the Game is not Taleb's best book – that's *Fooled by Randomness* – but it's his most accessible. I highly recommend it.

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[1] Some Jews say a prayer for the dead upon learning that a fellow Jew, especially a family member, has left the faith; this "punishment" has not done much to stem the rate of intermarriage or the decline in Jewish religious fervor.

[2] Index funds, as a concept, started with Jack Bogle's senior thesis at Princeton in 1951. Value

investing traces its origins to Graham and Dodd [1934]. Graham, Benjamin F., and David L. Dodd. 1934. *Security Analysis* (first edition), New York: Whittlesey House/McGraw Hill.

[3] The probability of surviving 100 successive double-or-nothing fair bets with one's fortune intact is about 1 in 10^30, the latter representing a number far larger than the number of seconds since the universe began.

[4] I've further simplified Taleb's already simple example by making the bet double-or-nothing and the odds 1:1 (that is, a 50% chance of winning, a fair bet). Taleb's example involves smaller losses.

[5] The right way to think about this is to start with the probability of *not* getting into an accident, which is .9999. One then takes this number to the 10,000th power, for a result of a (rounding) 36% chance of not getting into an accident in any of 10,000 trials. Thus the probability of getting into an accident is 64%.

[6] This is also the point of my article with Barton Waring, "What Investment Risk Really Is, Illustrated," https://larrysiegel.org/what-investment-risk-really-is-illustrated/.

[7] Taleb's Facebook post of August 21, 2015, https://www.facebook.com/nntaleb/posts/10153269370143375. I've corrected a number of typos.

[8] Or chapters of the forthcoming book were serialized in magazines – it's hard to tell which.