

## Cider in Our Ears

“One of these days in your travels, a guy is going to show you a brand-new deck of cards on which the seal is not yet broken. Then this guy is going to offer to bet you that he can make the jack of spades jump out of this brand-new deck of cards and squirt cider in your ear. But, son, do not accept this bet, because as sure as you stand there, you're going to wind up with an ear full of cider.”

- Sky Masterson, *Guys and Dolls*

We moderns suffer from chronic chronological snobbery, from the persistent delusion that our theories are new, from our inability to distinguish the novel from the perennial. Seeking to explain the market meltdown last year, the chatter of financial gurus has been full of references to black swans, statistical anomalies and multi-standard deviation events. As our quote demonstrates, though, the awareness that a surprising disaster can upset a seemingly safe action is not new. Wherever the concept originated, since the Broadway musical *Guys and Dolls* (book by Jo Swerling and Abe Burrows, based upon a Damon Runyon story) dates from 1950, we know the notion is at least *that* old.

Sky Masterson relays his father's advice to Nathan Detroit to explain his refusal to bet on a supposed sure thing ~ something to do with cheesecake and strudel at Mindy's. Legions of Nathan Detroit-like Ph.D.s invaded Wall Street in the past two decades, physicists, mathematicians and other forms of financial engineers, thinking up elaborate bets to entice credulous investors. Most of the creators *and* takers of these bets were market pros.

We now know many of these bets came to a bad end. For the most part, the failure of the bets, and the resulting market carnage for all investors, did not stem from dishonesty. Instead, they were the disastrous result of the hubris of the physicists and mathematicians trying to be financial gods ~ intellects gone astray, intellects unaware of their own limits, intellects overestimating their power. The financial engineers on Wall Street believed that their sophisticated, delicate statistical models trumped experience; that their cleverness trumped common sense; that their mathematical equations trumped human nature. They were wrong. The market impact of their inventions left us with cider in our ears.

The idea that the best and the brightest cannot tame, or even truly understand, market chaos is frightening. It is hard for investors, as a group, to come to grips with the notion that *they* are

the source of the chaos, that *their* irrationality drives the manic-depressive behavior of the markets. Accordingly, after every financial disaster, there is a hunt for villains – there must have been the market equivalent of somebody sticking their hand in the till. This reveals another species of hubris – believing not in the perfectibility of our mathematical expression of the markets but in the perfectibility of the human actors involved. Many excellent analyses of the recent market crash conclude with a rousing endorsement of increased regulation as the cure for our problems.

Investors yearn for intelligent, efficient regulation to sustain confidence, but we cannot believe the only barrier to market perfection is getting a new regulatory bill through Congress. Again, *Guys and Dolls* informs our views, specifically the ineffectiveness of the police in shutting down the gambling ring. The gambler Big Jule brags that his record proves his innocence – “Thirty-three arrests and no convictions.” Crooks have been around since commerce began, despite various regulatory frameworks under capitalist, communist, socialist, mercantilist and feudal economic systems. Regulators, however intelligent, well intentioned and well funded they may be, are not magicians. In any event, the well-publicized but limited number of Ponzi schemes did not cause the bulk of the tribulations for investors last year. That trouble resulted from the mistaken belief that, with the help of some new mathematical models, we had tamed the disorder of human nature as reflected in the markets.

“It’s...unusual for a successful sinner to be unhappy about sin.”  
- Sarah Brown, *Guys and Dolls*

Even though legal misconduct was not really the source of the market’s recent problems, the purported alchemy of sophisticated market tools and concepts creates an environment where thievery can flourish. Trendy theories seem to diminish the

usefulness of traditional rationality and common sense, the best guards against dishonesty. In the late 1990s, for example, investors made millions investing in Internet startups with no profits and, in many cases, no sales. This did not make sense, but we were in a supposed new era, where investors came to believe the old ways of thinking were no longer useful. Should we have been surprised, then, that people did not suspect that anything was amiss at Enron or WorldCom? Leading investment banks recently assured investors that sophisticated “market neutral” techniques could yield superior returns with little volatility. Should we have been surprised, then, that nobody questioned the performance of Bernie Madoff’s hedge fund? As Sergeant Sarah Brown points out in the play, one can hardly expect a sinner to repent successful sinning.

This pattern likely will continue. If we will not allow big banks to fail, for example, and we even leave the management teams and board of directors intact, should we be surprised if the banks conclude that they are playing with “house money” provided by the taxpayers, with managers keeping the upside but avoiding the downside? If this is the lesson learned, there may be more crises in the future, not fewer, increasing the need for vigilance by investors. If you wish for your ears to remain cider-free, you need to realize that you cannot delegate common sense and rationality either to mathematical geniuses or to government regulators. Unexpected things happen, whether it is in the form of market crashes, debt implosions or cider squirting out of decks of cards, and you need to be prepared. Do not just rely on luck being a lady – contact us at [www.sigmainvestment.com](http://www.sigmainvestment.com) or at (503) 419-3938.