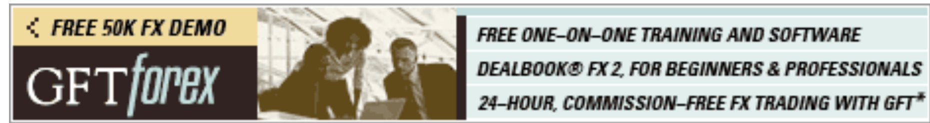

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Nassim Nicholas Taleb: Profiting from market uncertainty

This options trader and philosopher bets against the crowd. He explains why traders continue to under-estimate the role of randomness in the markets and how betting on the possibility of rare events provides an edge.

By DAVID BUKEY

Nassim Nicholas Taleb has traded options for more than 20 years, either for major investment banks or on his own as a fund manager and pit trader — but he bristles at being labeled a trader.

Taleb describes himself as a philosopher who argues that traders underestimate the role of randomness, and fund managers' successful track records might be more easily explained by luck than skill or experience.

Unlike many options traders who collect premium from selling out-of-the-money (OTM) options, Taleb focuses on buying far OTM options that have a low probability of making money but post extraordinary returns if they do.

Instead of studying how the market did move, Taleb analyzes all the scenarios that *might have* occurred as well. Wild market spikes and crashes are admittedly rare events, but their reward is so large it offsets their infrequency.

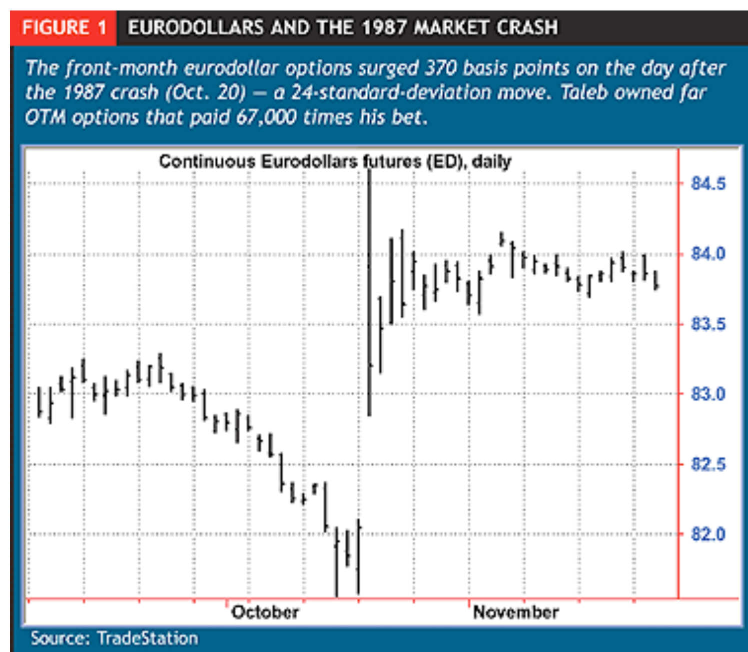
"The likelihood is completely irrelevant compared to the payoff," Taleb says.

Taleb first realized that long OTM options can produce

unusual returns after he began trading currency options for Banque Indosuez in late 1984. When leaders of the G-5 countries (U.S., Japan, West Germany, France, Britain) agreed to devalue the U.S. dollar by signing the Plaza Accord on Sept. 22, 1985, he held long OTM options that surged in value, which caught his bosses off-guard.

"They said it's impossible for such a small position to generate so much profit," Taleb says. "So I learned two things — the market could deliver these crazy events, and people didn't understand these payoffs."

Taleb has spent the past two decades studying the characteristics of options, but it was his windfall following the 1987 stock market crash that put him on the map. His long position in front-month eurodollar options gained 67,000 percent as the market gapped up 370 basis points on Oct. 20, the day after the crash (Figure 1).



Despite this success, Taleb had a love-hate relationship with the markets, so he decided to become a scholar and research the science of uncertainty. In addition to holding top trading positions at Credit Suisse First Boston, Union Bank of Switzerland, CBIC-Wood Gundy, Bankers Trust, and BNP-Paribas, Taleb earned an MBA from Wharton and a Ph.D. from the University of Paris.

He also wrote two books: *Dynamic Hedging* (John Wiley & Sons, 1997) and *Fooled by Randomness* (Textere, 2001). Taleb is perhaps best known for *Fooled by Randomness*, which explains why we're genetically disposed to misjudging probability. The book, now in its third edition, explains the relationship between luck and the markets with simple, entertaining examples and describes why market moves are too unpredictable to analyze with standard statistical

techniques.

After finishing his Ph.D. in 1998, Taleb founded Empirica, a private investment fund, which he actively managed until 2002. He won't discuss its performance record, although he continues to trade options and earned a seven-figure income from trading last year, according to 2004 tax returns disclosed to *Business Week* last fall.

Currently, Taleb is a professor in the sciences of uncertainty at the University of Massachusetts at Amherst and also teaches at NYU and the University of Paris. He spoke with us in early December about his market experiences, the nature of options, the flaws in using the bell curve to price options, and why our brains have trouble judging probability.

AT: *You mentioned in* Fooled by Randomness *that the 1987 stock market crash really made you as a trader. What happened?*

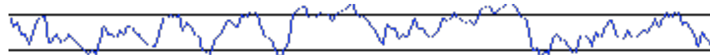
NNT: I was long out-of-the-money OTM options in about anything that traded. People were laughing at me.

AT: *On both sides of the market? Calls and puts?*

NNT: Yes, particularly in financials and currencies — eurodollars, the deutschemark, and the Japanese yen. My largest position was in the yen because its volatility was tremendously low. I also had a collection of [other long OTM currency options], like Swiss franc/Australian dollar and Swiss/Kiwi (*New Zealand dollar*).

In October 1987, I went to a symposium in Philadelphia. The market had effectively been dead, particularly the financials and currencies. I was on stage with five other traders, and they all said this is the death of volatility. Their idea was central banks now run the world. The banks are getting sophisticated and can force stability just like they can control inflation. There's no reason to buy an option because the world is moving into a far better regime of managed movement. So anybody buying an option was an idiot.

These guys depressed me. I thought my life was over, because we're not going to have volatility — or at least no large deviation. Of course, the stock market crashed a few days later and the rest is history. The first thing I noticed [as the market tanked] was stocks didn't move the most.



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