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Perspectives

Black Monday and Black Swans

John C. Bogle

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Abstract

Investors need to be aware that rare events with an extreme impact that, afterwards, we think we could have predicted—in short, black swans—happen in the markets. Those wh… carefully

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carries an extreme impact), and retrospective predictability (after it happens, human

nature enables us to accept it by concocting explanations that make it seem predictable). Black Monday demonstrates that not only can anything happen in the stock market; anything does happen.

In this article, I take advantage of the anniversary of Black Monday to explore risk as a measurable aspect of investing and as an uncertainty that is always with us. We speak of “forecasts” and “probabilities,” but the application of the laws of probability to our financial markets is badly misguided. Black swans do occur.

Black swans remind us of uncertainty. What other black swans are lurking beyond the horizon, waiting to become part of financial market history? The fact is that the movements of the stock market exhibit a lot of randomness. So, the knowledge that black swans can and do occur holds important lessons for how we think about risk.

Black swans are one reason that many theorists warn us to beware of using past Gaussian stock market return patterns and thinking we have defined the bounds by which we can predict the future. Furthermore, changes in the nature and structure of our equity markets—and a radical shift in the participants—are making shocking and unexpected market aberrations ever more probable. Over the past two centuries, the United States has moved from an agricultural economy to a manufacturing economy, to a service economy, and to a financial economy—and a global one at that. The nation is becoming a country where no business actually makes anything. Our financial intermediaries merely trade pieces of paper, swap stocks and bonds back and forth with one another, and pay the financial croupiers a veritable fortune.

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Notes

[1] From its September 1929 high of 381 to its July 1932 low of 41, the Dow dropped by an astonishing 90 percent.

[2] Before the discovery in the 17th century of Australia, where black swans are common, Europeans thought that all swans were white; to imagine swans of any other color was completely unreasonable.

[3] The average annual return on stocks during the 1926–2006 period was 10.4 percent. Curiously, in only 2 years of those 80 years did the returns realized fall between 9 percent and 11 percent. The "average" year, then, rarely occurred.

[4] This thesis, written for Princeton University, was entitled "The Economic Role of the Investment Company" and was published in Bogle (2001).

[5] For a discussion of the stock market's historical returns, including each decade's investment return, speculative return, and total return, see pp. 15–18 of Bogle (2007).

[6] In this section, I have liberally quoted and paraphrased investment adviser Frank K. Martin (2006). Martin's quotes from Hyman Minsky come from Minsky's 1974 article "The Modeling of Financial Instability: An Introduction," in Modeling and Simulation.

[7] Joseph Schumpeter (1883–1950) characterized capitalism with the famous phrase "creative destruction," in which the old ways of doing things are endogenously
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[11] These write-down amounts are from the New York Times (1 February 2008, p. C6).

[12] Spoken at a symposium entitled “The Greenspan Era: Lessons for the Future” in Jackson Hole, Wyoming, 26 August 2005.

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