Navigating BLACK SWAN Events

By Jim Wilkinson

In his 2007 book, *The Black Swan*, finance professor and former Wall Street trader Nassim Nicholas Taleb introduced the term "black swan event" to describe certain unforeseen events affecting financial markets. Lately, I've started hearing the term tossed around in discussions of falling oil prices, but does the recent drop in oil prices qualify as a true black swan event? If so, how can we navigate through it to come out on the other side stronger? Before we answer these questions, we need to get some background.

What Is a "Black Swan Event"?

According to Taleb, there are three attributes that are common to all black swan events:

- The event is unpredictable (at least to the observer).
- The event has widespread ramifications.
- After the event has occurred, people will assert that it was indeed explainable and predictable (hindsight bias).

Examples of black swan events might include the rise of the Internet, the invention of the personal computer, the occurrence of World War I, the dissolution of the Soviet Union, and the attacks by terrorists on September 11, 2001. Whether an event is a black swan often depends upon the observer. The Thanksgiving turkey sees its demise as a black swan, but the butcher does not.

It's important to draw the distinction between a black swan event and a crisis. Not all black swan events are crises; any lottery winner will attest to that. Also, not all crises are black swan events. Terrorist attacks are, unfortunately, a frequent occurrence worldwide, but the terrorist attacks of September 11, 2001 were of unprecedented magnitude and unpredictability, hence their characterization as a black swan.

Origin of the Term "Black Swan"

Prior to 1697, no water bird black swan had been observed in Western civilization, giving rise to the notion that such creatures didn't exist. For this reason, the term became used to describe situations of impossibility. After a black swan was finally observed in Western Australia in 1697, the notion was disproved. Since then, the term "black swan" has been used to describe situations where perceived impossibilities have been disproven and paradigms have been shattered.

A Look at the Recent Decline in Oil Prices

In order to determine whether the falling oil prices of the past several months constitutes a black swan event, let's look at whether the event exhibits the characteristics of all black swans: unpredictability, widespread effect, and hindsight bias.

Unpredictability

Did the dramatic drop in oil prices catch everyone by surprise? I think so. Recently, I was sitting in a meeting with a client in the oilfield services industry and his attorney. They were discussing the terms of the company's planned bankruptcy when I happened to look out the window and see construction cranes setting the girders for the new facility they had planned before oil prices began

their free-fall. My client simply didn't see this coming. My guess is that he is not alone.

Widespread Effect

I like to use the following analogy to describe the trickle-down effect of dramatic events. Imagine that you are fishing behind a hydroelectric dam with five turbines. The demand for electricity isn't that high, so they shut off two turbines. You feel the change in the water level immediately, but your buddy fishing a mile downriver doesn't feel the change for a couple of hours. Ask yourself, where are you in the river?

Economists estimate that for every job in the energy industry, there are three to four related secondary jobs. With current predictions of 50,000 jobs lost in the oil patch, what will the effect be on those secondary industries? I think it's safe to say that the effects of this will be felt by everyone. It's simply a matter of when.

Hindsight Bias

Once the dust has settled and oil prices begin to stabilize, it's highly likely that there will be those who will insist that we should have seen this coming. With the glut of oil in the marketplace over the past several years, a price correction was bound to happen. After all, trees don't grow in the sky.

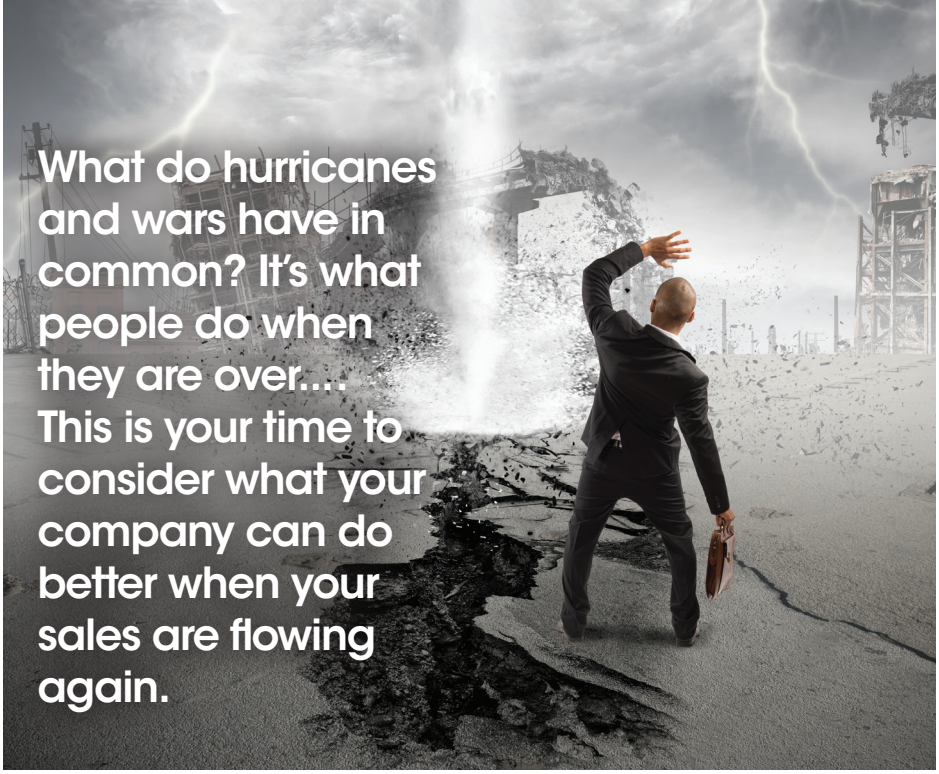
Is the recent decline in oil prices truly a black swan event? Your answer will likely depend upon your situation, but based upon the criteria set forth by Taleb, one could certainly make the case that it is.

Dealing with Black Swan Events

How can we avoid becoming the turkey? According to Taleb, not by attempting to predict the unpredictable. Rather, he says our time would be better spent preparing for the impact of negative black swans that may occur and positioning ourselves to be able to exploit the positive ones.

Preparing for negative events is really just managing your business for the troughs. Since there's no real way to know how long a trough will last, it's important to have a plan in place that considers all possible durations. What steps do you take if the crisis resolves in six months? What if it lasts 6 to 12 months? What if there's no end in sight? What will each case look like in regards to your financials—revenue projections, cash flow projections, etc.? How much overhead can you carry in these stages?

Developing these plans will require some serious evaluation of Key Performance Indicators (KPIs) to determine what triggers you should be keeping an eye on. You'll need to know major KPIs in your industry. Figure them out by talking to key customers, investigating competitors,



and researching benchmarks. Once you have identified your KPIs, it's time to track them and analyze variances using trend tools, break-even analyses, and what-if scenarios.

Breaking down your plan into steps based upon duration will ensure that you don't cut too deeply and that you have the greatest possible resources available when things turn around.

Strategies for Managing Black Swans

Crises present a unique opportunity to get your house in order. During times of prosperity, business often moves so quickly that bad decisions are made on many fronts that don't become apparent until things start going downhill. Like Warren Buffett says, "You never know who's swimming naked until the tide goes out." What are some of the steps you can take to help manage for the troughs? Here are a few ideas.

Weed the Garden

Perhaps an obvious opportunity that is still worthy of mention is to look at removing unnecessary costs such as overhead expenses. Overhead costs can easily rise with revenue but don't tend to decline as quickly when sales drop off. Change up your structure to make more of your variable versus fixed costs in order to ensure that costs stay in line with volume.

Another place to look is personnel. It may seem harsh, but this is the right time to fix hiring mistakes. You have a commitment to your people to keep your business running, so remove those who don't fit. When business turns around, you'll be prepared to take on the right fit.

Last, check out your products and services. Compare their profitability, and cut those that are costing you money or are not highly profitable. Consider diverting resources to those products or services that perform better in the current environment.

Learn How to Do More with Less

Your business will benefit highly from increased productivity, which is different for every business at this time. To identify what can improve in your business operations, utilize the following formula:

$$\text{Productivity} = \text{Throughput} \div \text{Resources}$$

Discovering the throughput and resources for your business while using less resources to generate greater throughput will improve productivity and, therefore, profitability. With slower sales, you can find the time to evaluate your operations.

Reduce Leverage

Reducing leverage becomes especially important during uncertain times. Twenty years ago, a debt-to-equity ratio greater than 3 to 1 was considered high risk. In order to be considered a risky investment today, a company would need to have a debt-to-equity ratio of greater than 4 to 1. As the speed and availability of information increases, so does our comfort level with risk. This can be a problem when negative surprises happen.

React Quickly

The biggest mistake I see companies make is reacting too slowly. If you want to cook a frog, you can't just throw it in a boiling pot of water. It'll simply jump out. You must start it out in cool water and slowly turn up the heat so it doesn't notice the change. It's important to recognize the signs of trouble early to avoid becoming a boiled frog.

Prepare for the Next Battle

What do hurricanes and wars have in common? It's what people do when they are over. First responders to hurricane damage plan for how they will do better during the next natural disaster. The military strategizes how they will do better in the next war. Based upon historical trends, my guess is that these types of events are becoming more common but less dramatic. In other words, we can expect more course corrections of shorter duration. This is your time to consider what your company can do better when your sales are flowing again.

The Sky Isn't Falling

Preparing for adversity shouldn't be viewed as pessimism. It's just sound business practice. Knowing that you have a plan in place in case of negative surprises will give you the confidence to take advantage of any positive black swan events that come along. N

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