

Murphy's Law, Black Swans and Donald Rumsfeld

Consider these two situations:

Whole Foods, Inc. discovered and subsequently revealed their CEO had been anonymously touting his firm's stock for years on an Internet financial chat site. Instantly, their CEO's effectiveness was massively reduced. Who knew? Who could have thought it?

Suppose you are selling your company to Warren Buffet. The contracts and associated documents are huge, and you don't pay too much attention to the details, letting your lawyers worry about all that. You especially ignore a clause that states that if before the deal closes the NYSE is shut for more than 48 hours, excluding normal non-business days, the agreement is null and void. Hey, you never heard of such a closure. The date is 10 SEPT 2001.

In both situations, a "Black Swan" wakes you up, and you experienced a Black Swan Event (BSE).

Don't you just hate it when something you never even imagined comes out of left field and tanks your business? On the other hand, I'd bet you don't mind at all when it boosts your portfolio 30% in a day (say, for example, by a great discovery in a firm's labs you hadn't known they even cared about, let alone were investing in). Either way, you've been hit by an event you hadn't thought about, and you didn't even know you could think about it, and it makes a huge impact! Financial markets are clearly susceptible to this kind of shock, or in the modern lingo, BSE. There are externally induced shocks, such as 9/11 or bombing of Pearl Harbor. But there are also endogenous shocks as exemplified by the massive drop in Dow Jones Industrial Average of 20% in 1987, and the Russian bond default in 1998. Such shocks are easy to list—in retrospect.

Welcome to the part of the world you don't know you don't know about. I call this "DKDK". It can make a huge difference to your wealth. Understanding the DKDK world can assist anyone. In the context of military combat operations, Donald Rumsfeld famously said to reporters we cannot deal with the "unk unks"—those unknown unknowns that live in the DKDK zone.

What You Don't Know You Don't Know

In 1955 Joseph Luft and Harry Ingham described the relationship between what we know about our own behavior and what others know about it, using a simple 2 x 2 matrix. This was a powerful distinction, and it was first applied in the framework of organizational development. But this matrix, expanded to generalized to states of knowledge, and which came to be called the "Johari Window" has endured since then and continues to illuminate analyses of knowledge.

The matrix elegantly locates the realm of DKDK in the context of all knowledge and our own awareness of our knowledge. The 2 x 3 matrix below is an extension of the Johari window that clarifies the boundaries to our limits of knowledge.

		State of Knowledge		
		Known to me	Unknown to me	Un-knowable
State of Awareness of Knowledge	Know	Consciously competent	Consciously incompetent (Learner)	Boundary of knowledge
	Don't Know	Unconsciously competent (expert)	Surprise! Mr. Murphy and Black Swans live here	Wasted effort

Luft, J. and Ingham, H. (1955) "The Johari window, a graphic model of interpersonal awareness", Proceedings of the western training laboratory in group development. Los Angeles: UCLA

DKDK is where Murphy's Law rules ("Whatever can go wrong will go wrong") and Nassim Taleb's Black Swan lives. Investors ignore this knowledge realm at great peril.

Black Swan Events

According to Taleb, a Black Swan Event (BSE) is one that, within a designated context.

- is extremely unlikely, so unlikely as to have no measurable probability of occurrence.
- has an huge impact.
- can be explained only after the occurrence, since it emerges from the DKDK realm.

Clearly a BSE emerges from the realm of what you don't know you don't know.

Preparing for the Black Swan

How can we benefit from knowing about DKDK? Given nature of BSE, we cannot predict them, but we can get ready for them if they emerge. By definition, there are only certain things that can be done. First, know that DKDK events happen. Second, try to discover such events. Third, be ready to manage the arrival of such an event.

As you try to discover BSE possibilities, you can increase your exposure to good BSEs, and defend against bad ones.

- Open-mindedly explore large areas of knowledge you do know about and imagine what else could emerge. This is like casting a large net and drawing it in.
- As a child, most of your world is in DKDK, but your parents know very well a huge amount of what you know and don't know. So find "parents" for a certain area of

interest. Enlist support from others who may well know some of what you DKDK. Be extremely networked; restlessly talk with others; think broadly about the world.

- Speculate about what could happen to anything of value you are considering. Again, imagination rules.
- Use scenarios to isolate key areas for imagining BSEs.