Hedge Fund Returns: A Skeptic Sees Lady Luck in Charge

Chidem Kurdas, New York Bureau Chief Tuesday, October 5, 2004

NEW YORK (HedgeWorld.com)— Speaking at a September seminar organized by 100 Women in Hedge Funds, Nassim Nicholas Taleb – author, mathematician, trader, and chairman of Empirica LLC – argued that success in money management is mainly due to chance and disasters are inevitable for hedge fund investors.

In this view, differences between managers are a lot more random than most people think and we tend to find reasons after the event to explain success and failure—reasons that in fact are utterly irrelevant. “We are better at ‘postdicting’ than predicting,” Mr. Taleb quipped.

Thus one manager may look like a genius after running a profitable fund for years while another with identical skills is in trouble. But if the difference between the two is luck, not ability, investors are mistaken to think that they are safe with the apparent genius.

As Mr. Taleb sees it, much-used Sharpe ratios may provide reassurance but are not really useful in making investment decisions. The two managers above might have identical Sharpe ratios to begin with, yet end up with widely divergent returns.

Lottery

He cited findings from cognitive psychologists, in particular from Daniel Kahneman, a recent winner of the Nobel Prize in economics, showing that people are prone to a variety of systematic biases. When confronted with real life situations, even the statistically sophisticated make simple mistakes like extrapolating from an inadequate sample.

There is built-in survivorship bias in many explanations. We notice the survivors’ attributes and conclude that these make for success, but the failures may have had the same characteristics. Since they have not survived, we do not see them.

A manager’s “edge” or advantage is not always random, Mr. Taleb acknowledged. There is such a thing as skill, but it is very hard to identify in trading. A lot of people can fool themselves and everybody else for a long time, he said.

He concluded that disasters are inevitable. With many hedge funds putting on the same trades, breakdowns are more probable than ever. “Long-Term Capital Management is a picnic compared to what’s going to happen to you guys,” he said to the audience, which included professionals on the investor side.

“What is your proposed solution?” asked one, in a concerned tone. Selecting managers is an unfair business, like being judged for not picking the winning lottery ticket, Mr. Taleb suggested. He emphasized that hedge funds are not alone in concealing randomness under a rug; the entire banking industry does it.