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Fooled by randomness: the hidden role of chance in life and in the markets

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BOOK REVIEW

Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets
Nassim Nicholas Taleb, 2004
Penguin Books, London; RRP £9.99; ISBN 978-0-141-03148-4; opening vii-xxxix; 5-316 pages

The notion of gambling, traditionally applied to specified and organised games of chance, is increasingly being used to refer to a wider spectrum of behaviours and activities. In *Fooled by Randomness,* Taleb argues that chance plays a dominant role in many aspects of daily life, including financial markets, and that to succeed in life the role of chance must be understood in order to maximise gains and minimise losses. Probability is defined as “the acceptance of the lack of certainty in our knowledge and the development of methods for dealing with our ignorance” (p. x). Much like a therapist aiming to teach problem gambling clients to challenge irrational beliefs, Taleb aims to encourage his readers to clearly see the illusions of skill in their lives and recognise that the patterns that behaviours are commonly based on are merely random outcomes interpreted with biases. In several incidences, Taleb uses examples from the gambling literature to explain the role of chance, probability and perceptual biases, most frequently in relation to the business world and markets. The field of gambling is changing and embracing multidisciplinary research and directions and, as such, this book is interesting in so far as it explores the concept of gambling beyond traditional games and in application to other aspects of life.

Although a work of non-fiction, references and literary sources are seldom used, and the majority of these are clustered in 22 pages of notes appended to the fourteen chapters. Taleb draws heavily from his stated experience as a trader with examples of success and failure, particularly in business, used to outline the importance of chance (or luck as he frequently refers to it) as opposed to talent, knowledge, strategy or skill in leading to success. The book is compartmentalised into chapters, but the argument is not clearly outlined or developed. Rather, the same point (success is based on chance and will ultimately result in failure) is repeated with various explanations provided and theories discussed. Unlike the ‘hard’ sciences and games of chance, in the social sciences and life the rules, limits and factors that determine random outcomes are not well understood. This makes outcomes much more difficult to predict, causing Taleb to argue that the largest part of success or failure is due to randomness. The thesis is more conversational and circular than direct, but the author appears to be arguing that a) success is relative to those around us (i.e., it is better to have a bit more money than our neighbours than to have a lot of money but be surrounded by even richer individuals); b) skill, talent, and strategies are less important than chance; c) a series of wins will ultimately be followed by losses and vice versa (“risk taking is frequent randomness foolishness” p. xli); d) success is best achieved by minimising losses and not taking large risks (i.e., don’t chase losses or success – win big, then go home); and e) history can’t be relied upon – it will often repeat itself and the absence of past outcomes does not mean an outcome will not occur.

Any reader hoping to uncover the secrets to financial success will be disappointed, much like those who read books on how to win at blackjack or how to win on gaming machines (slots, pokies, video lottery terminals, fruit machines, etc.). Similarly, this book is not suitable for students of business, economics or commerce due to the lack of references and well-explained scientific theories. However, Taleb does outline several key concepts of randomness, perceptual biases and heuristics, logic, induction, probabilities, and mathematical reasoning (to an extent). The book is written in relatively simple, conversational language, as opposed to academic idioms, making it an interesting and relatively easy read.

Of particular interest to those in the gambling field are the many parallels seen between Taleb's explanation of behaviours in the financial markets and traditional gambling. For example, he states that one is more likely to succeed with one large investment, than a series of small investments, as the role of chance in each investment increases the likelihood of an unsuccessful outcome. Similarly to the role of probabilities in gambling on gaming machines, an investment portfolio is more likely to show a steady direction over a longer course in time (in the case of gambling this would be negative, whereas wise investments may increase). For the same reasons that gambling is exciting, with small wins and losses over a session despite the downward trajectory of the eventual outcome, markets also fluctuate on a regular basis. For this reason, close monitoring of hourly, daily or even weekly movements may cause traders and investors undue stress and anxiety due to random market fluctuations. One interesting section sees Taleb outline the characteristics of 'Market Fools' which include: an overestimation of the accuracy of their beliefs in some measure; a tendency to stick with a system; a tendency to change/rationalise stories and explanations for behaviour; no precise plan for what to do in the event of losses; absence of critical thinking expressed in the absence of revision to plans when faced with unexpected outcomes (i.e., losses or big wins); and denial. Sound familiar? Another example of the similarity between traders and gamblers comes from the authors' statement that investors would prefer to keep the number of losses low and the number of gains high, rather than optimising total performance merely for emotional reasons. This is similar to preferences expressed by gamblers who would rather have small wins to allow them to sustain play, than expecting to hit the jackpot.

Despite these apparent similarities with gamblers, Taleb states that 'gambler' is considered a derogatory term among market traders and, recognising our human propensity to make irrational trading decisions takes steps to minimise these. For example, he describes only examining statements at a predetermined point or threshold, reducing access to excess information, being aware of superstitious behaviours and making decisions ahead of time on how to react to market movements.

Although it is an interesting read, it is quite possible that those involved in financial markets and the business world may disagree with the authors' stance that "No matter how sophisticated our choices, how good we are at dominating the odds, randomness will have the last word" (p. 246). Indeed, unpredictable events and occurrences may impact financial markets, but the fact that some individuals are more successful than others is unlikely to be explained by randomness alone. Unlike gambling games in which outcomes are entirely determined by chance, skill and talent does play a role in other areas of life and sound decisions can be made to increase the likelihood of overall success. This is similar to success in some gambling games, such as poker –

as although the fall of cards may be random, betting patterns, knowledge of probabilities and interactions with the other players do involve skills which play a role in determining overall outcomes. This book offers a relevant view on the role of and perception of randomness in the world and argues that actions are gamblers more often than we would believe. It is relevant to researchers with an interest in exploring a wider definition of gambling than has been traditionally used, particularly those from a business, commerce, or economic background. Although the book is light in academic references, it provokes interesting concepts that may be followed up with empirical research.

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